Methodology

Global Methodology for Rating Finance Companies

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Introduction to DBRS Methodologies

• In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking evaluations that assess an issuer’s ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
• In addition to general business, regulatory and financial risk factors, the DBRS rating methodologies include consideration for many subjective factors, nuances and intangible considerations. As such, the approach in this methodology is not based solely on statistical analysis, but includes a combination of both quantitative and qualitative considerations.
• The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the entity may be strong in most other areas.
• DBRS rating methodologies are underpinned by a stable rating philosophy, which effectively minimizes rating movement due primarily to economic changes. DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
I. Global Methodology for Rating Finance Companies - Overview

In this methodology, DBRS explains the key operational and financial factors that it considers in rating finance companies (FinCos) globally. This methodology is an update of the prior finance company rating methodology, Rating Finance Companies Operating in the United States, which had been in place since April 2008. It also replaces Rating Captive Finance Companies (June 11, 2010), Rating Auto Finance Companies Operating in the United States (May 1, 2008), and Non-Captive Automotive Finance Companies (April 12, 2006). To clarify the elements of the analysis, this update introduces rating grids for finance companies that cover the key underpinnings of the ratings by building block. Where appropriate, this methodology considers the characteristics of the environment in which FinCos are operating, including such areas as industry structure, regulation, legislation, and economic conditions, which generally vary across countries. This methodology also considers the evolving marketplace in which finance companies compete, as well as structural changes amongst finance companies, including the growing role of banking subsidiaries within finance company organisations. The analysis determines the fundamental credit strength or intrinsic assessment (IA) of a FinCo, which for independent FinCos is also the final rating. For FinCos that are part of larger organisations, the final rating also incorporates any support from within the organisation.

This methodology covers a broad range of finance companies that provide commercial and consumer financing in different sectors. Typically, finance companies are reliant on wholesale funding in various forms and maturities, but are increasingly using bank subsidiaries as a source of retail funding. Among the sectors where finance companies are active include: automobile financing, residential mortgage companies, student lending, consumer finance, commercial finance, commercial leasing including aircraft, railcar and container leasing. This list is not all encompassing, but rather illustrates the diverse nature of finance companies. The main body of this methodology provides the core framework for DBRS’s approach to rating finance companies. In the various appendices to this methodology, additional details are provided on the rating factors of rating finance companies in specific sectors, including captive finance companies, auto finance, rental car companies, aircraft leasing, container leasing and mortgage related.

From an organizational perspective, finance companies perform a variety of roles, from independent companies to specialized operations within larger organisations. Some finance companies operate as subsidiaries of manufacturing companies by providing financing for the sale of the company’s products. Meanwhile, some retailers, especially in Europe, have FinCo subsidiaries that facilitate customer purchases in these companies’ retail operations. In Europe, and to a lesser extent in the U.S., many finance companies operate within larger banking organisations, as specialized arms leveraging the FinCo’s more specialized skills or more extensive geographic reach. Some finance companies have made greater use of banking legal vehicles to provide a source of funding by enabling them to raise deposits by leveraging their brand names and franchise positions, and may benefit from central bank access. This methodology is applicable both to standalone finance companies and to subsidiaries of larger financial institutions or commercial organisations. For finance companies within banking organisations, DBRS uses the Global Methodology for Rating Banks and Banking Organisations and the DBRS Criteria: Support Assessment for Banks and Banking Organisations in combination with this Finance Company methodology.

A key element in the analysis is determining the ownership and role of a finance company, whether on a standalone basis or as part of a larger organisation. When a finance company is part of a larger organisation, the final rating is determined by combining the IA of the FinCo with the assessment of support from the FinCo’s parent and the broader organisation as warranted by the nature of the organisation. For finance companies that are part of nonfinancial corporations, the approach to support parallels the approach that DBRS utilizes for support provided by corporate parents to their subsidiaries. In some cases, the relationship can be very close, as exists between parents and captive finance companies. The treatment of captive FinCos is discussed in detail in Appendix C of this methodology.

For finance companies with banking subsidiaries, DBRS uses the Global Methodology for Rating Finance Companies and DBRS Criteria: Support Assessment for Banks and Banking Organisations in combination with the Global Methodology for Rating Banks and Banking Organisations. The specialty finance industry has changed meaningfully in the past decade. This has been due in part to the challenges that arose for finance companies that had narrow wholesale funding during the stressed financial markets. These changes have also reflected the growing global competition from banks, as banks have become more willing to enter the higher yielding lending areas that were historically the domain of finance companies. To leverage deposit funding and other attributes of banks, more finance company organisations now have meaningful banking components, typically through banking subsidiaries. In the
U.S., companies with predominantly finance company business lines are designated as bank holding companies when they own a banking subsidiary.

Relative to banks and insurance companies with comparable scale, the ability of independent finance companies to achieve high ratings is typically constrained by three factors:

- Revenues for the typical independent finance company tend to be more heavily focused on spread income than many banks, which typically have more diverse revenue sources from related fees for services and ancillary activities. Moreover, independent finance companies often focus on a specific industry or lending product, which can result in the finance company having a monoline nature. This contrasts with the typically broader range of lending, deposit taking and other businesses of most banks.

- Most finance companies have a reliance on wholesale funding that makes them more sensitive to market confidence than a typical bank. This reliance reflects their primary focus on lending and related services as the core of their franchise. Wholesale funding is important as a means for FinCos to fund these credit activities and stronger FinCos generally have significant competencies in managing their funding. Nevertheless, this form of funding is not inherently a component of their franchise, unlike banks, where deposits and other liabilities also drive customer relationships and contribute to the stability of deposit funding. To the extent that a finance company organisation has a banking entity that provides it with sizeable stable deposit funding for its lending activities, its reliance on wholesale funding is reduced, and its funding profile is strengthened.

- Finance companies are subject to considerably less formal regulation than banking organisations, although the extent of this regulation varies by country and over time. While regulation does not always prevent problems at banks and represents an additional cost, regulation and supervision do result in more constraints on banks including on leverage, direction that prevents entry or excessive volume in riskier sectors and may mean that, when problems do occur, they are identified earlier and dealt with more robustly than would otherwise be the case. With less formal regulation and limited impact on core areas like the payments system, DBRS typically gives no consideration for government support in the case of finance companies.

Given the nature of finance companies, this perspective on the ratings makes sense. The extent of a finance company’s risk is contingent upon its leverage. By contrast, banks have to weigh the benefits of being better rated to attract business from customers who value safety, such as depositors and other counterparties, against the benefits of providing financing that attracts borrowers who value a finance company’s willingness to take risk and utilize its skills to provide them with financing. Inherently, a very highly rated finance company would either have a very limited base of low risk customers or have abundant capital that yielded low returns to its shareholders. As a result, even an “A” rated independent finance company is relatively unusual, as it would need to generate considerable revenues from low risk activities relative to the typical lending profile. Stronger finance companies tend to be in the lowest investment grade category of BBB. It would be very unusual for a finance company to attain a rating in the AA range without clear and meaningful support from a large strong bank or corporate parent that was rated in the AA rating category.
II. The Approach to Rating Finance Companies

DBRS provides ratings of finance companies as a measure of their ability to meet their financial obligations. Typically, finance companies provide financing in various forms, as well as related services, to commercial and retail customers. Reflecting this financing, the major risk for most finance companies is credit risk. Generally, finance companies rely on wholesale funding in various forms and maturities ranging from unsecured debt to securitizations. The methodology provides an analytical framework for assessing a finance company’s fundamentals and its ability to meet its obligations.

