

SMARTER PERSPECTIVE: RECEIVABLES

The Looming Crisis in Subprime Auto: Why Lenders Need to Brace for Impact

By Jay Stone

In the evolving landscape of the subprime auto market, a significant issue is on the horizon, one that could have profound implications for lenders involved in asset-backed lending (ABL) and private credit. Over recent years, the dynamics of lease residual values have changed drastically, particularly impacting those who deal with subprime auto portfolios. This shift is creating a potential crisis requiring urgent attention and strategic preparation.

The Drastic Decline in Lease Security Values

From 2020 to 2022, vehicle lease security values (LSVs) were relatively stable at approximately 40%. At that time, lenders could rely on these values as a safety net; in the event of a default, repossessing a vehicle would enable a significant recovery of the loan amount due to the vehicle's retained value. This was a period characterized by high vehicle prices, driven up by supply chain constraints and increased demand during the COVID-19 pandemic.

However, the scenario has changed dramatically in 2023 and 2024. As a result of rising interest rates and a corresponding decrease in vehicle prices, LSVs have plummeted to around 20%,

marking a 50% decline. This substantial drop in LSVs is a stark indicator of the evolving risk environment within the subprime auto sector. Vehicles, which once served as robust collateral, are no longer holding the same value, leading to potential losses for lenders that were previously unseen.

Factors Driving the Decline

Several factors are contributing to the rapid decline in lease security values: **Higher Interest Rates:** The increase in interest rates has raised the cost of borrowing, which, in turn, has dampened consumer demand. This reduction in demand affects the resale value of vehicles, pushing LSVs downward.

Decreasing Vehicle Prices: During the height of the COVID-19 pandemic, vehicle prices surged due to limited supply and heightened demand. As supply chains stabilize and new vehicle inventories increase, used car prices have started to decline, further diminishing LSVs.

Implications for Private Credit and Lenders

While some industry analysts predict a soft landing for the subprime auto

market, the evidence suggests otherwise. The rapid decline in LSVs could lead to substantial challenges for private credit lenders, who have traditionally not engaged deeply in the subprime auto space but have increasingly taken on ABL loans. These loans, secured by assets such as vehicles, are now at risk due to the declining values of those assets.

When lenders move to repossess vehicles following a borrower default, they find that the assets they relied on are worth significantly less than anticipated. This erosion in asset value directly impacts their ability to recover loans, which can lead to cascading losses across their portfolios.

The Need for Enhanced Vigilance and Strategic Planning

Given the volatility in lease security values, lenders must adopt a more vigilant and strategic approach to risk management. Key steps include:

- **Continued Auditing of Borrowers' Cash Flow and Asset Values:** A consistent and thorough examination of where lending occurs is critical in a market where asset values are becoming increasingly unstable. Understanding the real value of the



assets being leveraged is essential to mitigate risk.

- **Preparation for Distress in Subprime Portfolios:** As higher interest rates persist and vehicle values continue to decrease, subprime auto portfolios are increasingly likely to enter distress. Lenders should adjust their risk management frameworks to reflect this new reality.

How Hilco Receivables Can Provide Support

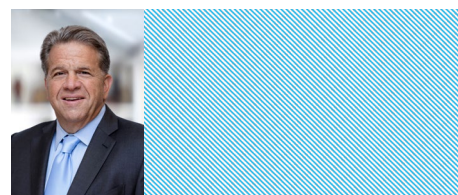
Hilco Receivables is positioned to assist lenders in navigating this complex environment. With expertise in acquiring distressed portfolios, Hilco Receivables offers solutions that can help soften the impact of declining LSVs on lenders' books. Lenders can mitigate potential losses and refocus their strategies to better align with current market conditions by offloading problematic assets to experts like Hilco. In today's uncertain economic climate, lenders who are proactive and strategic

in managing their portfolios will be better positioned to weather the challenges ahead. Hilco Receivables can play a crucial role in this process, providing the expertise and resources necessary to effectively manage distressed subprime auto loans.

Conclusion: Navigating a New Reality

The subprime auto market is on the brink of significant upheaval, particularly for lenders involved in private credit and asset-backed lending. The sharp decline in lease security values is reshaping the risk landscape, demanding a new level of vigilance and strategic planning. Lenders must stay ahead of these changes, understanding their vulnerabilities and preparing to act decisively to protect their interests.

As the industry adapts to this new reality, experienced partners like Hilco Receivables will be critical in helping lenders manage risk and navigate an increasingly unpredictable market.



JAY STONE IS CHIEF EXECUTIVE OFFICER AT HILCO RECEIVABLES

Jay is recognized as one of the foremost experts in the Accounts Receivable industry. For over thirty years Jay has developed an in-depth knowledge of A/R management Analysis and Risk Assessment, Portfolio Purchasing and Liquidation, B2B Debt Collection, Debt Purchase, Call Center Operations, International Debt Recovery, and more.

Contact Jay at jstone@hilcoglobal.com