



Methodology

*Rating Auto Finance Companies  
Operating in the United States*

APRIL 2008



*Insight beyond the rating.*

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DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



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# Rating Auto Finance Companies Operating in the United States

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## Rating Auto Finance Companies

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DBRS provides ratings as a forward-looking measure of an 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 a complex 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 are 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 for captives, asset and business concentrations, asset quality measurement differences, remarketing efficiencies, lease residual exposure and funding concentration and limitations. Ownership of the automotive manufactures financing arm, separation and ring fencing have taken on renewed focus, as the U.S. manufacturers continue to struggle to regain profitability.

While not all-encompassing, these factors provide a relatively complete range of rating considerations for 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 strong 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.



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## The U.S. Automotive Finance Industry in Perspective

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The landscape in the U.S. automotive finance industry is one of continual change, yet the highly competitive business environment is the one constant. Although dominated by the “captive finance companies” associated with the manufacturers, the financial stress at the U.S. auto manufacturers has fostered changes to the ownership structure of the captives and has encouraged more non-traditional players to enter the fray. Today of the three U.S. “captive” finance companies, only Ford Motor Credit remains wholly owned by the manufacturer.

Banks and other financial institutions participate in this industry, which is not surprising given the short-term nature and the prepayment predictability of this asset class. DBRS, however, looks cautiously at these 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. Also, non-captives must be able to compete with the financial incentives given to the consumer which are supported by the manufacturers; this is often achieved through a lower cost of funding.

The 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). In the United States, approximately 40% of retail automotive loans and leases are generated through the three U.S. captive finance companies, GMAC, LLC, Ford Motor Credit LLC and DaimlerChrysler Financial Services Americas LLC. The balance of the market is highly fragmented; the other participants include the captive finance companies of foreign manufacturers, banks, credit unions, independent automobile finance companies and various other financial institutions.

In addition to the more traditional risks, such as credit risk, liquidity risk and market risk, the specialty lending industry is subject to other risks such as headline (reputation) risk, regulatory risk and predatory lending risks. 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. Although noteworthy regulation regarding consumer protection regulation exists, the auto finance industry is generally largely not viewed as an industry with significant regulation. Unlike banks, regulation differs greatly from company to company, and as such, financial reporting and transparency are not uniform.



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## Rating Methodology Overview

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Ratings assigned to a U.S. finance company reflect the opinion of DBRS on the company's credit quality. Reflecting a detailed analysis of a company's strengths and the challenges it faces, these ratings are provided as a forward-looking measure of the rated entity's ability to meet its financial obligations in a timely manner. The long-term ratings express DBRS's view on a company's remoteness from defaulting or otherwise being unable to pay as agreed on its obligations. Differences in the strengths of an institution relative to its peers are also reflected in their ratings. DBRS does not employ a formulaic approach in determining ratings, but rather seeks to combine the inextricably linked elements into an overall assessment of the rated organization's strength.

Long-term senior ratings cover senior unsecured debt and other similar senior obligations, as well as a company's ability to meet its full payment obligations on financial contracts on a senior basis. DBRS rates various debt securities issued by the financial institution individually and these ratings are adjusted for the seniority of the securities versus the senior unsecured debt rating. Short-term ratings indicate the capacity of an issuer or borrower to fulfill in full its short-term repayment obligations in a timely manner within a one-year horizon.

### MONITORING

Once issued, DBRS regularly monitors ratings for appropriateness and makes changes when deemed necessary. A wide range of indicators of a company's health are followed: Earnings are evaluated and events are assessed to determine any impact on the institution's fundamentals. Ratings are an intermediate-term assessment of strength across economic and credit cycles. Lower earnings that are driven by a deteriorating economy or weakness in specific sectors are not a cause to downgrade, unless the deterioration reveals inherent weaknesses in the company's franchise, its earnings power, its risk management processes or its exposure to risk.

### RATINGS BASED PRIMARILY ON INTRINSIC STRENGTH

For U.S. finance companies, ratings are based primarily on the intrinsic strength of the rated entity. Each rating is the product of a detailed analysis that leverages qualitative and quantitative analysis. The analysis utilizes publicly available information, as well as non-public information that the company may share with DBRS as an "insider" under Regulation Fair Disclosure.

DBRS uses both public information, which includes financial reports, regulatory disclosures and company presentations, and non-public financial information, such as budgeted revenue and capital targets, loan granularity and asset quality trends, in its analysis. Face-to-face meetings provide further input and an opportunity to assess the quality of the organization's executives – among other things – to manage the franchise and adjust to a changing environment.

