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Subprime and nonprime auto ABS still add value to portfolio performance, but investors need to do their homework.

Market Tone

Spreads in the ABS sector continue to remain firm, with the exception of the non/subprime auto sectors. With the rise in consumer delinquency and recent publicized developments in the subprime auto loan sector, subprime auto spreads widened approximately 10bp-15bp, while nonprime spreads are out on average 5bp.

A Perspective on the Subprime Market

During the past three weeks, there has been an increasingly intense amount of focus on the subprime auto market. Investors have become concerned about the potential for poor credit performance and also the potential for fraud. There has been a generous (and, in most cases, unjustified) amount of guilt by association, which has extended to virtually all subprime — and nonprime — auto ABS issuers. Investors want to better understand their exposure to individual transactions and have adjusted pricing to cheaper levels in the meantime.

The explosive growth in the non/subprime automobile finance industry last year have led to more aggressive underwriting and apparently higher losses. According to Moody's Investor Service, issuance of subprime and nonprime auto-backed securities jumped 57% in 1996 from $5.5 billion to $8.6 billion, the year before. In particular, subprime issuance accounted for a larger percentage of the total non/subprime issuance in 1996, with subprime deals accounting for 33% of total non/subprime issuance rated by Moody's, compared to 21% for 1995. Given the novelty of the subprime industry and the relative lack of seasoning of many issuers' portfolios, it is likely that this sector will experience other negative events during the course of the year. While this possibility implies certain ongoing risks, it also suggests that opportunities will arise on a selected basis. We recommend that, instead of secularly resisting the subprime auto ABS sector, investors should rather adopt an open, disciplined analytical approach focusing on the following points:

1. Who is the issuer? What is the issuer's current niche, what is its strategic vision, and is it capable of implementing its business plan? Has it demonstrated the capacities to price for risk and service effectively?

2. What is the structure of the ABS transaction? Is there a surety wrap? Is the insurer's commitment unconditional and irrevocable? Are there liquidation or amortization trigger events? Are there any circumstances under which the surety bond provider does not have an obligation to provide for shortfalls of interest and principal?

3. Can the risks be diversified? Are the causes of loss systematic (for example, tied to the economy) or lender-specific? Is there enough available information to make this determination? Are spreads wide enough to provide attractive risk-adjusted (expected) returns on a portfolio basis — considering the likelihood that some percentage of the industry will experience turmoil?

4. To what degree does the issuer have the capacity, willingness, and discipline to support troubled transactions, avoid headline risk, and communicate with market participants? To address these questions properly, investors need to develop a sufficiently detailed understanding of individual issuers. Accomplishing this objective may involve spending time with management or making due diligence visits, providing that issuers are willing to spend this time. As we have said on a number of occasions, ABSs are *not* commodities — and, even though most ABS structures insulate the fundamental credit of the transaction from the credit of the issuer, the structure does not separate spread-widening risk from the circumstances and actions of the issuer.

Given all of these considerations, however, we still believe that opportunities will exist to use subprime auto ABSs to outperform various performance benchmarks. But it's got to be on a true value-added basis on the part of portfolio managers.

Figure 1. Percentage of ABS Floating-Rate and Fixed-Rate Issuance, 1995 to Year-to-Date

	1995-96	1997
Floating-Rate	48.9%	45.8%
Fixed-Rate	51.1	54.2

ABS Asset-backed security.
Source: Salomon Brothers Inc.

Figure 2. Year-to-Date ABS Issuance by Sector, 1996-1997 (Dollars in Billions)

	1996	1997
Auto Loans	$1.6	$1.0
Credit Cards	7.7	2.8
Home Equity Loans	2.2	1.3
Manufactured Housing	0.5	0.2
Student Loans	0.0	0.0
Other	2.6	0.5
Total	$14.6	$5.8

N/A Not Applicable. Source: Securities Data Co.

Figure 3. Comparison of Quoted Spreads and Static Spreads

	Avg. Life (Yrs.)	Quoted Spread (bp/Curve)	Static Spread[e] (bp)	Difference (bp)
3-Year Bullet	3.00	23	23	0
5-Year Bullet	5.00	29	29	0
Wide Window Auto[a]	1.81	37	29	8
Short Auto[b]	1.06	35	28	7
Wide Window HEL[c]	3.63	85	75	10
Short HEL[d]	1.16	47	39	8

[a] Assumes collateral original WAM of 60 months and remaining WAM of 54 months, 9% coupon, 1.3% ABS prepayment speed. [b] Assumes collateral original WAM of 60 months and remaining WAM of 30 months, 9% coupon, 1.3% ABS prepayment speed. [c] Assumes collateral remaining WAM of 174 months, 11% coupon, 20% CPR prepayment speed. [d] Assumes collateral remaining WAM of 120 months, 11% coupon, 20% CPR prepayment speed, security maturity in 30 months. [e] Static spread of bullets incorporates the richness or cheapness of the on-the-run Treasury benchmarks. bp Basis points. CPR Constant prepayment rate. HEL Home equity loan-backed securities. WAM Weighted average maturity.
Source: Salomon Brothers Inc.