Reflecting the core components of a finance company, DBRS’s approach is to separate the analysis into five interlocking building blocks that are combined to obtain the rating of the finance company. This approach enables the many aspects of a finance company to be separated into manageable components that can be analyzed separately and then combined together. This approach is similar to that which DBRS applies to banks and banking organisations. For independent finance companies, the analysis generates a final rating. For finance companies that are part of larger organisations, the analysis generates an intrinsic assessment (IA), which is expressed on the DBRS rating scale. This assessment of intrinsic strength is combined with a support assessment of potential support from the FinCo’s parent or other internal support provider to derive a final rating for the FinCo. The process of combining the building blocks is not a simple weighting scheme, but rather an assessment of a FinCo’s integrated strength.

The analytical process

The analytical rating process starts by assessing the strength of each of the building blocks, beginning with Franchise Strength, utilizing available information including qualitative and quantitative data. Ranging from “very strong” to “very weak”, these grades are then combined to reach an opinion on the FinCo’s Intrinsic Assessment (IA), expressed as a rating on the DBRS rating scale. The IA is then checked through comparisons with peer groups. The final rating is then adjusted to take into account any explicit support from a parent or other entity in an organisation within which a FinCo operates. In limited cases the final evaluation could consider whether the FinCo benefits from any systemic support.

The following exhibit illustrates the elements of the five building blocks:

<table>
<thead>
<tr>
<th>Interconnected Building Blocks</th>
<th>Illustrative Elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchise Strength</td>
<td>Business mix, customer loyalty, depth and breadth of customer base, variety of customer segments, market positions, product mix, competitive strengths, distribution channels, management quality</td>
</tr>
<tr>
<td>Earnings Power</td>
<td>Diversification, net interest margin, fees &amp; commissions, efficiency, capacity to absorb adverse events</td>
</tr>
<tr>
<td>Risk Profile, Asset Quality and Risk Management Processes</td>
<td>Risks: Credit, loan portfolio composition/concentration, interest rate, market, operational, legal, regulatory</td>
</tr>
<tr>
<td>Funding and Liquidity</td>
<td>Funding profile; nature/scale of deposit base, if present; securities portfolio; credit lines; emergency liquidity plans</td>
</tr>
<tr>
<td>Capitalisation</td>
<td>Capital structure and adequacy, levels, mix, quality, composition</td>
</tr>
</tbody>
</table>

USING THE BUILDING BLOCKS TO DETERMINE THE RATING

DBRS considers these building blocks to be significantly interrelated and considers each building block an essential element in the overall assessment. Nevertheless, there is a sequence to the assessment that provides a perspective on the relative importance of the building blocks.

From DBRS’s perspective, franchise strength is the most important driver underpinning a FinCo’s 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. Better-rated companies tend to have stronger, more defensible franchises and hence can generate more resilient earnings power.
Strong, resilient earnings provide the first line of protection for creditors. DBRS views a FinCo’s earnings power as a critical factor in the rating. Resilient earnings provide the capability to withstand adverse events without invading capital and continue to provide resources for the FinCo to absorb sustained weakness in the credit quality of its lending/financing portfolio. Importantly, strong earnings power means a FinCo can generate the resources to rebuild capital after adverse events. While a strong franchise does not guarantee strong earnings power, usually one is derived from the other. 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.

The central risk for most finance companies is credit risk in their lending/financing, which generally dominates their risk profile. The analysis focuses not only on the characteristics of the FinCo’s credit risk, but also how well the FinCo manages these risks. Underwriting processes, collateral valuation and various other specific aspects of risk management can be important elements in analyzing a FinCo’s credit risk profile. Finance companies also have extensive operational risk related to their management of originations and servicing in their lending operations and other activities. Market risk is typically a modest component of overall risk and primarily reflects the potential impact of interest rate movements, but can also involve risk in holding of securities, securitization residuals and other asset holdings related to a FinCo’s lending activities. For leasing companies, risk from changes in market values, i.e., market risk, is a larger component of the overall risk profile due to the exposure of these companies to the residual value of the leased asset.

Funding and liquidity are also critical components given FinCos need to fund their credit activities. DBRS views a good funding profile as one that includes a diversity of funding by sources and type, as well as a low level of balance sheet encumbrance, which contributes to financial flexibility. Another feature of a good funding profile is the alignment of the characteristics of the assets being funded with the characteristics of the funding, for example, by aligning maturities. As most FinCos are reliant on confidence-sensitive sources of wholesale funding, a FinCo’s funding profile is typically a constraint on its rating. As the first line of defense during a funding crisis, liquidity is a critical component of this building block that is not assessed in isolation, but rather is considered 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 should the company’s franchise and earnings power be viewed as weak.

Similarly with capitalisation, high capital ratios are unlikely to drive a high rating in isolation. In evaluating the strength of a FinCo’s capital, 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 levels that DBRS considers necessary to be strongly capitalized to absorb low-frequency, deep loss events as to be manageable from a capital perspective to maintain market confidence.
The intrinsic assessment reflects the combination of the various components of the building blocks. This process of combining the building blocks is not a simple weighting scheme, but rather an assessment of a FinCo’s integrated strength. The preliminary IA is on a continuum from AA to CCC.

As a general principal, it is easier for a building-block weakness to cause a negative impact than it is for a building block’s strength to enhance a FinCo’s IA. The importance of the Franchise Strength building block limits upward movement and it will often take a combination of greater strength from different areas to push up the final rating. Because major weakness in any building block can cause significant challenges for even a strong FinCo franchise, downside movement is less restricted. The potential impact from the four remaining building blocks is more similar and each individual building block has material capacity to result in downward rating movement.
On the upside, the Earnings Power building block has the largest potential, as stronger earnings are one of the most effective means for a FinCo to cope with periods of stress. Further, there is upside from Funding & Liquidity, as there are benefits in a FinCo having liquidity strength over and above the level that allows it to operate through stressful environments.

For the magnitude of the four remaining building blocks to impact the IA in combination depends on the relative strength of each block versus the Franchise Strength (see Exhibit 2 above). The final conclusion is not a simple additive exercise. Considerations would be given for factors such as the grade by building block, the interlocking play between the building blocks and the relative strength of each component within the blocks. Since FinCos are concentrated in particular business lines, the assessment can factor in how this business concentration affects the importance and interaction among the blocks. While the diagram denotes “notches” to add clarity to the magnitude of the underlying process, the actual assessment process is much more complicated and notching must also often contend with a limited number of appropriate rating categories.
III. Assessing Finance Company Strength by Building Block

Building Block (1) - Franchise Strength

DBRS considers the franchise strength of a finance company as a key factor in the rating. Franchise strength is typically reflected in the robustness and resiliency of a FinCo’s market position. This position is generally underpinned by its skills and competitive advantages. For some finance companies, a key component is often its various client bases and the strength of its relationships with these clients. For others, their client relationships are more transactional, and their franchise strength reflects their reputation for service and responsiveness, often utilizing a visible brand. DBRS views a strong and defendable franchise as a central factor in a finance company’s ability to generate resilient and sustainable earnings.

