



Methodology
*Non-Captive Automotive
Finance Companies*

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Insight beyond the rating.

U.S. Financial Institutions Rating Methodology for Non-Captive Automotive Finance Companies

EXECUTIVE SUMMARY

Dominion Bond Rating Service (DBRS) provides ratings as a forward-looking measure of a non-captive auto finance company's ability to meet its financial obligations. As with all ratings, the general economic environment is the first consideration when assigning ratings. From that starting point, DBRS takes into account a number of industry-specific, qualitative, and quantitative factors.

DBRS ratings are assigned by weighing in a blend of quantitative and qualitative factors, as opposed to a matrix approach, where key ratios and factors are entered and a rating is determined. Qualitative factors, such as the firm's franchise strength, risk profile, strategic direction, corporate governance, and quality of management are critical in this assessment. The quantitative analysis of the company's asset quality, earnings power, capitalization and funding, and liquidity position is also essential in assigning a rating.

In the context of an evolving competitive landscape and the various market participants, DBRS offers the following rating methodology as a summary of the key factors that drive the ratings determination of companies that participate in the auto finance industry. The purpose of this

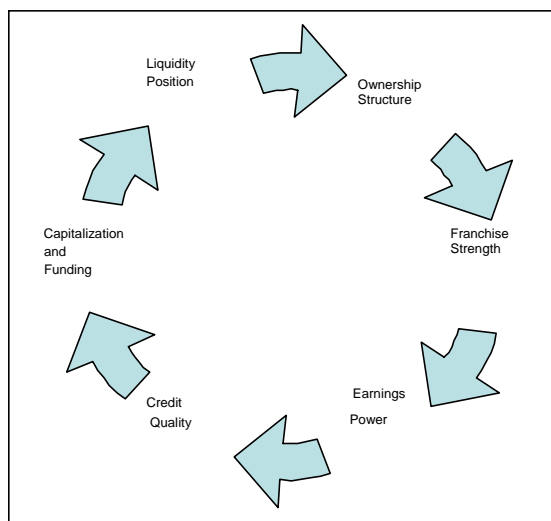
methodology is to identify and discuss key rating factors and the specific idiosyncrasies of the auto finance industry, and discuss how they impact a company's rating and the rating process. These factors include parent support and related considerations, asset and business concentrations, asset quality measurement differences, remarketing efficiencies, lease residual exposure, and funding concentration and limitations.

While not all-encompassing, these factors provide a relatively complete range of rating considerations for non-captive auto finance companies. The relative importance of each factor will change with time and by company, and are not presented in order of importance. In certain cases, a major strength for a company can compensate for particular weaknesses, and conversely there are cases in which one weakness is so critical that it can override a number of strengths of a generally solid company. The specialty finance industry is a constantly evolving, robust industry with many participants from various pedigrees; as such, custom analysis is crucial. For instance, finance companies often operate within a bank holding company, and as such, bank analysis methodology is used along with this methodology.

I. UNDERSTANDING INDUSTRY FUNDAMENTALS

DBRS believes that ratings are the computation of quantitative and qualitative strengths – including franchise strength, which incorporates the quality of management, the earnings power of the franchise, the asset quality of the firm and the risks in the portfolio and business mix, the capitalization and funding given the risks, and liquidity position. The ownership structure is also a consideration both as a factor in evaluating the franchise, but also in the context of assessing any support from the owners.

The rating process begins with a comprehensive analysis and complete understanding of the dynamics and inherent risks of the industry in which the company operates. An historical perspective along with current and future trend analysis is employed. DBRS considers the cyclical and volatility of the business, and the competitive environment. If the barriers to entry are low or there is a high level of product commoditization, DBRS attempts to gauge the competitive advantage, if any, of the rated company.



The landscape in the automotive finance industry is one of continual change, yet the one constant is the highly competitive business environment. Although dominated by the captives, the financial stress at the U.S. auto manufacturers has encouraged more non-traditional players to enter the fray. Banks and other financial institutions are once again active participants, which is not surprising given the short-term nature and the prepayment predictability of this asset class. DBRS look cautiously at these new participants, as their historic commitment to this asset class has varied, especially in the prime sector. Non-captive financial institutions have historically had limited success in the prime auto financing sector and have routinely abandoned the industry when times got rough with declining returns and elevated losses. Moreover, historic problems with leasing portfolios also played a role owed to unexpected deterioration in residual values and change accounting rules. However, given the industry's current landscape, this too is subject to and will likely change.

