First Brands collapse a symptom of spreading financial rot

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The collapse of the auto parts company First Brands, which filed for bankruptcy at the end of last month with debts of more than $10 billion and counting, is not a "Lehman moment" for the US financial system. However, it has brought multiple warnings about the stability of the $2 trillion private credit and the potential for even bigger collapses.

The story of how First Brands owner, Patrick James, went from a secretive small-scale businessman, with a history of defaults and questionable financial practices, to the owner of a business, with connections to some of the biggest names in the financial world is bound up with the rise of private credit over the past decade.

A major report earlier this month in the *Financial Times* (FT) on the rise of James, detailed how he was able to become the owner of a multi-billion dollar company and acquire a string of luxury homes. It was bound up with a major shift in the US financial system.

"How he raised billions of dollars with little public scrutiny, after moving on from more conventional forms of borrowing, is a story not just of one man's past practices and the debts and lawsuits that they spawned.

"It is also a reflection of the nearly $2 trillion private credit industry—lending by non-bank institutions that can often be opaque—and the broader risks created by its rise."

The turn by James to new sources of financing, coincided with the financial debt boom that resulted from the ultra-low-interest rate policies of the US Federal Reserve which began after the global financial crisis and continued for more than a decade.

With money pouring into the financial system, a new breed of financiers arose outside the banking system looking to use the cash on their hands in riskier ventures and willing to "overlook the occasional red flag," as the FT put it.

"Lenders were now no longer handing him [James] over millions of dollars; they were wiring his businesses billions."

Then a storm hit in the form of rising interest rates, the Trump tariffs, which have impacted the auto industry, and a tightening market.

One of the main financiers of First Brands was the investment bank Jefferies, well-known for its willingness to chase profits through risker ventures as it sought to use the cash on its hands, and was not bound by regulations that govern banks.

The modus operandi of the firm is perhaps best indicated by the fact that its chief executive, Rich Handler, who has been in the position for 25 years, hails Michael Milken as his "friend, mentor and hero."

Milken rose to fame in the 1980s as the junk-bond king. He was jailed in 1989 on charges of fraud and insider trading with a sentence of 10 years, subsequently reduced to two, and was ultimately pardoned by Trump in January 2020. Millken's practices, initially frowned on, have now become standard operating procedure and he is widely regarded as a pioneer of the present-day financial system.

Anxious not to be singled out and well aware that the activities of his firm are widely replicated, Handler has emphasised that First Brands "engaged with a range of banks and Wall Street firms over the last 10 years."

The collapse of First Brands, preceded by the failure of the auto financing company Tricolor, has brought warnings there could be more shocks to come.

The chief executive of Apollo Global Management, Marc Rowan, whose company helped set in motion the demise of First Brands when it shorted the company's debt, said he was "not surprised" to see "late-cycle accidents."

"I think it's a desire to win in a competitive market that sometimes leads to shortcuts. In some of these more levered credits, there's been a willingness to cut corners."

First Brands was financed through collateralised loan obligations (CLOs). This is a procedure in which loans across a range of companies are bundled up and made into a security which is then sliced up and sold off. The logic behind it is that major investors are protected from failure by one or two companies.

The CLOs are highly leveraged as the firms financing them use debt to boost their profits. The FT has noted that in some cases a CLO could be leveraged ten-fold. That is an equity contribution from the firm may be $50 million, supporting a $500 million loan portfolio.

Such an arrangement can bring vast profits provided the value of the underlying asset keeps rising. But it brings major losses if the value of the asset falls.

There are now concerns that if there is a spate of losses via CLOs, this could have a significant impact on Wall Street.

The FT cited the remarks of Andrew Milgram, chief investment officer at Marblegate Asset Management, who said: "Inside credit markets for more than a year, there has been a grudging recognition that there was and is a series of credit problems that could be substantial and dangerous to the overall economy."

The chief executive of JP Morgan Chase Jamie Dimon echoed some of these concerns even as he reported on record profits, noting the $170 million hit taken by his bank as a result of the Tricolor collapse.

"My antenna goes up when things like that happen. I probably shouldn't say this but when you see one cockroach there are probably more," he said.

The notion that the First Brands collapse is the expression of a coming crisis or is a "canary in the coal mine" for the broader financial system has generally been dismissed on the grounds that the amounts involved are small relative to the size of the market. The same, it should be recalled, was also said of the subprime mortgage market in 2007.

But as a column in the *Australian Financial Review* noted, even as it backed the assertion that it was not the start of a systemic crisis, the First Brands fallout did raise two questions.

"First, how on earth could a no name, relatively small company borrow so much money from the smartest people in the room, and no one noticed a problem until it was too late?"

The second question, it said, related to the recent fall in the share prices of some of the private capital giants which have dropped by as much as 14 percent since mid-September. Did this indicate that "there are more unexploded hand grenades such as First Brands out there"?

The International Monetary Fund certainly thinks so. In its *Global Financial Stability Report* issued last week, it noted that "banks are increasingly lending to private credit funds because these loans often deliver higher returns on equity than traditional commercial and industrial lending."

It said while global financial markets appeared calm there were shifting grounds in the financial system that would raise vulnerabilities if the risks were not addressed.

One of these shifts was the expanding role of non-bank financial institutions, with increasing ties to the major banks, both in government bond markets and corporate debt markets.

"Such links," it said, "raise the specter of excessive risk taking and interconnectedness in the financial system."

In other words, while the major banks are not directly involved in riskier investments, they are increasingly lending to private capital firms which are, and as the First Brands experience has revealed, can be hit with significant losses.