In evaluating a finance company’s market position, DBRS considers the FinCo’s brand positioning and awareness in the market along with its market share. In this evaluation, DBRS takes into account the overall size and state of the market. The strength of a company’s market presence directly impacts its 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 FinCo’s business and product offerings. For some types of FinCos, the depth of client relationships can be a key factor, especially for those FinCos that have extensive relationships with their clients, such as typically arises in aircraft leasing or fleet management. The analysis will then focus on the strength of the customer relationships and the depth and breadth of the customer base. For other FinCos, particularly ones where retail customers borrow for a specific one-time purchase, such as in auto or home buying, the evaluation of franchise strength may focus on the strength of the FinCo’s ability to source new business. This involves consideration of characteristics such as the company’s track record, service quality and brand position.

Scale can be particularly relevant in providing commoditized services profitably. Greater scale enables a FinCo to spread the typically higher overhead costs associated with these businesses over a larger revenue stream. A leading market position often leads to scale and cost efficiencies. The analysis considers a FinCo’s position and the extent to which it can take advantage of such economies or is at a disadvantage versus competitors. Technology capabilities can be an important differentiator. FinCos with strong IT platforms and the ability to leverage these capabilities can have an important advantage in competing, even against larger competitors.

Those companies with strong and sizeable market positions tend to have the resources to more readily cope with and adjust to changes in the regulatory and operating environment. Generally, such stronger FinCos are also better positioned to respond to shifts in strategies of existing competitors or the entry of new competitors. An important component of franchise strength can be the FinCo’s licenses and regulatory vehicles for conducting its businesses. This could include banking licenses. Also important is the FinCo’s relationships with its regulators.

Revenue potential expands with the ability to provide a broad range of products, to offer access to specialists, tailor products to the local market or customer requirements and increase visibility and acceptance among customers. Importantly, the ability to withstand competition improves with greater market share.

DBRS views favorably those FinCos with a diverse and deep distribution network. Distribution networks include direct, indirect and digital channels to originate and deliver products to customers. A broad range of distribution channels allows a FinCo to reach a broad range of potential customers while delivering the product in the customers’ preferred manner, deepening the customer relationship. DBRS reviews a FinCo’s utilization of direct and indirect sales channels as well as its ability to leverage on-line and mobile technologies to broaden its distribution capabilities. While having a wide range of distribution channels is generally a positive, if these channels are not sufficiently deep the benefits of diversity may not be captured. For example, while a FinCo may have a direct-sales force with nationwide coverage, if the number of sales representatives is small relative to the number of customers within their region then the benefit of broad geographic coverage is unlikely to be fully realized.

A FinCo’s international scope and success in operating internationally may be an important strength, if these international operations add to the FinCo’s diversification and resiliency of earnings. DBRS evaluates international operations in light of the FinCo’s franchise position in each country or region where it is operating. In considering international operations, DBRS is concerned with the FinCo’s ability to operate successfully in more than one jurisdiction, including its management capabilities, technology, compliance, risk controls, financial structure and regulatory requirements. In some cases, international operations could pose more risks for a FinCo than they add in franchise scope or earnings power.
Once a company’s competitive advantages have been identified, DBRS evaluates whether these advantages are sustainable and defendable. A FinCo’s ability to generate earnings, its ability to manage through competitive pressures and business cycles and its ability to defend its franchise are all important attributes to be considered when assessing the strength of its business franchise. Given FinCos reliance on wholesale funding, DBRS sees those finance companies with strong franchises as better able to navigate capital market disruptions, all other factors being equal.

Management is also an important component when considering the strength of a FinCo’s franchise. A strong management team is important for achieving the potential of the FinCo’s franchise through strong earnings, well managed risk, well aligned funding and liquidity and appropriate capitalization. Strong management teams sustain the development of a FinCo’s franchise to ensure that it remains competitive. Strong management is more capable of maintaining investor confidence, allowing a finance company to maintain access to markets during periods of weakening market confidence. A strong board of directors with the appropriate level of independence and expertise is also important to ensure appropriate corporate governance and reduce the risk of adverse management action.

In evaluating management, DBRS assesses the depth of management experience, succession planning and corporate governance. Additionally, management’s ability to execute on operating strategies is assessed to gauge the effectiveness of management. Further, management’s acquisition appetite and experience integrating previous acquisitions are included in the assessment of franchise strength. Stronger management teams generally have proven their ability to respond to evolving operating environments and successfully execute their strategies that build the strength of their companies.

This evaluation also generally considers the ownership structure and the organisation within which the FinCo operates. The ownership structure of a FinCo, which can vary from private ownership to being just a component of a much larger public corporation, can have an important impact on how the institution operates and how it is governed. The analysis seeks to understand how this structure can impact a FinCo’s operations, objectives, strategies and governance. Investors in listed companies benefit from increased disclosures and the additional scrutiny of the markets that reflects ownership of the FinCo’s securities.
<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Very Strong</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Passable</th>
<th>Weak</th>
<th>Very Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market/competitive positions</strong></td>
<td>Top tier, resilient positions in most or nearly all markets in diversified major business lines with strong brand presence and/or deep customer relationships; significant geographic reach adds to diversification.</td>
<td>Top or 2nd tier, but resilient, definable positions, in majority of markets with a number of business lines with solid brand presence and/or strong customer relationships; geographic reach adds significant diversification.</td>
<td>2nd-tier presence in some markets/business lines with a material brand presence and/or solid customer relationships; or Top or 2nd Tier position in limited number of business lines with some geographic diversification.</td>
<td>Moderate presence in some markets and business lines with a material brand presence and/or established customer relationships; geographic presence adds some diversification.</td>
<td>Limited presence in a few markets and business lines with limited brand presence and/or limited customer relationships; geographic presence adds limited benefit.</td>
<td>Very limited presence in a highly fragmented market and business lines with little brand presence and/or very limited customer relationships; limited benefit from geographic presence.</td>
</tr>
<tr>
<td><strong>Business mix and product range</strong></td>
<td>Complete or nearly complete product set for major business lines for the specific model the FinCo pursues across its operating geography; very significant benefit from diversification, synergies and scale.</td>
<td>Robust product set for a number of business lines for the specific model the FinCo pursues across its operating geography; some benefit from diversification, synergies and scale.</td>
<td>Strong product set in some business lines for the specific model the FinCo pursues across its operating geography; some benefit from diversification, synergies and scale.</td>
<td>Solid product set in some business lines for the specific model the FinCo pursues across its operating geography; limited benefit from diversification, synergies and scale.</td>
<td>Moderate product set in a few business lines for the specific model the FinCo pursues across its operating geography; limited benefit/added cost from diversification, synergies and scale.</td>
<td>Limited product set in a few business lines for the specific model the FinCo pursues across its operating geography; diversification is a negative/adds costs; small scale.</td>
</tr>
<tr>
<td><strong>Distribution channels</strong></td>
<td>Wide or nearly complete distribution network in sectors where it operates; very skilled personnel; appropriately located; very close relationship with customers; very consistent/experienced service capabilities.</td>
<td>Robust distribution network in sectors where it operates; skilled personnel; appropriately located; very strong relationship with customers; consistent/experienced service capabilities.</td>
<td>Strong distribution network in sectors where it operates; generally skilled personnel; mostly located; strong relationship with customers; largely consistent service capabilities.</td>
<td>Solid distribution network in sectors where it operates; less skilled personnel; located; solid relationships with customers; service capabilities.</td>
<td>Limited distribution network in sectors where it operates; skilled personnel; poorly located; weak relationships with customers; very strong service capabilities.</td>
<td>Limited distribution network in sectors where it operates; skilled personnel; poor locations; very weak relationships with customers; unreliable service capabilities.</td>
</tr>
<tr>
<td><strong>Management quality &amp; depth</strong></td>
<td>Well articulated, consistent strategy; high degree of management stability/experience; clear, appropriately organized reporting lines; effective Board of Directors (BoD).</td>
<td>Developed and steady strategy; strong degree of management stability/experience; clear, appropriately designed reporting lines; effective BoD.</td>
<td>Sound performance or minor weakness in one or more of the following: articulation and consistency of strategy; management stability and experience; succession plan; reporting lines, and BoD.</td>
<td>Relatively sound performance or some level of minor deficiency in one or more of the following: articulation and consistency of strategy; management stability and experience; succession plan; reporting lines, and BoD.</td>
<td>Some level of weakness in one or more of the following: articulation and consistency of strategy; management stability and experience; succession plan; reporting lines, and BoD.</td>
<td>Higher level of weakness in several of the following: articulation and consistency of strategy; management stability and experience; succession plan; reporting lines, and BoD.</td>
</tr>
<tr>
<td><strong>Operating environment and Regulation</strong></td>
<td>Very strong ability to cope with and adapt to changes in the environment or regulatory areas.</td>
<td>Well positioned to cope with potential future environmental or regulatory changes.</td>
<td>Acceptable capacity to handle change from potential environmental or regulatory change with minor impact on franchise.</td>
<td>Has the capacity to handle change, but major changes could be challenging.</td>
<td>Limited capacity to handle change; major changes could be materially challenging.</td>
<td>Unlikely to successfully adjust to a major change in regulatory or operating environment.</td>
</tr>
</tbody>
</table>
Building Block (2) - Earnings Power