The non-captive automobile finance industry is typically segmented according to the type of vehicle sold (new versus pre-owned) and the credit characteristics of the borrower (prime, near prime, or subprime). U.S. loan originations in 2005 totaled approximately \$500 billion. With a total of approximately 25% of the retail loans, the U.S. captives, General Motors Acceptance Corporation, Ford Motor Credit Company, and Chrysler Financial Corporation, dominate the automobile finance market. The balance of the market is highly fragmented; the other participants include the captive finance companies of other manufacturers, banks, credit unions, independent automobile finance companies, and various other financial institutions.

II. QUALITATIVE CONSIDERATIONS

Judging the Strength of the Business Franchise

DBRS integrates franchise strength and a company's competitive position in each rating. The company's ability to generate earnings, the ability to manage through competitive pressures and business cycles, and the firm's ability to defend its franchise are all essential rating factors and are to be considered when assessing the strength of the business franchise.

Typically, a strong franchise, along with scale, is essential for success; smaller, less-established businesses are at a disadvantage. Although there is a potential for size bias, as often a few large players dominate an industry, small firms are often more nimble and, as such, are able to adapt more quickly to market pressures and conditions. Moreover, smaller players develop particular skills or technologies that protect their niche. Accordingly, small companies are not viewed as "unsuccessful" firms, but are firms that clearly have additional risks, as these have less resources (both financial and management), and are often more at risk to actions by larger players.

Management is also a factor when considering the business franchise. DBRS assesses depth of management experience,

succession planning, the quality of mid-level management, and corporate governance to assess the quality of the management team. Additionally, operating strategies laid out by management are compared to a company's actual performance and are used to gauge the effectiveness of management. Other factors such as the overall business strategy and business model and systems/technology are all included in the assessment of franchise strength.

The Corporate/Ownership Structure

The corporate structure of each rated entity is appraised. DBRS attempts to identify and discuss salient risks and rating implications within the corporate structure. Public companies, which are subject to more scrutiny, tend to be more transparent than private companies, and a public company's increased ability to raise equity are both positive influences to the rating.

Although there is noteworthy regulation regarding consumer protection regulation, the auto finance industry is generally not viewed as an industry with significant regulation. DBRS looks positively at entities that operate within a bank holding company or other regulated financial institutions. The additional layer of regulation and the funding advantages will likely be reflected in a higher rating for this structure than for non-bank operated entities.

Other Industry Risks

Additionally, DBRS attempts to evaluate the other risks in this industry. Headline (reputation) risk, regulatory risk, and predatory lending risks are staples in the specialty lending industry. Equally important are the interest rate environment and the state of the company's ultimate consumer, all of which are also considered when assessing industry risk. Unlike banks, regulation differs greatly from company to company, and as such, financial reporting and transparency are not uniform.

The Non-Captives Approach

To compete effectively, the non-captive auto finance companies typically forge relationships with dealers to offer their products to consumers that are sourced through the dealers.

Overall, non-captive auto finance companies have seen mixed results, especially in the prime credit business, as non-captive lenders find it difficult to compete with the U.S. manufacturer supplemented loan products offered through the captives. Non-captives have seen more success in the financing of non-U.S. autos, as the U.S. manufacturers have been particularly active in their finance subvention programs.

Non-captive direct lending has enjoyed a high level of success and is more widespread in the non-prime and used car sector. The U.S. captives have had limited success in managing the non-prime business and typically shy away from it.

Banks can also be strong competitors; they can compete as indirect lenders utilizing dealers to source loan applications. Banks also seek to benefit by providing floor-plan funding and other banking services to auto dealers. Banks also compete as direct lenders, marketing auto lending products directly to their banking client base. Banks, however, have had smaller appetites for sub-prime lending.

As well, DBRS believes the non-captives can be formidable competitors when playing to their strengths; to this end, DBRS reviews the depth and tenure of dealer relationships, the expertise and the extent of the company's market presence in the particular asset class, and the profitability of this business line.

