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Is the auto lender's bankruptcy an outlier or a harbinger?

Tricolor and the Subprime Debt Canary

Subprime auto lender Tricolor Holdings filed for Chapter 7 bankruptcy last week, and the collateral damage could strike banks and trading houses. Investors have poured into risky consumer and corporate debt in a hunt for higher yields. Could Tricolor be a canary in a subprime debt mine?

Tricolor caught investors and creditors off guard when it said Wednesday it is liquidating after 18 years in business. The Texas-based firm specialized in lending to car buyers with no credit history or Social Security number, including undocumented migrants in the Southwest. Its business grew amid the Biden-era surge in migration and auto prices.

The company made loans by drawing on a line of credit from banks. It then packaged the loans and sold them to investors as assetbacked securities (ABS). Tricolor's creditors include Fifth Third Bank, JPMorgan Chase and Barclays, which could face losses.

Ditto investors who bought its packaged auto loans, including Pacific Investment Management Co. and AllianceBernstein. A tranche of its higher-quality loans issued in June that received a triple-A credit rating was trading last week at 78 cents on the dollar. A lower tranche was trading at 12 cents after—believe it or not—trading above par this summer.

Media reports say the Justice Department is investigating potential fraud at Tricolor, which has declined comment on the reports. Its troubles raise questions about whether frothy financial conditions have caused creditors and investors to ignore financial and other risks hiding in plain sight.

A Tricolor ABS issuance this year showed that more than two-thirds of its borrowers lacked a credit score. For those with credit scores, the average was 614. More than half didn't have a drivers' license, which suggests they may lack permanent legal status. President Trump's deportations raise the chances of a surge in defaults by migrants who leave their debts behind as they leave the U.S.

A broader market problem is that auto lenders in recent years have extended the duration of loans to keep monthly payments affordable. 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.

Many young people borrowed to buy cars during the pandemic when they didn't have to make student loan payments. Now they are struggling to repay both. Auto delinquencies and car repossessions are getting closer to 2009 recession levels. Yet investors have continued to snap up subprime auto debt. Note

The Federal Reserve may cut interest rates this week, though current financial-market conditions suggest that monetary policy isn't all that restrictive. Companies with low credit ratings issued a record amount of debt this summer as they sought to take advantage of high investor demand and shrinking risk premiums. There's always a reckoning after periods of easy money, and the question is whether Tricolor is an outlier or a harbinger.