Earnings power is the capacity of a finance company to generate resilient and sustainable earnings. Considerable emphasis is placed on earnings, as they are the first layer that protects creditors. DBRS’s approach is to consider this capacity across a business cycle, rather than focusing only on current earnings. Stronger earnings power means a finance company has the capacity to absorb unanticipated losses and non-recurring expenses, build capital and invest in the franchise while paying dividends expected by shareholders. In assessing earnings power, the analysis looks at the components underlying earnings and the FinCo’s ability to withstand stress. Finance companies that demonstrate strong and consistent earnings generally will have continued access to funding and can build capital to protect creditors. In assessing earnings power of a finance company, DBRS concentrates not simply on the level of earnings, but also on the quality of earnings, which encompasses the components of earnings and the volatility of separate earning streams which underpin the sustainability of earnings.

In assessing earnings power, DBRS focuses on the strength of recurring earnings. A key measure in this analysis is income before provisions and taxes (IBPT). In assessing the strength of a company’s IBPT, DBRS evaluates underlying core earnings adjusted for one-time or non-core items. Such items typically include one-time gains or losses on the sale of assets or businesses, gains on sale of securities, gains or losses on the redemption of debt, fair value adjustments, fresh start accounting accretion, restructuring costs, legal and regulatory fines and debt extinguishment charges. While the analysis of earnings may adjust for such non-recurring items, these items may still be factored into the ratings if they have a significant impact on the other building blocks. For example, they may indicate weaknesses in the franchise or in risk management. Moreover, DBRS considers the trends and history of underlying earnings in evaluating the trajectory of earnings and their volatility around this trajectory. This evaluation favors companies with a history of sustained increases in earnings over companies with more volatile earnings. In this assessment, DBRS also considers the level and trend in a company’s earnings relative to that of its industry peers.

Revenues:
The principal source of revenues for most finance companies is net interest income (NII). Typically, NII is the difference between the interest earned on a company’s assets and the interest paid on its funding. Some FinCos, however, generate a substantial portion of their revenues from originating and selling new loans or other financings. These gains on sale tend to be more closely correlated to the volume of originations. FinCos also generate revenues from a variety of fees and commissions related to the provision of financing and other services, such as servicing loans. If gains on sale are an important component of revenues, the analysis may also consider the ability of the FinCo to generate assets that can meet market requirements on a consistent basis.

Loan Yield 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. To evaluate a FinCo’s loan yield relative to its peers, one DBRS measure compares yields and margins on a risk-adjusted basis, which is calculated as net interest income less credit losses over average earning assets.

Net interest margin (NIM) is an important gauge of a FinCo’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 interest rate risk, and would therefore be viewed as a positive rating consideration.

Non-Interest Income
An important element in analyzing earnings is the contribution of non-interest income sources, typically service charges, transaction charges, insurance and other fee-related revenue streams. Relatively high non-interest income from these items as a percentage of net revenues is generally considered favorably, because such products or 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.

However, DBRS views some forms of noninterest income, such as gains on sale, less positively as they potentially increase the volatility of earnings and are somewhat more dependent on market conditions. In particular, a sharp downturn in originations typically results in a sharp drop in revenues, but costs may be harder to shed. Better managed FinCos with this business profile are generally better prepared to reduce costs in such circumstances and have demonstrated the willingness to act in prior downturns.

Revenue Diversification
The analysis of revenue diversification starts by examining the contribution of various components that contribute to earnings. The analysis takes into account any diversification across industry sectors that is represented in the loan portfolio, as well as the geographic dispersion of loans and receivables. The broader the industry coverage 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 FinCo 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. The evaluation of revenue diversification also considers the contribution of fees and commissions that are generated either as a component of lending activities or through fee-based products.

**Efficiency**
An important consideration for earnings power is the efficiency of the FinCo’s operations and how well management manages operating expenses. One useful measure is the efficiency ratio, which is generally the ratio of operating expenses to operating revenues. Alternatively, DBRS will also consider the ratio of operating expenses to average earning assets in evaluating a FinCo’s efficiency. DBRS analyzes these metrics over time and relative to peers to judge the FinCo’s overall level of efficiency. In comparing efficiency ratios across FinCos, differences in business mix are taken into account. Where feasible, comparisons are made across FinCos with similar business mixes.

**Profitability Measures**
In gauging the strength of earnings, the analysis looks at various profitability measures. Effective use of the balance sheet is reflected in returns on average assets (ROAA), which is net income as a percentage of average assets (annualized). While a good starting point, this ratio can be distorted by differences in tax rates among industry participants. Provision levels can also differ. Accordingly, DBRS considers IBPT- to-average assets as another useful profitability measure.

A key measure of earnings power is the ability of those earnings to absorb credit losses from the portfolio of interest earning assets. DBRS uses the ratio of provisions for loan losses-to-IBPT as an important barometer of this capacity. This measure helps indicate the extent to which earnings are absorbing losses and how much further earnings can decline without invading capital.