The analysis takes advantage of the analytical framework that DBRS's U.S. financial institutions group (U.S. FIG) has developed to quantify or evaluate various elements underpinning a company's intrinsic strength. By using various ratios and other metrics, as well as taking into account qualitative characteristics, this framework helps determine the strength of the firm. By integrating the interconnected elements of a company's strength, the framework facilitates the evaluation of the overall financial profile. Trends over time provide a useful perspective on whether a company is gaining or losing strength. Trends over time combined with metrics and stress tests also help identify strengths and weaknesses.

Peer group comparisons are a particularly valuable tool for identifying relative strength and understanding trends over time, however, given the varied business models of finance companies, peer comparison is often difficult. In determining the appropriate peers, DBRS considers financial institutions that are rated similarly by DBRS as well as institutions that are of similar size, business model and operating footprint.

For some finance companies external factors, such as parent support, can play a role in determining ratings.



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## Analytical Elements – Interconnected Building Blocks

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DBRS's ratio analysis focuses on five interconnected aspects of a company's financial health: The following exhibit lists the five building blocks and provides illustrations of their application:

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### The Five Building Blocks

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<b>Interconnected Building Blocks</b>	<b>Illustrative Elements</b>
Franchise Strengths	Business mix, market positions, other distribution channels, and management quality
Earnings Power	Diversification, net interest margin, efficiency, capacity to absorb adverse events
Risk Profile, Asset Quality and Risk Management Processes	Credit, interest rate, market, operational, legal, regulatory risk, loan portfolio composition/concentration
Liquidity	Funding profile, presence of a deposit base, securities portfolio, credit lines, emergency liquidity plans
Capital Structure and Adequacy	Capital levels, mix, quality and composition

### DETERMINING THE RATING FROM THE BUILDING BLOCKS

DBRS considers these building blocks to be significantly interrelated and considers each building block an essential element in the overall assessment. Accordingly, ratings reflect the interdependent nature of a finance company's ability to meet its obligations in a timely manner, rather than a simple additive weighting scheme.

Nevertheless, there is a sequence of the assessment that provides a perspective on the relative importance of the building blocks. Franchise strength is the key driver of the rating. The stronger the franchise, the higher the rating is likely to be. It is unusual for a company to be well rated if it has a weak franchise, absent some form of parent or structural support mechanism. Equally important is the earnings power that it generates from its franchise. Strong, resilient earnings provide the best protection for creditors. Earnings provide the capability to withstand adverse events without invading capital. Resilient earnings provide resources to rebuild capital after adverse events.

A strong franchise does not guarantee strong earnings power, although usually one is derived from the other. Companies can have franchises with a number of strengths, such as leading market positions. Better-rated companies tend to have stronger, more diversified franchises and hence more resilient earnings power. In assessing earnings power, DBRS takes into account the risk profile that reflects, among other things, the business mix, concentrations and exposure to stress scenarios.

Liquidity is another critical, but interrelated building block that should not be assessed in isolation, but rather in the context of the entire institution. A highly rated finance company is not likely to have weak liquidity, but high liquidity by itself would not necessarily result in a high rating if the company's franchise and earnings power were weak. On the other hand, highly specialized niche lenders with strong liquidity may be rated highly although their franchises and earnings power are less strong.

Similarly with capital adequacy, high capital ratios are unlikely to drive a high rating in isolation, if a company has a weak franchise and poor earnings power relative to its risk profile. In evaluating capital adequacy, the analysis seeks to identify how well the company is capitalized relative to its risk profile, earnings power and regulatory requirements. It is important for well-rated entities to have a comfortable capital cushion above well-capitalized levels to ensure that their businesses are not constrained by adverse events and/or regulatory actions.



## 1. Franchise Strength

### Qualitative Considerations

#### *Judging the Strength of the Business Franchise*

DBRS integrates franchise strength and a company's competitive position in each rating. A 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.

In assessing a company's franchise strength, DBRS considers:

- Business mix
- Customer product penetration and length of customer relationships
- Customer service, asset servicing capabilities
- Competitive advantages/disadvantages
- Distribution channels
- Special skill sets
- Product range, product innovation
- Systems and technology
- Operational capabilities across geographies and businesses
- Integration of different businesses and product lines
- Management's skills
- Management of business risk
- Strategy for sustaining growth, potential for growth

The strength of market presence directly impacts a company's capacity to attract new business and compete effectively. In this respect, market penetration is a key consideration, as measured by the size and breadth of the company's businesses and business offerings. Scale can be particularly relevant in providing commoditized services profitably, so as to spread the typically high overhead cost associated with these businesses over a larger revenue stream.