The Captive Advantage

DBRS believes the captives have an overall competitive advantage over other direct lenders. The close ties with the manufacturer along with the depth and breadth of the dealer network typically have a positive impact on the finance arm as the parent provides a steady source of originations, further intensified through subvention programs.

Parental Support and Other Parental Considerations

When opining on non-captive auto finance companies that are subsidiaries of a larger corporation, parental considerations, such as the credit strength of the parent and the parent's intentions with regard to the finance subsidiary, are considered. A stand-alone rating is determined prior to adjusting for parental support or drag, if the parent is a weaker entity. Any formal agreement between the subsidiary and the parent is considered. Generally the

parent/subsidiary agreement range from the strongest, a unconditional guarantee of the subsidiary's debt to the weakest, an operating agreement. The strongest of these agreements is an unconditional guarantee, in which case DBRS will likely rate the organization the same as the parent (assuming a higher-rated parent). Indeed there are cases when little or no parental support is factored in the rating. Refer to DBRS's "Rating Parent-Holding Companies" methodology for additional detail.

Evaluation of Exposure to Dealers

DBRS determines a lender's exposure to dealers, dealer groups, and, ultimately, to any one manufacturer. This exposure could be in the form of real estate secured, working capital, and floorplan lending. Floorplan lending finances a dealer's inventory (the inventory "on the floor") that is pending the product's retail sale.

Further, DBRS looks at the lender's ability to service this relatively servicing-intensive asset class. DBRS reviews the lenders processes by which it monitors the aging of receivables and the status of collateral, in which the lender typically has a security interest. Because of the importance of the collateral in floorplan lending, DBRS reviews the audit function, which is considered a critical element of servicing. Audits include on-site visits and monthly inventory audits. Although the floorplan lending business is dominated by the captives, DBRS believes that non-captive lenders can effectively manage a floorplan loan portfolio.

III. QUANTITATIVE CONSIDERATIONS

Asset Quality

Asset quality is a primary consideration in assessing all finance companies. The primary source of principal repayment is converting the assets into cash. As such, receivables yields need to reflect the risk taken. Analysis of the quality of the receivable portfolio, combined with the annual percentage rate (APR) on the loans, is essential in the overall review of asset quality. In other words, DBRS asks if the company is being properly compensated for the risk it is taking.

Credit risk and asset quality varies widely from institution to institution, and are largely dependent on the firm's mix of borrowers (credit profiles), asset classes, and to what degree the company retains or sells its risk. Asset quality impacts future earnings through provisioning, and credit losses can eventually impair capital. Therefore, asset-quality measures are an integral part of DBRS's analysis. However, analysis of delinquencies, net charge-offs, provisioning, and other traditional measures are not all the asset quality story. DBRS also looks to the risk of the firm's balance sheet, through retained interests in securitizations, seller's interests, servicing rights, and other volatile asset classes.

Portfolio profiles

The examination of asset quality begins with an assessment of the credit profile of the borrowers that the company targets. Although traditionally lenders stay within certain credit quality bands, the lines between the asset classes – subprime, near prime, and prime – continue to blur. DBRS reviews the extent to which a company participates within different asset classes, and what benefits this diversification brings to the rated entity.

DBRS looks to traditional delinquency and loss measurement as a preliminary gauge of asset quality. DBRS reviews the company's delinquency horizon to determine the length of time until repossession, which is typically 75-90 days for prime loans and 60-90 days for subprime. Clearly, the quality of the underlining asset is a determinant in the timing of repossession. Additionally, DBRS opines on the impact a company's charge-off policy has on the timing of the loss realization.

DBRS examines portfolio growth, as high origination volume can often mask credit issues. Portfolio seasoning analysis is imperative as losses typically occur in the first six to 18 months following originations. Higher losses occur early in the loan's life, as borrowers are typically in a

negative equity position (owing more than the vehicle is worth). Portfolio delinquency and loss statistics are reviewed against the company's history, expectations, and those of other lenders with similar asset composition.