An important aspect of a FinCo’s earnings is its capacity to pay interest on its debt. In reviewing a finance company’s leverage, one metric is interest coverage. Generally, DBRS looks at interest coverage as core EBITDA-to-annual interest expense. For DBRS, core EBITDA is a company’s EBITDA adjusted for any non-recurring revenue or expenses. Further, DBRS may exclude gains on sale of assets, if DBRS considers the gains on sale of assets to be volatile or unsustainable. For leasing companies and rental car companies, depreciation is a significant expense and a cost of doing business. As such, DBRS will adjust EBITDA to include depreciation on leased or fleet assets, while excluding general corporate depreciation from the calculation of EBITDA.

The table below outlines the key ratios used to assess a FinCo’s profitability.

<table>
<thead>
<tr>
<th>Profitability Ratios (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest margin (NIM)</td>
</tr>
<tr>
<td>Risk adjusted margin</td>
</tr>
<tr>
<td>Efficiency ratio</td>
</tr>
<tr>
<td>EBITDA-to-annual interest expense</td>
</tr>
<tr>
<td>IBPT/ avg. assets</td>
</tr>
<tr>
<td>Net income growth</td>
</tr>
<tr>
<td>ROAA</td>
</tr>
<tr>
<td>ROAE</td>
</tr>
</tbody>
</table>
**Earnings Quality**

The quality of earnings also matters. In evaluating earnings quality, the analysis considers the stability, predictability and diversity of earnings. Interest and other fee-based revenues are generally considered stable, recurring and predictable and are viewed positively. DBRS considers those entities that are reliant on gains on sale for revenue generation as having lower quality of earnings given that these gains can be volatile and unpredictable.

<table>
<thead>
<tr>
<th>QUALITY OF EARNINGS RATIOS (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on loans sale/revenue</td>
</tr>
<tr>
<td>Net interest income/revenue</td>
</tr>
<tr>
<td>Servicing and other fee income/revenue</td>
</tr>
<tr>
<td>Origination income/revenue</td>
</tr>
</tbody>
</table>

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. Two ratios, Net interest income as a percentage of revenues and Loan servicing fees as a percentage of revenues, are useful in identifying firms with strong recurring and predictable earnings.

**BUILDING BLOCK: EARNINGS PROFILE**

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Very Strong</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Passable</th>
<th>Weak</th>
<th>Very weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue generation &amp; Quality</strong></td>
<td>Powerful and resilient revenue generation supported by solid, extensively diversified mix across multiple business segments and/or geographic regions; high, very stable risk-adjusted NIM reflects resilient assets yields and consistently low funding costs</td>
<td>Strong revenue generation; above peer level of revenue mix across well-diversified business lines, customer segments and/or geographic regions; high, relatively stable risk-adjusted NIM reflects resilient yields and generally low funding costs</td>
<td>Largely solid revenue generation; above peer level of revenue mix across well-diversified business lines, customer segments/and/or geographic regions; high, but variable risk-adjusted NIM reflects yields and variable funding costs</td>
<td>Mostly solid revenue generation, with reasonable balance of net interest income and non-interest income for sector(s) in which it operates, diversification across business lines, customer segments/and/or geographic regions; high, but variable risk-adjusted NIM reflects yields and variable funding costs</td>
<td>Weakness in sources of revenue, balance and stability of net interest income and non-interest income, diversification across business lines or geographic regions; less stable, moderate risk-adjusted NIM with above average exposure to elevated funding costs</td>
<td>Weak and unstable revenue generation; below peer mix of revenues; weakening demand in key markets, customer segments or business lines; unstable, inadequate risk-adjusted NIM with significant exposure to elevated funding costs</td>
</tr>
<tr>
<td><strong>Expense control</strong></td>
<td>Well-established cost control culture with demonstrated ability to manage operating costs over time, consistent positive operating leverage; benefits from significant economies of scale</td>
<td>Robust cost control culture with strong ability to manage costs over time, consistently positive operating leverage; benefits from economies of scale</td>
<td>Adequate cost control culture with satisfactory ability to manage operating leverage; below optimal scale in some business lines</td>
<td>Weak cost control culture impacted by numerous one-off events and consistently weak operating leverage; suboptimal operations and little to no economies of scale</td>
<td>Weak cost control culture evident by weak operating efficiency ratios that are well above peers, inconsistent/weak operating leverage; insufficient scale to compete effectively</td>
<td>Very weak cost control evident by weak operating efficiency ratios that are well above peers, inconsistent/weak operating leverage; insufficient scale to compete effectively</td>
</tr>
<tr>
<td><strong>Ability to absorb credit and other charges</strong></td>
<td>A proven capacity to generate earnings/IBPT to consistently absorb credit or other losses with little or no history of capital invasion, given FinCo’s risk profile</td>
<td>A robust ability to generate earnings/IBPT to absorb credit and other losses with limited history of capital invasion, given FinCo’s risk profile</td>
<td>An adequate ability to generate earnings/IBPT to absorb credit and other losses with limited history of capital invasion, given FinCo’s risk profile</td>
<td>Earnings/IBPT lack resiliency to absorb credit costs with frequent episodes of capital invasion, given FinCo’s risk profile</td>
<td>Earnings/IBPT have limited cushion over credit costs and lack resiliency to absorb elevated credit costs, given FinCo’s risk profile; frequent episodes of capital invasion;</td>
<td></td>
</tr>
</tbody>
</table>
**Building Block (3) - Risk Profile**

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 FinCo has taken and how well it manages these risks. Indeed, weakness in risk management that results in unexpected losses can potentially lead to negative investor reaction and an inability to access the capital markets. A FinCo’s track record in managing risk, particularly its asset-quality performance, through economic cycles is a key rating consideration.

DBRS’s evaluation of a company’s risk profile begins with an understanding of the company’s risk management and control functions. For example, DBRS considers the make-up of the company’s risk committee at the Board level and the process for setting the risk appetite. Further, the risk reporting function is reviewed.

**Credit Risk Management**

Credit risk is typically the predominant risk taken on by most finance companies. DBRS views strong credit risk management as entailing sound underwriting and origination processes along with strong servicing and collections operations. In evaluating a company’s management of its credit risk, DBRS reviews the company’s underwriting standards; management of concentrations by geography, sector and product; and use of proprietary scoring models. Where relevant, the analysis will also consider policies regarding exceptions and the processes for managing and limiting exceptions. This also applies to constraints on portfolio risk, such as limits on certain types of loans or other financings. DBRS seeks information on revisions to underwriting criteria and the approval process for these revisions. Further, DBRS evaluates the process for updating the proprietary scoring model, including validation testing and approval process for model updates. From DBRS’s perspective, sound servicing and collections are a requisite for effective management of any loan or lease portfolio. As such, DBRS assesses the robustness of the servicing and collection IT platforms, training and practices. Further, to the extent relevant under national regulatory regimes, DBRS reviews regulatory compliance training and monitoring.