Franchise strength is an important element of any financial institution's ratings. DBRS's fundamental premise is that companies with strong market shares in their chosen business lines generally have better market positions and stronger franchises. Higher market share leads to scale and cost efficiencies in marketing, advertising, infrastructure and technology. Revenue potential increases with the ability to provide a broader range of products, to offer access to specialists, customize products to the local market and to increase visibility and acceptance among customers. Importantly, the ability to withstand competition improves with greater market share

#### *Management's Contribution to the Franchise*

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.

Management's acumen in the creation and maintenance of an optimal business mix, together with the viability and achievability of strategic initiatives for entering new markets, building out the current footprint and broadening the product mix are considered. In this context, the experience and depth of the management team to run an institution, along with the capacity of operating systems and the robustness of administrative policies and practices – such as credit administration – to safely manage business volumes are taken into account. While success in delivering strong earnings and franchise growth is viewed positively, the risk profile that is generating this growth and the ability of management to cope with an adverse environment are also analyzed.



### *Quality and Role of the Board of Directors*

The independence, experience and diversity of the board members are also evaluated. An active board meeting several times a year that consists of predominantly independent members bringing together a broad range of experience in business and finance is preferred. The composition and independence of the board is particularly relevant especially for entities that are partly owned by or share common ownership with a manufacturer.

### *2. Earnings Power*

In assessing earnings power, the analysis looks at the components underlying earnings and the company's ability to withstand stress. These include asset yields, funding costs, net interest margin and efficiency. The revenue contribution of fees and commissions, the efficiency of the operating platform and the amount of loan loss provisions recognized also influence profitability. Effective use of the balance sheet is reflected in returns on assets. Ultimate profitability reflects the combination of earnings and capital strength relative to the company's risk profile. Trends over time and peer comparisons provide opportunities to gauge the strength and trajectory of earnings power.

DBRS looks at both the quantity and quality of earning 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 should 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.

### *Profitability Measures*

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. In gauging the strength of earnings, the analysis looks at various profitability measures. 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. Accordingly, DBRS considers income before provisions and taxes to average assets as 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.

Earnings strength is assessed by the extent to which earnings can simultaneously cover large unanticipated losses and non-recurring expenses, accommodate balance sheet growth and pay dividends expected by shareholders – all without weakening stockholders' equity. One of the key measures financial health is the amount of loan loss coverage, defined as pre-provision income relative to loan loss provisions. This measure helps indicate the extent to which earnings can decline and losses simultaneously increase without invading capital. 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 table below outlines the key ratios used to judge a firm's profitability level.

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**Profitability Ratios (%)**

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ROAA  
REAE  
ROR (net income/revenue)  
ROAMA  
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 of 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. 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 indicate 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.

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**Quality of Earnings Ratios (%)**

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Gain on loans sales/revenue  
Net interest income/revenue  
Servicing and other fee income/revenue  
Origination income/revenue

### *Revenue Diversification*

The analysis of revenue diversification starts by examining the contribution of various components that contribute to earnings. The analysis takes into account the any diversion of industry sectors represented in the loan portfolio, as well as the geographic dispersion of loans. Revenue diversification includes the presence of fee-based products and their relative contribution to net revenues. The broader the industry coverage, which in the case of automotive assets includes new and used vehicles, and geographic dispersion in the loan portfolio, the more resistant net interest income is to economic dislocations in a specific market or industry. The analysis also takes into consideration the competency of the financial institution in originating and underwriting the risk in those asset classes and geographic areas, as well as its ability to appropriately price the risk inherent in those transactions.



### *Loan Yield, Cost of Funding and Net Interest Margin*

An important indicator of earnings power is the loan yield, which reflects the company's business mix and the risks inherent in its loan portfolios. A lower-than-peer group average yield on loans can be mitigated by a lower risk profile in the loan portfolio.

The cost of funding liabilities is a critical component of earnings power. Generally, a greater reliance on wholesale funding leads to above-average funding costs. Moreover, an undue reliance on less stable wholesale funding may make an institution more susceptible to market-funding disruption. Higher aggregate funding costs can be mitigated by minimal reliance on volatile funding sources.

