Collapse of car lender Tricolor sends out a tremor

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The collapse last week of the Texas-based subprime auto lender Tricolor Holdings and its filing for bankruptcy, stating it was going out of business rather than undertaking a restructuring, has raised concern that it could be the harbinger of similar events.

Tricolor made loans to low-income residents and immigrants, often without a Social Security number, financed with credit from banks and private investment firms, including some of the major names in the finance world.

The loans were then packaged and sold off in tranches – from high to low-grade—as asset-backed securities (ABS). When the collapse took place, the most secure tranche, which had been given a triple-A rating as recently as June, was trading at 78 cents on the dollar, with the lowest at just 12 cents. As of March, there were $1.4 billion in such securities outstanding.

Tricolor's business model was a repeat of the sub-prime mortgage operation that played a central role in sparking the financial crisis of 2008.

While most media commentary noted this fact, there were reassurances that Tricolor was an outlier rather than a harbinger of a broader crisis and that the subprime auto lending market was only an eighth of the size of the subprime mortgage market at the time of the crash.

But there were concerns, nonetheless, because major banks, including JP Morgan Chase, Barclays, and the regional US bank Fifth Third, each of which has around $200 million in exposure to Tricolor and were named as secured lenders in its bankruptcy filing.

A number of asset management firms held Tricolor bonds, including such well-known names as AllianceBernstein, Pacific Investment Management Co, and Janus Henderson.

The immediate cause of the collapse was the announcement on Tuesday last week that the Justice Department was investigating possible fraud on the basis that Tricolor had used the same collateral on multiple loans.

The filing for bankruptcy said the company had more than 25,000 creditors and between $1 billion and $10 billion in liabilities—a disparity that would seem to indicate a chaotic accounting system.

The company made loans to people often in very straightened circumstances, desperate in need of transport to obtain work and leading a precarious existence. Tricolor's average loan of $21,381 carried an interest rate of more than 16 percent.

Subprime lenders such as Tricolor, a report by CNN explained, actually expected borrowers to default on their loans because they could quickly repossess the car in question and then resell it. Some even installed GPS tracking devices to enable repossession teams to quickly find them, and in some cases, could even disable the ignition systems once there was a default on a loan.

The Tricolor collapse is an indication that beneath the hype about the strength of the American economy, there is a very different situation for many of the poorest sections of the population, and more broadly, the growing divorce between the financial markets and the underlying real economy.

According to an editorial comment in the *Wall Street Journal*: "Stretched after years of inflation, low-income borrowers are falling behind on payments, and many are underwater on their loans. They owe more than they could get for trading-in or selling their cars."

Young people borrowed to buy cars during the pandemic when they did not have to make student loan payments but were now struggling to pay both.

"Auto delinquencies and car repossessions are getting

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close to 2009 recession levels. Yet investors have continued to snap up subprime auto debt."

In its report on the Tricolor collapse, Bloomberg noted: "For years, investors have piled into the subprime auto market, swelling its size to some $80 billion, to reap the kinds of interest rates that few debt products on Wall Street offer."

Peter Cechinis, director of research at Axonic Capital, told the news outlet: "ABS market participants are creating incredible demand for subprime auto loans, and this is resulting in loose, and sometimes even reckless, underwriting. While the Tricolor bankruptcy may seem isolated and idiosyncratic, one would be remiss not to ask whether or not it's a canary in the coal mine for subprime auto lending."

This overall expansion was reflected in the operations of Tricolor. According to a report from Kroll Bond Rating Agency, its lending has risen to around $1 billion in 2024, five times its level in 2020.

The Bloomberg report said that in 2023, asset-backed bonds tied to subprime auto loans had threatened to deliver losses for the first time since the 1980s, and that since that time, the "cracks have only widened," and that "at least a dozen ABS currently at risk of taking losses," according to a report prepared by Citigroup.

A report in the *Financial Times* entitled "Car lender's failure hints at what's under the hood in private credit" drew attention to the wider significance of the Tricolor collapse.

It said that because of the rise in so-called shadow banking—the growth of non-bank private credit institutions—what is called a "mini-drama" involving a company little known outside a few states in the US, had "maxi-implications for banks everywhere."

While the amounts involved at Tricolor were small in relation to the overall financial system, they were still significant. The underlying process was part of a wider trend.

"So-called asset-based lending, which involves slicing and dicing things such as auto debt, student debt, airplane leases, and mortgages, is a linchpin of the private credit revolution sweeping Wall Street."

It drew attention to a report from Fitch Ratings, which said that US banks currently had $1.2 trillion outstanding in loans to non-bank financial institutions. This was a 20 percent jump in a year, compared to an increase of less than 2 percent in commercial loans over the same period.

Two "worrying possibilities" to emerge from the demise of Tricolor were that the "American consumer, notably the lower-income segment that Tricolor served, is in rougher shape than imagined" and that lenders who dole out auto loans and the like have not been careful in their underwriting choices, and their bank backers have not been asking the right questions.

It expressed the hope that Tricolor might be a "helpful spur" to step up scrutiny "rather than a sign that it is already too late."

History, particularly that of the subprime mortgage crisis, suggests it could well be the latter.

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