After Tricolor collapse another indebted US auto-connected firm goes under

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24 September 2025

When the Texas-based subprime auto lender Tricolor Holdings filed for bankruptcy earlier this month, the *Wall Street Journal* posed the question as to whether it could be "a canary in a subprime debt mine."

This week it was revealed that the US auto company, First Brands, involved in the manufacture of parts and highly dependent on debt, is facing bankruptcy with its creditors involved to the tune of billions of dollars.

They include the private credit firm Jeffries and the Chicago-based UBS O'Connor.

A report in the *Financial Times* on Tuesday noted: "The speed with which First Brands' finances have deteriorated has shocked debt investors, who were already unnerved by the sudden collapse into bankruptcy of US subprime car lender Tricolor Holdings."

The FT said the company had "borrowed nearly $6 billion in private loans and has billions more in financing linked to its customer and supplier invoices, much of which is not reflected in its official debt figures."

The total figure for the company's debt may be as much as $10 billion.

Problems first emerged last month when First Brands reported that it had stopped a planned refinancing operation because investors had raised concerns about its financial reporting, with one person involved telling the FT that attempts to revive it were "dead."

First Brands used a method known as factoring, in which a company sells outstanding customer invoices to banks and investors to raise cash. It was also involved in a technique called reverse factoring, in which an investor pays the company's suppliers and then collects the money from it later.

Such operations are generally not included in the company's published accounts and are considered to be "off balance sheet."

The Ohio-based First Brands is a privately owned firm and is involved in the selling of auto parts including windscreen wipers, water filters and fuel pumps. Over the past five years it has grown rapidly through what the rating agency Moody's called earlier this year "an aggressive financial policy of pursuing fully debt financed acquisitions" of other companies.

It is not as yet entirely clear how and why the financial problems have emerged so rapidly but the pressure on the auto and auto parts industry flowing from the Trump tariff hikes and the decline in spending by less well-off sections of the population are no doubt factors.

The two auto industry bankruptcies within the space of a month have drawn attention to the role of private equity firms in providing finance for mid-sized and highly leveraged companies which are unable to obtain funding for riskier ventures from the banks. The private equity firms are drawn into such financing because of the higher rate of return it brings.

A single collapse may have been able to be dismissed as a one-off event but two in the space of just two weeks points to deepening problems in the credit market.

Major banks, including JP Morgan Chase and Fifth Third, have been caught up in the collapse of Tricolor and are set to lose hundreds of millions of dollars. One investor in Tricolor said the collapse of the company was one of the "worst things I've ever seen" in the asset-backed securities market.

In a comment to the FT, another raised the question of how JPMorgan had missed the potential problems at Tricolor.

"That's the shocking part of it. JP Morgan is one of the most sophisticated lenders in the entire world. How the hell could they have missed this?"

Moreover, the problems in private credit have been developing in plain sight.

Earlier this year a report on the private credit system carried out by Moody's in collaboration with the Securities and Exchange Commission and a former top adviser to the Treasury warned that it was so intertwined with the banking systems that it could be a "locus of contagion" in a future financial crisis.

This is because while the banks have been constrained by tighter regulations in the wake of the 2008 crisis, they lend money to hedge funds and other private credit providers which then provide the finance for riskier ventures.

The report found that private credit funds were enmeshed with the banks and this created linkages that introduced "modes of systemic stress."

The opaqueness of the private credit system and their role in making the financial network "more densely interconnected mean they could disproportionately amplify a future crisis."

The official position of financial authorities is that the regulations introduced after 2008 have made the banks more secure and guard against a repetition of those events. But this could very much be the case of generals fighting the last war because the financial landscape has changed markedly over the past decade and a half with private credit playing a much greater role in lending.

"Today's network of interconnections in the financial system is more distributed, with a denser web of connections than it had pre-crisis, when the system operated more a like a 'hub and spoke' model with banks at the centre of the network," the report said.

It found that banks are "increasingly involved private credit and other non-bank financial institutions through partnerships, fund financing and structured risk transfers that allow them to maintain economic exposure to credit markets while shifting assets off balance sheet."

In another report issued in May, economists at the Boston branch of the Federal Reserve came to the same conclusions about increased risk. They said that the banks were exposed to a new channel of risks by providing finance to non-bank organisations that were making loans to companies.

"Banks' extensive links to the private credit market could be a concern because those links indirectly expose banks to the traditionally higher risks associated with private credit loans," it said.

Rules set in place after the 2008 crisis sought to discourage banks from lending to highly leveraged companies that had difficulties servicing their debts. Banks then started to lend to private credit funds which made the loans.

The rating agency Fitch has reported that loans to non-bank financial institutions, which include private credit funds, had increased to $1.2 trillion at the end of March, a 20 percent increase in a year.

Financial regulators are concerned over this increase because as numerous reports, including from the International Monetary Fund, have made clear, they have little knowledge of, let alone control over, the activities of private credit funds and their connections to the major banks, describing these links as "opaque."

The tremors in financial markets over the failure of two highly leveraged companies in the space of just a couple of weeks is an indication that the type of turmoil warned of could assume even larger proportions.