Net interest margin (NIM) is an important gauge of a firm's ability to generate a spread between its funding costs and the yield on its assets. A stable NIM for a sustained period indicates both a balanced loan portfolio with a stable funding base and prudent management of the impact of interest rate volatility, and is therefore a positive rating consideration.

### *Non-Interest Income*

An important element in analyzing earnings is the contribution of non-interest income sources. Relatively high non-interest income as a percentage of net revenues is generally considered favorably, because such businesses typically involve limited amounts of assets, capital and credit risk. Thus, non-interest income boosts profitability and, at the same time, lowers the company's exposure to credit and interest rate risk.

### *Efficiency*

An important consideration for earnings power is the efficiency of a rated entity's operations and how well management manages operating expenses. One useful measure is the ratio of operating expenses to operating revenues, which shows both trends over time and its performance relative to its peers. While expense ratios can indicate differences in efficiency, especially over time, they are also impacted by the mix of business.

## **3. Risk Profile, Asset Quality and Risk Management Processes**

Taking risk is an inherent function of finance companies. A critical element of the rating process is evaluating the nature and extent of the risks that a company faces and how well it manages these risks. In this building block, the ratings process looks at a range of risks and risk management processes. Credit risk generally receives the most attention. Also addressed are interest rate risk, market risk and operational risk. The track record in managing risk generally and asset quality in particular through economic cycles, and its capacity to sustain a sound credit profile in the intermediate future are key rating considerations. In this context the robustness of the firm's policies and procedures, together with the depth and experience of its management team are key considerations. Meeting with management also enables DBRS to assess management's general risk appetite and approach to management of those risks.

### *Asset Quality and Credit Risk Management*

Asset quality performance is reviewed and the prevailing trends analyzed in a process that involves the use of various ratios, loan migration data based on the internal rating scale and trends in customer creditworthiness and collateral coverage. Additional factors include the company's capacity to cover loan losses from earnings and the adequacy of its capital cushion in case earnings should not be sufficient to offset losses.

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 of 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



Further, DBRS looks to how well management copes with deterioration in credit quality by recognizing and addressing the problems as part of the assessment. Additionally, management's ability to properly gauge and adjust its loan loss provisions is also qualitatively evaluated.

### *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 days to 90 days for prime loans and 60 days to 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 payments positively impacts the 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% to 50% of the subprime 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 dialers, behavioral scoring and the effectiveness of loss mitigation and collections techniques are considered. Given the extensive experience and the asset concentration, DBRS expects the captive's servicing and collections to be best in class.

### *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 disposes 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 dealer actions. DBRS assesses the auto company's remarketing capabilities, recovery trends and marketing times, while it is understood that significant external factors, such as the overall used vehicle market, also impact recovery and timing. DBRS will review these factors as they relate to a company's peers and to industry trends.

#### *Lease and Leases Residual Asset Exposure*

DBRS determines the finance company's exposure to residual assets of leases; often, in the case of the captives, this risk is shared with the manufacturer. 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. Accordingly, DBRS closely monitors trends in the used vehicle market.

Additionally, 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. Often, the manufacturer compensates the finance company for early terminations, which is yet another factor considered in a captive's reliance on the parent. Residual performance is an important factor in opining on the companies' residual setting policies, as well as determining the adequacy of reserves.

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.

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#### **Asset Quality Ratios (%)**

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##### **Owned**

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

##### **Managed**

60+ day delinquencies/managed receivables

Managed NCOs/avg. managed receivables

##### **Quality of Balance Sheet**

Residual interest/avg. assets

Goodwill and intangibles/avg. assets

MSR/tangible common equity



## 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 underlining loans held in the securitization trust. 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 write downs/impairments and the reasonableness of the assumptions used for valuation.

Additionally, this asset class adds a level of accounting risk as market prices are typically not readily available for the credit enhancement assets. Fair value is determined using discounted cash flow models, using certain key assumptions, all of which are subject to change, especially in time of market instability. The recent reduced investor appetite for many non-traditional asset types has significantly impacted these assumptions, especially the applicable discount rate, causing valuation adjustments. Moreover, 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.

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.

Lastly DBRS looks to the impact of other credit enhancements of securitizations, as these credit enhancements have the potential to trap cash in the company's securitizations should any securitization breach an overcollateralizing trigger, thereby stressing the issuers liquidity. Moreover, this has the potential to reduce credit protection for the unsecured debt holders.

