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PULLING THE TRIGGER IN WHOLESALE AUTO ABS

The vehicle distribution system is a critical part of the auto industry. Wholesale distribution of vehicles is the way that original equipment manufacturers (OEMs) reach their end customers, the dealers. Many franchise dealers finance their inventory through finance companies related to the OEMs. These receivables are repaid when the dealers sell the vehicles to their end customers, the retail consumers.

The receivables created between the finance company and the dealerships are the primary collateral for wholesale auto, or floor plan, asset-backed securities (ABS). Captive auto finance subsidiaries have issued floor plan securitizations since 1994. These securitizations rely on the OEMs to produce vehicles, the dealers to make wholesale purchases of the vehicles (i.e., create the receivables) and the dealers to sell vehicles to generate cash flow to repay the receivables.

With the close relationship between OEMs and the captive finance companies, floor plan securitizations have in the past included amortization triggers based on the OEM's filing for bankruptcy under Chapter 11 (reorganization) and Chapter 7 (liquidation) of the U.S. Bankruptcy Code to provide investor protection against losses. However, corporate restructuring has helped de-link certain OEMs from their related finance companies. As a result, some recent floor plan ABS transactions have been issued without a Chapter 11 amortization trigger (Chapter 7 filing is still an amortization event). These recent transactions appear to have compensated for the absence of the Chapter 11 trigger by including additional investor protection in the form of higher levels of credit enhancement.

The increased level of credit enhancement is justified based on the potential negative effects on dealers and finance companies in the event of an OEM's long and costly reorganization. The risks associated with an OEM's reorganization in bankruptcy are unique and may differ among OEMs. For example, OEMs can influence the value of vehicles and the dealers' ability to sell vehicles. OEMs often provide support to dealers, including interest-free periods and subvention programs, to help dealers sell cars and repay wholesale purchases. During reorganization, however, there is no certainty that the OEM would continue to provide such support, thus presenting additional risk to the dealers' ability to generate vehicle sales to repay wholesale purchases.

Furthermore, in the floor plan ABS sector, there has never been an OEM bankruptcy, which would have provided guidance as to how OEMs may act and how floor plan ABS may perform in the event of a Chapter 11 bankruptcy filing by an OEM. Industries that could provide some parallels to auto OEMs include vehicle-parts suppliers, rental car companies, airlines and steel manufacturers. However, there is very limited securitization and transaction performance history available from these sectors for comparison, and unique legal or operational characteristics of these industries yield mixed results of reorganization efforts for bankrupt companies.

As a result, the increased levels of credit enhancement in recent floor plan ABS transactions that include additional enhancement to offset the elimination of the Chapter 11 bankruptcy trigger appear to be justified given the uncertainty of how an OEM might act following a Chapter 11 bankruptcy filing and the absence of any examples to use as meaningful comparisons.

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