

Households' Pecking Order of Debt and the Pricing of Asset-Backed Securities*

Roland Füss[†] Dominik Meyland[‡] Stefan Morkoetter[§]

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Abstract

This paper studies the role of households' pecking order of debt in the pricing mechanism and rating migration of U.S. consumer debt asset-backed securities (ABS). Our empirical results show that the household's delinquency on mortgage and auto loan increases spreads of ABS using these loan types as collateral. However, an increase in delinquency on credit card and student loans often lower ABS spreads in other types of collateral. We argue that delinquencies on these types of loans in a household's loan portfolio provide liquidity to other loans. In contrast, rising delinquencies on mortgages, which are typically the first to be repaid in the pecking order, are an indicator of a severe shock that spills over to other loan types, triggering a simultaneous increase in ABS spreads. Furthermore, we find for residential mortgage-backed securities (RMBS) a lower probability of future rating downgrades in times of high mortgage delinquency. In general, ratings are adjusted according to changes in the business cycle. Our empirical results suggest that liquidity provision causes a larger downgrade probability, and thus, is not sufficient to avoid future downgrades.

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[†]Swiss Institute of Banking and Finance (s/bf), University of St.Gallen (HSG), Unterer Graben 21, 9000 St.Gallen, Switzerland; Swiss Finance Institute (SFI), Geneva, Switzerland; Research Fellow at the Center for Real Estate and Environmental Economics, NTNU Business School, Trondheim, Norway; Phone: +41 71 224-7055; Email: roland.fuess@unisg.ch.

[‡]Swiss Institute of Banking and Finance (s/bf), University of St.Gallen (HSG), Unterer Graben 21, 9000 St.Gallen, Switzerland; Phone: +41 71 224-7027; Email: dominik.meyland@unisg.ch.

[§]St.Gallen Institute of Management in Asia (SGI), University of St.Gallen (HSG), 110 Amoy Street #03-01, 069930 Singapore, Singapore; Phone: +65 68507-338; Email: stefan.morkoetter@unisg.ch.