DBRS looks to the conservativeness of methods used to report delinquencies as a company's reporting methods can also mask asset quality issues. The most conservative method is reporting loans based on original contractual payment, where loans remain delinquent until contractually due payments are received. On the other hand, lenders can report delinquencies using less conservative methods. The regency or present contract method of reporting delinquencies will report a delinquent loan as current, if the borrower is paid to date, through the use of extension or modification of loan term. DBRS believes that such payment arrangements are an integral part of prudent loan servicing; however, the danger is that this collection technique may push out recognition of loss. DBRS believes that this reporting method distorts delinquencies, as loans that are current through the use of extensions and renewals may never be made current.

DBRS does recognize that, in certain cases, such as a deeply subprime borrower or a contract that is severely underwater, the receipt of one, or just a few, delinquent payment positively impacts cash flow of the loan. The company's actual cure rate for extended loans is determined and compared to that of the company's peer group. DBRS opines on the volume, frequency, and effectiveness of extensions, as compared to peers and to the company's own history. Extensions in subprime portfolio are frequently significant (40%-50% of the portfolio), whereas prime portfolios are materially less, closer to 5%.

In addition to the credit statistics discussed above, detailed analysis of loan administration, such as the use of advanced systems, predictive diallers, behavioral scoring, and the effectiveness of loss mitigation and collections techniques are considered.

Moreover, DBRS includes concentration measures of asset quality. Firms with loans concentrated in one geographic area have increased the risk of suffering losses due to regional economic downturns. Similarly, firms with concentration in one particular asset class have an additional level of credit and business risk.

Credit Enhancements Assets/Retained Interest in Securitizations

The presence of retained interests and sellers' interests in securitizations adds a key measure of credit risk. These assets are potentially among the largest on the balance sheet and can be subject to significant valuation adjustments. The quality of these assets will depend on the performance of the underlying loans held in the securitization trust. If the performance of the securitizations falls below expectations, impairment charges may occur, leading to reduced earnings and capitalization. Moreover, the reduced cash flow from the securitizations will negatively impact profitability. In

analyzing this exposure, DBRS considers the size and type of retained or sellers' interests associated with its securitizations, the frequency and degree of any writedowns/impairments, and the reasonableness of the assumptions used for valuation.

DBRS reviews to what extent the company retains the credit risk in its securitizations. Companies that retain higher levels of these high risk assets will require larger amounts of capital to support these assets. Since these assets represent the first loss position for the securitized loans, DBRS reduces equity dollar-for-dollar on a tax-affected basis.

Additionally, this asset class adds a level of accounting risk as market prices are not readily available for the credit enhancement assets. Fair value is determined using discounted cash flow models, using certain key assumptions. The most significant assumptions made are the cumulative net credit losses to be incurred on the pool of receivables sold, the timing of those losses, and the rate at which estimated future excess cash flows are discounted. The assumptions may change in future periods if actual performance differs from the assumptions, which may lead to mark-to-market valuation adjustments. DBRS compares assumptions used to others used by the peer groups. Moreover, DBRS will look to the company's own experience in managing impairments to this asset class.

Lastly, DBRS looks to the impact of other credit enhancements of securitizations, such as bond insurance and wraps. The concern is these credit enhancements have the potential to trap cash in the company's securitizations should the securitization breach an overcollateralization trigger, potentially stressing the issuer's liquidity. Moreover, this has the potential to reduce credit protection for the unsecured debt holders.

Loan Servicing and Remarketing Considerations

A strong loan servicing history is a requisite to effectively manage a portfolio. Asset quality measures are greatly influenced by the servicing capabilities and their collateral remarketing efforts of the lender. Like all finance companies, auto finance companies have to dispose of repossessed property; however, the key difference between this asset class and others, such as real estate, is that in virtually all instances automotive assets depreciate.

Any company in the auto finance business will ultimately be in the used car business as inevitably it needs to dispose of repossessed and off-lease vehicles in a timely, efficient manner to realize the maximum value. As such, the disposition of repossessed automobiles has become a business within a business for many lenders. Successful remarketing quickly and efficiently dispose of the vehicle. Accordingly, DBRS reviews the company's remarketing strategies as the company's effectiveness in selling repossessed and off-lease assets can have a significant impact on profitability.

To this end, the captives have made effective use of their network of dealers, specifically through their (typically on-line) dealer actions. Non-captives often rely on the more traditional retail and wholesales channels, such as public auctions. Although public actions are an efficient means to dispose of vehicles en mass, recoveries tend to be lower as the vehicles need to be stored prior to and shipped to the auction site. DBRS assesses the company's remarketing capabilities, recovery trends, and marketing times, while it is understood that significant external factors, such as the overall used vehicle market, impact recovery and timing. DBRS will review these factors as they relate to its peers and to industry trends.

