Applying the Concept: **Ford and GM Downgraded, Auto Loans Unaffected**

In May of 2005 Standard and Poor's lowered the credit rating of both Ford and General Motors to BB, one notch below investment grade. The press releases announcing the downgrades cited concerns about sales of two very profitable products: sports utility vehicles (SUVs) and pickup trucks. Sustained increases in gasoline prices had caused SUV sales to plummet, while increased competition in the market for full-sized pickup trucks has been eroding American manufacturers' market share.

A few days after the credit rating downgrade, Standard and Poor's issued a related press release with the headline "GM-Related Auto Loan, ABS Deals Unaffected by Corporate Downgrade." ABS stands for "asset-backed security." (See page 44 of Chapter 3 for the definition, and pages 142 and 144 of Chapter 6 for other examples.) In other words, the decision to lower GM's credit rating did not affect the ratings of the assets that are backed by loans to car buyers. So, while an investor buying a GM bond would pay a lower price and receive a higher yield after the downgrade, someone going into an automobile dealer to buy a car would find that the interest rate on the loan they are offered was unchanged.

Once upon a time, when manufacturers raised funds for auto loans themselves, this would not have been the case. But in the modern financial world, car loans bundled together into pools. Bonds are issued that are backed by these pools – these are the asset-backed securities. Two things make these asset-backed securities low risk. First, car loans are collateralized. If a borrower fails to make payments, the lender takes the car. Second, because that any two borrowers default simultaneously are unrelated, the overall default rates on large groups of auto loans are very predictable.[*] So, even though Ford and GM came onto hard times and will have to pay more to borrow, the interest rates faced by car buyers didn't change.

[*] This is a form of diversification. Recall from Chapter 5 that one way of reducing risk is to make investments with payoffs that are uncorrelated.