### *Managing Interest Rate Risk and Market Risk*

Given the importance of interest rate risk, considerable attention is paid in the rating process to evaluating the exposure to interest rate risk and how well it is managed. In this respect, the analysis considers the maturity profile of the company's assets and liabilities.

### *Operational Risk and Headline Risk*

Operational risk is an important consideration in evaluating a company's soundness and the potential for losses that could impair earnings and capital. These risks include diverse elements such as minimizing human error, failures in systems and technology and the inability to meet regulatory and compliance requirements. A company's track record in managing operational risk over time and its disaster recovery plans also receive considerable attention. DBRS monitors the company's track record of managing headline risk, which is considered elevated with all institutions that lend to consumers.

## **4. Liquidity**

Liquidity analysis focuses predominantly on the sources of funding and the stability under changing economic and interest rate environments. The maturity profile and cost of the various funding liabilities also have a material impact on the robustness of liquidity. Importantly, the contingency liquidity plans to deal with potential funding dislocations are reviewed.

DBRS looks at the company's capability to fund the financial obligations through all foreseeable market conditions as a key requirement for long-term viability; hence, this capability receives much analytical attention.



Given a finance company's funding appetite, liquidity is a key factor in the rating. 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. Recent market events truly tested many firms' liquidity profile and tested contingent funding plans. Lack of access to funding, along with weak liquidity, is one of the chief factors that lead 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 has longed believed that a firm should remain active in multiple funding channels and not be overly dependent on any one single source.

DBRS seeks to understand a company's preparedness for dealing with a liquidity crisis. Contingency liquidity plans should include sufficient long-term funding and reliable additional borrowing capacity from various sources to continue operations without major disruptions. DBRS also looks at a firm's access to a variety of liquidity sources beyond internal resources.

Securitization provides access to liquidity, but can pose challenges if access to the capital markets is restricted.

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. To achieve liquidity, lower rated firms typically pledge their assets in securitizations and various forms of secured lending, such as warehouse lines, 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 percentage 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 (or within) strong bank charters may be rated higher than their peers without the charter, due to 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. This 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:

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#### Liquidity Ratios

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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).



### *The Building of a Secondary Market for Auto Paper*

The competitive landscape within the automotive finance industry has changed, as a result of the extensive use of securitization and the continued operating stress of the U.S. auto manufacturers. Historically, the captive finance companies had considerable access to the debt market, thereby allowing the captive to maintain an on-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 develop.

### **5. Capital Structure and Adequacy**

The composition and adequacy of capital receives careful analytical attention as a measure of an entity's solvency and its capacity to absorb losses from operations and loan defaults in excess of its earnings. DBRS view capital adequacy as 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 from both expected and unexpected losses. Capital adequacy is judged against relative profitability, asset type, balance sheet risk and the general risk profile of the firm. Also factored into the analysis is the scale and diversity of the franchise, the resiliency of its earnings power, the reliability of its operating processes and the soundness of risk management processes.

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.

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.

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#### **Capitalization Ratios**

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- 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 should DBRS determine that the company is overly dependent on this form of equity. 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.



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### Quality of Equity Ratios (%)

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Preferred securities/total equity

Residual interests/total equity

Goodwill and other intangibles/total equity

#### *Capital Ratio Analysis*

The simplest capital ratio utilized by DBRS is the ratio of equity to assets, which indicates how well a company is protected from insolvency due to a decline in the value of its assets on a book value basis. To adjust for the greater risk that goodwill could be written down, DBRS also looks at the ratio of tangible common equity to tangible assets (TCE/TA) which assumes that goodwill is valued at zero. This measure tends to penalize firms that have made acquisitions. In evaluating capital adequacy, DBRS considers the extent to which a company is generating earnings from the acquired assets and the extent to which the assets underpinning the goodwill still have value.

DBRS reviews management's targets for various capital ratios. Also important is management's practice of paying dividends and its stock repurchase activity. A high dividend pay-out rate could be constraining, because shareholders come to expect the same amount of dividends in the future irrespective of the company's earnings. A high payout ratio could hinder healthy balance sheet growth and prudent investment into the firm's infrastructure and businesses.



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## Rating Considerations Beyond the Five Building Blocks

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In addition to the five interconnected building blocks, DBRS takes a range of other considerations into account in its analysis. Some key considerations are described below.