Lease and Leases Residual Asset Exposure

DBRS determines the finance company's exposure to residual assets of leases. Lenders that offer leases are typically required to take the vehicle back at the end of the lease term. The lesser assumes the risk of the residual value realization since the consumer can simply return the product, at lease end, and walk away. The lender is left to sell the vehicle and holds the risk that the full residual value is not realized at disposition.

DBRS reviews each issuer's residual setting methodology, and compares it to the industry and the actual performance of the company. The ratio of realized residual value-to-stated residual values is analyzed to determine the efficiency in managing residual value risk and the ability to liquidate off-lease vehicles.

DBRS monitors the turn-in rate, which is the number of vehicles returned to the lender at lease termination as a percentage of matured lease contracts (for the same period). DBRS reviews the company's ability to realize early lease terminations of lease contracts. Residual performance is an important factor in opining on the company's residual

setting policies, as well as determining the adequacy of reserves.

To manage residual exposure, lenders often purchase insurance to cover the difference between the stated value of the vehicle and the proceeds realized from the disposal of the vehicle sold at full maturity. DBRS gives limited credit for this insurance as, typically, this coverage is costly and often only covers catastrophic loss situations. DBRS reviews the company's actual payment record prior to giving any consideration for this policy.

There are certain key ratios DBRS uses to track the asset quality measures. These ratios are reviewed for each company and compared to the peers. Managed asset quality numbers are used to compare the quality of the on-balance sheet portfolio to the entire portfolio.

ASSET QUALITY RATIOS (%)	
<u>Owned</u>	
60-day delinquencies/net receivables	
NCOs/avg. loans	
NCOs/reserves	
Reserves/owned receivables	
NPAs/owned receivables + OREO	
Reserves/NPAs	
NPAs/tangible common equity	
NPA/pre-provision income	
Loss recovery ratio	
<u>Managed</u>	
60+ day delinquencies/managed receivables	
Managed NCOs/avg. managed receivables	
<u>Quality of Balance Sheet</u>	
Residual interest/avg. assets	
Goodwill and intangibles/avg. assets	
MSR/tangible common equity	

Earnings Profile

DBRS looks at both the quantity and quality of earnings as well as cash flow when evaluating profitability and a firm's earnings profile. Considerable emphasis is placed on earnings, as they are the first layer that protects creditors. Moreover, strong and consistent earnings allow the company continued access to funding and enables a firm to build its capital position for growth and credit protection. DBRS's measurement of earnings is consistent with its forward-looking perspective. DBRS reviews earnings on a risk-adjusted basis; earnings are judged relative to the risk that the firm is taking.

General profitability measures include review of the absolute level of earnings, earnings trends, volatility of earnings, and fundamental profitability analysis. Earnings history as well as earnings potential is considered; DBRS favors firms with a long history of increasing earnings. In rating companies with a shorter history, or companies that have not demonstrated the ability to overcome adversity, DBRS looks closely at the firm's franchise strength, future business prospects, and level of capital. As well, additional focus on the firm's appetite for risk and ambition to grow is considered, as history is less predictive.

DBRS believes that a firm's profitability is largely dependent on operating efficiencies, asset quality, and margin protection. DBRS employs several simple ratios to assess the quantitative measures of profitability. A standard profitability measure is return on average assets (ROAA), which is simply net income as a percentage of average assets (annualized). While a good starting point, this ratio often distorts profitability measures as tax rates differ among industry participants, and provision levels will differ for a portfolio lender and a securitizer. DBRS considers that income before provisions and taxes to average assets is a superior profitability measure. Additionally, DBRS removes any non-recurring extraordinary income or losses in this ratio, although this may be a rating consideration, if earnings are viewed as particularly volatile.

Return on revenue, also known as net profit margin, is a powerful ratio, as it is a quick measure of efficiency. The aforementioned ratios do not consider credit risk; as such, a seemingly profitable company may be considered less so on a risk-adjusted basis.

The box below outlines the key ratios used to judge a firm's profitability level.