DBRS looks to a FinCo’s policy towards reporting loan delinquencies, as well as the use of loan modifications and forbearance practices, as a company’s policies in these methods can also mask asset quality issues. The most conservative method is reporting loans based on original contractual payment, where loans remain delinquent until original contractually due payments are received. However, lenders can report delinquencies using less conservative methods. These reporting methods often distort delinquencies, as loans that are current through the use of extensions and renewals may never be made current by the borrower. While DBRS’s view is that such payment arrangements are an integral part of prudent loan servicing the danger is that these collection techniques may push out recognition of loss. Nevertheless, DBRS does recognize that, in certain cases, the receipt of one, or just a few, delinquent payments positively impacts the ultimate evaluation of the loan. As appropriate and where data is available, the company’s actual cure rate for troubled loans is determined and compared to that of the company’s peer group. DBRS evaluates the volume, frequency and effectiveness of extensions and modifications, as compared to peers and to the FinCo’s own history.

Asset quality performance is reviewed and the prevailing trends analyzed in a process that involves the use of various ratios, loan origination data based on any internal rating scale and trends in customer creditworthiness and collateral coverage. DBRS notes that high origination volume can artificially lower credit ratios and, as such, the analysis would consider adjusting for this characteristic with FinCo’s that are in very rapid expansion. Alternatively, in situations of significant growth or noteworthy changes in underwriting practices, DBRS may request loan performance data on a static pool or vintage basis to better judge asset performance relative to expectations. DBRS looks to delinquency rates, roll rates and both gross and net loss rates as a preliminary gauge of asset quality. DBRS reviews the FinCo’s delinquency horizon to determine the length of time until asset repossessions and/or charge-off. Additionally, DBRS opines on the impact a FinCo’s charge-off policy has on the timing of the loss realization.

Credit risk and asset quality vary widely from institution to institution and are largely dependent on the FinCo’s mix of borrowers (credit profiles), asset classes and the degree to which the company retains or sells its risk exposures. 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, the analysis of delinquencies, net charge-offs (NCOs), roll-rates, provisioning and other traditional measures are not the entire asset quality story.

Concentration of exposure to large customers in the lending book can expose a FinCo to the weakening operating performance of one or more of these customers. This concentration in business can also expose the FinCo to decline in revenues should these customers lose confidence in the FinCo and take their business away. As a result, concentration in customer exposures can have a negative impact on the earnings power and credit performance of a FinCo. Given these risks, DBRS typically reviews a FinCo’s top twenty customers by outstanding balance and annual revenues to evaluate the risks posed by the extent of any concentration, where this risk is significant.
Further, DBRS looks at how well management copes with deterioration in credit performance by recognizing and addressing the problems. Additionally, management’s ability to properly gauge and adjust its loan loss provisions is also evaluated.

Reserve adequacy is assessed given the FinCo’s underwriting standards, loan mix and operating environment. Further, DBRS compares the levels and trends in reserves to those of the company’s peers in judging adequacy of reserves.

There are certain key ratios DBRS uses to track asset-quality measures. These ratios as well as historical trends in these ratios are reviewed for each FinCo and compared to industry peers. Managed asset quality numbers are used to compare the quality of the on-balance sheet portfolio to the entire portfolio.

### Other Elements of Credit Risk

Other elements of credit risk are also important for some FinCos. DBRS also looks to the risk of the firm’s balance sheet, through retained interests in securitizations, seller’s interests, servicing rights and other asset classes.

DBRS also looks to gauge the finance company’s exposures to single counterparties. This exposure could be in the form of a funding exposure to one or a small number of banks in the finance company’s banking syndicate or to a single (or closely related) counterparty in the finance company’s receivable portfolio. DBRS obtains and reviews the company’s largest single exposures.

<table>
<thead>
<tr>
<th>Asset Quality Ratios (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>60-day delinquencies/net receivables</td>
</tr>
<tr>
<td>NCOs/avg loans</td>
</tr>
<tr>
<td>Reserves/NCOs</td>
</tr>
<tr>
<td>Reserves/gross receivables</td>
</tr>
<tr>
<td>NPAs/owned receivables</td>
</tr>
<tr>
<td>Reserves/NPAs</td>
</tr>
<tr>
<td>NPAs/tangible common equity</td>
</tr>
<tr>
<td>NPAs/pre-provision income</td>
</tr>
<tr>
<td>Loss recovery ratio</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quality of Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill and intangibles/avg. assets</td>
</tr>
<tr>
<td>Mark-to-market assets/avg. assets</td>
</tr>
</tbody>
</table>

### Market Risk

For most FinCo’s market risk is generally comprised of interest rate risk. For those FinCo’s with substantial leasing portfolios, the exposure to residual value risk is also a significant source of market risk that is addressed in the risk assessment.

Given the importance of interest rate risk for finance companies, considerable attention is paid in the analysis to evaluating a FinCo’s exposure to interest rate risk and how well the FinCo manages this risk. The analysis considers the maturity profile of the company’s assets and liabilities. The underlying perspective is to understand how well a FinCo has aligned the characteristics of its funding with the characteristics of its funding needs related to loans, leases, and other assets as it relates to interest rate risk. For example, interest rate risk is generally reduced when a FinCo’s funding maturities are generally aligned with the maturities of its loans or when the base index and the timing of the rate reset of its floating rate instruments match that of its floating rate loans. Alternatively, such alignment can be achieved through interest rate swaps or other actions. As part of this process, DBRS reviews the company’s interest rate hedging strategies and use of derivatives, as well as the mix of variable and fixed funding and any potential mismatches including basis mismatch with the funded assets.

For most FinCo’s with substantial leasing portfolios, the exposure to loss from residual assets is a critical risk. Losses from residual assets occur when the value of a returned asset realized at disposition is below that of the book value. To gauge a FinCo’s residual value management, DBRS reviews the company’s residual value setting and depreciation methodology, and compares it to industry practice. Further, DBRS evaluates the FinCo’s asset remarketing abilities and channels for disposing of returned assets. Finally, DBRS compares actual performance of gains and losses from disposing of returned assets. 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 assets.
Operational Risk