### THE CORPORATE AND OWNERSHIP STRUCTURE

#### *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. Given the current stress of the U.S. automotive manufacturers, ownership and degrees of separation are of key focus in the DBRS rating. DBRS begins with the ownership structure and the degree of separation between the manufacturer and the finance arm.

For wholly- or partially-owned captives, parental considerations, such as the credit strength of the parent and the parent's intentions with regard to the finance subsidiary are considered. If the rated entity is a subsidiary of a larger corporation, 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 are considered. Generally the parent/subsidiary agreement ranges from the strongest, an 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.

#### *The Captive Advantage*

DBRS believes that 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. Additionally, access to the dealer network assists the captive in the remarketing of repossessed and off-lease vehicles. Typically, DBRS will equalize the ratings of the captives to their parent ratings as the rating is typically set firmly by the strength of the overall parent. In some circumstances, typically in the case of a weak parent, with a stronger finance company arm, a captive may be rated above the parent, however, given the importance of most finance subsidiaries to the parent's business, and their stand-alone metrics, DBRS will typically not rate a captive below the parent. Refer to DBRS's "Rating Captive Finance Companies" methodology for additional detail.

#### *Parental Support and Other Parental Considerations*

Parental support can be implicit, in the form of various subvention programs, such as rate support, where the manufacturer offers its customers discounted financing through its captive finance company, while the captive is paid market rate. This provides the captive with a steady supply of new originations while the finance company assists its parent in selling product. DBRS looks to the level of subvention received from the manufactures through the various programs. DBRS believes that the captive should retain underwriting control and must be compensated for any risk it is taking.

#### *The Disadvantages of Parental Support*

Parental support has advantages and disadvantages; as a weak parent can negatively impact the captive's business through increased funding costs and reduced originations volumes. A weak parent's rating will typically result in a lower rating at the finance company subsidiary, which may ultimately limit funding flexibility. The parental taint can potentially obliterate an otherwise strong franchise as both investors and consumers may avoid the association with a weak entity.



DBRS determines the level of direct and indirect exposure; this can be in the form of secured or unsecured financings offered to the finance arm by the parent, inter-company transactions, buyback programs and residual support. Captives can manage the exposure to their parent by, in addition to other things, limiting inter-company borrowings, requiring residual support at the time of origination and through detailed operating agreements; however, the indirect exposure, such as asset concentration, are exceedingly more difficult to manage, as generally a captive's mission is to support the parent in selling product.

#### *Asset and Business Concentrations*

Closely related to parental considerations are asset and business concentrations. Asset concentration is a rating factor when reviewing independent monoline automotive lenders and banks. Conversely, DBRS believes that asset-type concentration is generally not a significant factor for the captives, given the size of the portfolio; however, this becomes more worrisome when the parent becomes noticeably weak, since the manufacturer is most likely the captive's largest client.

#### *Evaluation of Exposure to Dealers*

DBRS determines a lender's exposure to dealers, dealer groups and, ultimately, to the manufacturer. This exposure could be in the form of real estate secured, working capital and floorplan lending, in which the risk increases with a weak parent. Floorplan lending finances a dealer's inventory (the inventory "on the floor") that is pending the product's retail sale. Since manufacturers are typically obligated to buy back inventory should a dealer default, the manufacturer is a key factor into the risk profile.

Additionally, manufacturer support is evidenced by reimbursement of interest during transit, volume rebates, capital loans, repurchase agreements and floorplan incentives on specific models. Should the manufacturer fail, the withdrawal of these incentives would exacerbate the impact of the manufacturer's woes on their dealers.

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

### **NOTCHING AND SENIORITY OF RATED DEBT CLASSES AND PREFERRED SHARES**

In cases where the condition of a company has deteriorated significantly, equity owners are highly likely to face losses, while senior creditors may well not receive payment in full. Reflecting the greater risk of loss for holders of subordinated debt, as this debt is viewed as part of total capital, this debt is typically rated one notch below senior debt issued by the same entity. Similarly, ratings of trust preferred securities and preferred shares also take into account the ranking of these securities in the issuer's capital structure and the issuer's credit strength. Depending on the specific structure of trust preferred securities, they are typically rated one or two notches below senior debt. DBRS typically rates preferred shares two notches below senior debt.

In addition, debt issued out of a holding company is also more at risk and structurally subordinate to senior debt issued by its subsidiary bank and is therefore typically rated one notch lower.

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