PROFITABILITY RATIOS (%)
ROAA
REAE
ROR (net income/revenue)
IBPT/avg. assets
IBPT/avg. managed assets
Net interest margin
Net interest income/avg. assets
Net income growth
Efficiency ratio

Earnings Quality

The quality of earnings is of equal importance. Earnings quality is a function of stability, predictability, and diversity of earnings. Lower quality of earnings measures are applied to companies with volatile and unpredictable profitability or profitability that is largely impacted by origination volume. Interest and other fee-based revenues are considered stable, recurring, and predictable, all if which are viewed positively by DBRS.

A significant level of income variability is present with companies that record securitizations as off-balance-sheet transactions, as the bulk of its income is front-loaded and based on assumptions, such as the level of credit losses and prepayments. Should the company retain the residual asset class, much of the gain on the securitization transaction is recorded as a non-cash gain that is accreted into income through the life of the asset. This revenue source is considered of lesser quality as non-cash gains are subject to revaluation and potential mark-to-market adjustment if the actual performance of the securitized assets differs from expected performance. DBRS looks at the level of non-cash gains within the gain on sale of assets and opines on the assumptions used to calculate gains, as compared to peers' and actual performance.

DBRS uses the following key ratios to gauge a company's dependency on its origination abilities as a chief source of profitability. Origination fees and gain on sale of loans as a percentage of total revenues indicates a firm's dependency on new loan originations. Net interest income as a percentage of revenues and loan servicing fees as a percentage of revenues assist in identifying firms with strong recurring and predictable earnings.

QUALITY OF EARNINGS RATIOS (%)
Gain on loans sale/revenue
Net interest income/revenue
Servicing and other fee income/revenue
Origination income/revenue

Capitalization and Funding

Capital adequacy is the final line of protection against loss from credit risk, market risk, operation risk, and any other source of loss. Capital is required to protect the investors and lenders for both expected and unexpected losses. Capital adequacy is judged against relative profitability, asset type, risk of the balance sheet, and the general risk profile of the firm.

Leverage varies greatly between participants in the auto finance sector. The level of required capital is impacted by the quality of the on-balance sheet assets, credit enhancement assets, residual interests, and intangible assets needing larger levels of capital to support these assets.

In assessing capital adequacy, DBRS typically removes all goodwill and other intangibles from the equity account. Additionally, retained interests from securitizations that have credit risk, or are in a first-loss position, are removed from total equity (on a tax-affected basis). This provides leverage measures on an “at risk” basis. Loan loss reserves are added to equity as they are the first line of defence to absorb expected credit losses. The result, called adjusted equity is used in DBRS’s analysis of leverage and capitalization.

Moreover, the company’s ability and demonstrated history to raise new equity and its willingness and ability to retain earnings are considerations in determining a rating. DBRS also looks at earnings to common equity as an indicator of a company’s ability to raise additional equity. Whereas, tangible equity-to-assets is an indicator of credit protection.

DBRS uses the following ratios to opine on a finance company’s capitalization and leverage. Particular focus is given to ratios that consider tangible equity and adjust for the first loss position. Differing accounting treatment of securitizations make peer comparison difficult. When applicable, DBRS uses bank capital ratios, such as Tier 1 and Total Capital ratios, in the analysis, as they are often more readily comparable.

CAPITALIZATION RATIOS

Debt/tangible equity + loan loss reserves (x)
 Debt/adjusted tangible equity + loan loss reserves (x)
 Debt/total capitalization (%)
 Equity/assets (%)
 Tangible equity/tangible assets (%)
 Equity/managed assets (%)
 Tier 1 Capital ratio (%)
 Total Capital ratio (%)
 Dividend rate (%)

In addition to quantity of capital, quality of capital is a key rating consideration. The quality of capital varies significantly amongst participants in the auto finance industry. DBRS evaluates the extent to which a company is dependent on a lesser quality of capital, such as preferred stock and hybrids, which may be considered debt in certain cases. DBRS views preferred stock and trust preferred securities as costly forms of equity. A capital haircut may be applied to preferred capital.