Operational risk is an important consideration in evaluating a company’s soundness and the potential for unexpected 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 also monitors the company’s track record of managing headline risk, which DBRS considers elevated for all institutions that lend to consumers and small businesses.
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Analytical Assessment</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Passable</th>
<th>Weak</th>
<th>Very weak</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retail Credit Risk</strong></td>
<td>Low loss history, well-diversified portfolio mix by geography, sector &amp; product. Portfolios have characteristics such as: sizeable proportion of loans originated in-footprint, high proportion of secured loans v. unsecured loans; generally low LTV; owner-occupied; high level of primary lien position; strong borrower characteristics; self-origination; full recourse to borrower/guarantor; very strong servicing and collection capabilities</td>
<td>Strong retail credit risk profile is typically characterized by many of the strong risk profile with few attributes of weak risk profile</td>
<td>Satisfactory retail credit risk profile FinCo is typically characterized by attributes of very strong risk profile, but has some attributes of weak risk profile</td>
<td>Passable retail credit risk profile FinCo is typically characterized by attributes of very strong risk profile, but attributes of weak profile are more evident</td>
<td>Material loss history, concentrated portfolio by geography, sector &amp; product, sizeable proportion of out of footprint lending, high level of unsecured loans, high LTV loans, investor owned properties, high level of second lien positions, weak borrower characteristics, broker originated, limited recourse/guarantees; weak inconsistent servicing and collection capabilities</td>
<td>Material loss history, concentrated portfolio by geography, sector &amp; product, sizeable proportion of out of footprint lending, high level of unsecured loans, high LTV loans, investor owned properties, high level of second lien positions, weak borrower characteristics, broker originated, limited recourse/guarantees; very weak, inconsistent servicing and collection capabilities</td>
</tr>
<tr>
<td><strong>Wholesale Credit Risk</strong></td>
<td>Low loss history, well-diversified portfolio mix by geography, sector &amp; product. Portfolios have characteristics such as: granularity, high quality of collateral/loan to value, limited high LTV loans, a high level of subordinated positions, strong borrower characteristics, self-origination, full recourse to borrower/guarantor; very strong servicing and collection capabilities</td>
<td>Strong wholesale credit risk profile is typically characterized by many of the attributes of very strong risk profile with few attributes of weak risk profile</td>
<td>Satisfactory wholesale credit risk profile FinCo is typically characterized by attributes of very strong risk profile, but has some attributes of weak risk profile</td>
<td>Passable wholesale credit risk profile FinCo is typically characterized by some attributes of very strong risk profile, but attributes of weak profile are more evident</td>
<td>Material loss history, concentrated portfolio by geography, sector &amp; product, sizeable proportion of out of footprint lending, high level of unsecured loans, high LTV loans, investor owned properties, high level of second lien positions, weak borrower characteristics, broker originated, limited recourse/guarantees; weak inconsistent servicing and collection capabilities</td>
<td>Material loss history, concentrated portfolio by geography, sector &amp; product. Portfolios have characteristics such as: single-name concentration, low quality of collateral/security, high LTV loans, a high level of non-owner occupied positions, weak borrower characteristics, limited recourse to borrower/guarantor; very weak, inconsistent servicing and collection capabilities</td>
</tr>
<tr>
<td><strong>Market Risk</strong></td>
<td>Very low risk reflects either very well hedged interest rate risk, low FX risk, and very limited exposure to residual assets; OR very well managed market risk, which typically consists of: appropriate MM, requirements relative to balance sheet, very well hedged interest rate risk, proven ability to dispose of leased assets in excess of NBV, and low FX risk</td>
<td>Strong market risk profile is typically characterized by many of the attributes of very strong risk profile with few attributes of weak risk profile</td>
<td>Satisfactory market risk profile FinCo is primarily characterized by attributes of very strong risk profile, but attributes of weak profile are more evident</td>
<td>Passable market risk profile FinCo typically has some attributes of very strong risk profile with few attributes of the weak profile</td>
<td>Elevated market risk reflects either ineffective hedged interest rate risk, high FX risk and history of losses on disposal of real estate assets or sizeable impairment charges; OR poorly managed market risk, which typically consists of: sizeable MM requirements relative to balance sheet, ineffectively hedged interest rate risk, periodic losses on disposal of off-lease assets and high FX risk</td>
<td>High market risk reflects either ineffectively hedged interest rate risk, high FX risk and history of losses on off-lease asset disposal or sizeable impairment charges or sizeable impairment charges; OR poorly managed market risk, which typically consists of: sizeable MM requirements relative to balance sheet, ineffectively hedged interest rate risk, frequent losses from disposal of off-lease assets, and high FX risk</td>
</tr>
<tr>
<td><strong>Operational Risk</strong></td>
<td>Very strong operational capabilities and track record across organisation, immaterial regulatory issues and significant adaptability, successful history of managing reputational risk and legal risks, effective/harmonized technology and infrastructure</td>
<td>Strong operational risk FinCo has many of the attributes of the very strong risk profile with limited attributes of the weak risk profile</td>
<td>Satisfactory operational risk FinCo is primarily characterized by some attributes of the very strong risk profile balanced by some attributes of the weak risk profile</td>
<td>Passable operational risk FinCo typically has some attributes of the very strong risk profile with a few attributes of the weak profile</td>
<td>Weak operational capabilities and track record, especially if operating in numerous jurisdictions, noteworthy regulatory issues and weak adaptability, poor history of managing reputational risk &amp; legal risks, underdeveloped technology/infrastructure, weak disaster recovery plan</td>
<td>Very weak operational capabilities and track record, especially if operating in numerous jurisdictions, noteworthy regulatory issues and weak adaptability, poor history of managing reputational risk &amp; legal risks, underdeveloped technology/infrastructure, weak disaster recovery plan</td>
</tr>
<tr>
<td><strong>Risk Management</strong></td>
<td>Highly effective and established policies and processes, appropriate reporting lines, strong underwriting, proven loan loss reserve management, effective counterparty risk management, and sound remedial credit management; track record of very effective response to deterioration in credit conditions or environment</td>
<td>Strong risk management FinCo typically has many of the attributes of very strong risk profile with few attributes of the weak risk profile</td>
<td>Satisfactory risk management FinCo typically has attributes of very strong risk profile balanced by attributes of a weak risk profile</td>
<td>Passable risk management FinCo typically has some attributes of the very strong risk profile with limited attributes of the very strong profile</td>
<td>Improperly and poorly defined policies and processes, inappropriate reporting lines, weak underwriting, unproven loan loss reserve management, ineffective counterparty risk management and weak remedial credit management; track record of weak, ineffective response to deterioration in credit conditions or environment</td>
<td>Risk management processes are considered weak overall. Policies and processes are not properly defined, inappropriate reporting lines, weak underwriting, unproven loan loss reserve management, ineffective counterparty risk management and weak remedial credit management; track record of weak, ineffective response to deterioration in credit conditions or environment</td>
</tr>
</tbody>
</table>
Building Block (4) Funding and Liquidity

FinCos’ funding profile and their funding management are key factors in their intrinsic credit strength. Closely related are the strengths of their liquidity position and their ability to withstand stress on their funding. Finance companies in general are dependent on wholesale funding, which is typically more susceptible to the loss of confidence than retail deposits. The need for FinCos to have well-developed, diverse funding sources is essential for wholesale market-funded companies. However, some FinCos benefit from retail funding, predominantly through ownership of a bank or other deposit taking institution. Other FinCos are part of a larger organisation and can benefit from the strength of the parent organisation and its ability to provide funding. The analysis considers these structures and their contribution to the funding profile of the FinCo. The financial crisis of 2008/2009 tested the liquidity position of many firms, as well as their contingent funding plans. One of leading causes of failure among FinCos is the combination of a loss of its access to funding and its limited liquid resources that would enable it to survive this loss of access. Those FinCos with strong funding and liquidity profiles are better able to cope with funding stress and maintain or restore capital market funding within a reasonable period.

The profile of a FinCo’s funding has several dimensions, including the sources, maturity, collateralization/securitisation and seniority of its funding. Stronger profiles generally demonstrate diverse stable sources with a balanced maturity profile and appropriate used of collateral/securitisation with some unencumbered assets. DBRS views a well-developed funding profile as a FinCo’s first layer of protection against a liquidity crisis. Indeed, to minimize the risk of a liquidity crisis, in the case of a market disruption, a FinCo should remain active in multiple funding channels and not be overly dependent on any one single funding source. Funding from multiple sources and channels can provide stability to funding and provide alternatives should one market face a disruption.