QUALITY OF EQUITY RATIOS (%)

Preferred securities/total equity
 MSRs/total equity
 Residual interests/total equity
 Goodwill and other intangibles/total equity

Liquidity

The need for well-developed and diverse funding sources is essential for market-funded companies, particularly for those that operate without the benefit of deposit gathering or other support such as a strong parent. Given an auto finance company's funding appetite, liquidity is a key factor in the rating. Lack of access to funding, along with weak liquidity, is one of the chief factors that leads to failure. Accordingly, DBRS believes that abundant liquidity is requisite. Moreover, to minimize risk of a liquidity crisis, in the case of a market disruption, DBRS believes that a firm should remain active in multiple funding channels and not be overly dependent on any one single source.

Large, highly rated companies have significant access to the debt markets and generally find their operations through use of commercial paper, senior debt, preferred and common stock, and securitizations. Lower-rated companies are more dependent on bank financing, securitizations, and other forms of secured debt. Some companies may attempt to use bank charters to fund production.

DBRS also looks to the company's ability to sell or securitize loans and other assets to manage liquidity. As such, asset quality is a deliberation in assessing liquidity. Higher-quality assets have characteristics that are easily measurable, predictable, and well understood, and as such are inherently more liquid. An institution that has a lower quality of assets that are illiquid and whose market value is highly volatile will clearly face greater liquidity challenges than an institution with high-quality, easily quantifiable assets.

Generally, finance companies without significant banking operations are rated lower than their bank peers. Accordingly, they have limited access to unsecured borrowings, and, as such, tend to be secured borrowers. This often leads to structural subordination, principally in smaller, lower-rated companies. To achieve liquidity, these firms pledge most of their assets in securitizations and various forms of secured lending, such as asset-backed commercial paper (ABCP), secured lines of credit, and repurchase agreements. Consequently, pledged (secured or encumbered) assets are not available to the estate in the case of a default, placing the unsecured lender in a subordinate position. DBRS reviews the amount on unpledged (unencumbered or unsecured) assets as a ratio to unsecured debt as well as a percent of total assets. In cases where unencumbered assets are limited, meaning that the company's balance sheet is largely encumbered, DBRS may notch the unsecured debt below the corporate debt rating, reflecting potential structural subordination.

Finance companies that operate with strong bank charters will likely be rated higher than the peers without the charter, citing superior liquidity, funding flexibility, and increased regulation. The bank/thrift charter offers steady access to deposits, Federal Home Loan Bank (FHLB) advances,(if

they have applicable assets) and other forms of low-cost funding. The funding flexibility reduces the firm's dependency on wholesale funding and the fickle capital markets. Additionally, DBRS also considers interest rate management when reviewing funding and liquidity. DBRS reviews match funding, interest rate exposure, hedging effectiveness, and maturity schedules.

Key ratios for liquidity and funding profile include the following:

LIQUIDITY RATIOS	
Pre-tax income interest coverage (x)	
Total debt/EBIT (x)	
Total debt/EBITDA (x)	
Deposits/total funding base (%)*	
Short-term debt/total debt (%)	
EBITDA/debt maturing in one year	
Cash flow coverage (x)**	
Repos/total debt (%)	
Dividend date (%)	

* Total funding base = liabilities + securitizations.
 ** Free cash flow/interest + debt maturities (next 12 months).

Funding Mix and Limitations

As with the ratings of all finance companies, DBRS believes liquidity risk is one of the chief risks for non-captive auto lenders. Funding profiles are quite varied in the industry. The subprime monoline lenders typically lean towards secured funding and are active participants in the asset-backed securities (ABS) marketplace. Auto finance companies that operate with a bank charter and significant deposit franchise frequently have better rounded funding profiles. DBRS reviews a lender's availability and source of funding.

The Building of a Secondary Market for Auto Paper

The competitive landscape within the automotive finance industry has changed, owed to the extensive use of securitization and the recent weakness at the U.S. auto manufacturers. Historically, the captive had considerable access to the debt market, thereby allowing the captive to maintain a portfolio of owned auto receivables. The lack of need for funding significantly retarded the development of a secondary market for auto paper. However, the current environment has transformed the industry, heightened the competitive environment, and has allowed the secondary market for auto receivables to not only develop but flourish. The once nascent whole loan market has developed and broadened significantly. Auto loan portfolios are being managed more like mortgage portfolios. DBRS expects this market will continue to mature going forward.

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