While a diverse and stable funding profile is critical, a funding profile that is not properly aligned with the asset base can increase the exposure of a finance company to firm specific or market wide liquidity events. The usage of short-term debt to fund longer-dated assets, for example, exposes the company to liquidity stress if it is unable to roll the short-term funding. As a result, DBRS reviews a company’s asset-liability management reporting and funding philosophy, including funding mix targets in relation to the expected behavior of the assets. DBRS recognizes that the positive attributes of securitization, particularly those structures in which the assets are funded for their life, thereby largely eliminating refinancing risk. Nonetheless, securitization can result in asset encumbrance, which can reduce financial flexibility.

DBRS’s analysis of liquidity focuses on the sources of funding, the alignment of the characteristics of its funding with the characteristics of the loans and other assets being funded, the form of liquidity, the quantum of available liquidity as compared to requirements and the stability under changing economic and interest rate environments. Contingency liquidity plans should include sufficient committed long-term funding and reliable additional borrowing capacity from various sources to continue operations without major disruptions. Importantly, the contingency liquidity plans to deal with potential funding dislocations are reviewed. DBRS considers the risk profile and the stability of earnings generation in determining the minimum timeframe of liquidity coverage, but in most cases DBRS views 12 months of liquidity as the minimum acceptable level of liquidity for being able to achieve investment grade ratings. Moreover, DBRS will compare a company’s liquidity plan/coverage to those of its peers in assessing the appropriateness of the timeframe to required funding. For commercial paper programs, DBRS views committed 100% back-up facilities as the standard.

The sources of liquidity are important. DBRS views unrestricted cash and committed unsecured facilities to be the most reliable form. DBRS reviews the bank counterparties to the facilities and the length of these banking relationships as well as other banking products utilized by the company. Moreover, DBRS reviews any material adverse change clauses (MACs) and financial covenants that may preclude the company from accessing the facility in certain scenarios. If a finance company holds a securities portfolio, DBRS will review the quality and liquidity of those securities and will apply a haircut to valuations where appropriate.

Finance companies whose operations include entities with bank charters may be rated higher than their peers with similar profiles that do not have such charters, due to superior liquidity, funding flexibility and increased regulation. The bank or similar charter provides access to deposits, as well as access to central banks and other sources of official funding (e.g., the Federal Home Loan Bank (FHLB) advances). This funding flexibility can reduce the firm’s reliance on wholesale funding and may provide back-stop liquidity. In the assessing the position of finance companies with deposit gathering abilities, DBRS will review the deposit base applying elements of DBRS’s Global Banking Methodology.
Key ratios for liquidity and funding profile include the following:

<table>
<thead>
<tr>
<th>Liquidity Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits/total funding base (%)</td>
</tr>
<tr>
<td>Short-term debt/total debt (%)</td>
</tr>
<tr>
<td>EBITDA/debt maturing in one year</td>
</tr>
<tr>
<td>Liquidity Coverage (Available Liquidity-to-Next 12 months maturities)</td>
</tr>
</tbody>
</table>

In general, FinCos make extensive use of both secured and unsecured funding, but typically are more reliant on secured funding than banks. This often leads to structural subordination for senior unsecured obligations. 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 unsecured creditors in the case of a default, placing the unsecured lender in a subordinate position. DBRS reviews the amount and quality of 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 issuer debt rating, to reflect the structural subordination.
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Very Strong</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Passable</th>
<th>Weak</th>
<th>Very weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funding mix</td>
<td>Exceptionally strong and resilient funding profile underpinned by a diversity of funding channels; sizeable sources of very stable funding, such as deposits; wholesale funding sources are very well diversified, deep and dependable; good, flexible balance of secured and unsecured funding appropriate for business mix</td>
<td>Very strong and resilient funding profile underpinned by diversity in funding channels; some sources of very stable funding, such as deposits; wholesale funding sources are diversified, deep and dependable; good flexible balance of secured and unsecured funding appropriate for business mix</td>
<td>Strong and resilient funding profile underpinned by diversity in funding channels; some sources of very stable funding, such as deposits; wholesale funding sources are diversified, deep and dependable; good flexible balance of secured and unsecured funding appropriate for business mix</td>
<td>Solid and resilient funding profile with diversity in funding sources such that there would be alternatives if funding challenges arose in one source; some sources of very stable funding, such as deposits; wholesale funding sources are generally diversified, deep and dependable; good balance of secured and unsecured funding appropriate for business mix</td>
<td>Less robust funding profile with reliance on securitization or other secured funding as a funding sources; reliance on less diversified and relatively less reliable wholesale funding sources</td>
<td>Weak or challenged funding profile typically reliant on a single wholesale funding channel with little to no diversity in funding sources</td>
</tr>
<tr>
<td>Alignment of funding sources and their uses</td>
<td>Funding profile is very well aligned with the nature, scale and maturity of the assets being funded</td>
<td>Funding profile is broadly aligned with the nature, scale and maturity of the assets being funded</td>
<td>Generally well aligned funding profile with some mismatches in the nature, scale and maturity of the assets being funded</td>
<td>Generally aligned funding profile with some sizeable mismatches in the nature, scale and maturity of the assets being funded</td>
<td>Overly reliant on limited funding sources; significant mismatches in the nature, scale and maturity of the assets being funded</td>
<td>Generally reliant on one channel of funding with limited providers; substantial mismatches in the nature, scale and maturity of the assets being funded</td>
</tr>
<tr>
<td>Ability to withstand a stressed environment</td>
<td>Well-established contingency funding plan is in place supported by accessible emergency liquidity sources and on balance sheet liquidity through cash, securities and a high level of unencumbered assets relative to potential liquidity needs; typically backstopped by highly rated parent</td>
<td>Well-developed contingency funding plan is in place supported by a high level of unencumbered assets relative to potential liquidity needs supported by an accessible liquidity buffer and relatively reliable emergency liquidity sources; well rated parent can be important source of support</td>
<td>Solid, well-developed contingency funding plan is in place supported by a strong level of unencumbered assets relative to potential liquidity needs supported by an accessible liquidity buffer and relatively reliable emergency liquidity sources</td>
<td>Contingency funding plans are in place and viewed as acceptable. An appropriate level of unencumbered assets relative to potential liquidity needs supported by an accessible liquidity buffer and relatively reliable emergency liquidity sources</td>
<td>Limited unencumbered assets and/or a high level of encumbered assets relative to potential liquidity needs supported by a modest liquidity buffers</td>
<td>Contingency plans are either nonexistent or insufficient given requirements and narrow funding profile. High level of asset encumberance restricts flexibility.</td>
</tr>
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</table>
Building Block (5) - Capitalisation
Assessing a FinCo’s capitalisation is the final building block in the rating process and has links to the prior building blocks. This assessment involves considering both the FinCo’s available capital and the risks that this capital needs to address. Strong capitalization implies that a FinCo has ample capital to cope with the risks inherent in its business and risk profile under diverse economic environments and financial market conditions.

The fundamental purpose of a FinCo’s capital is to provide a buffer to protect its liability holders from loss. Strong capitalisation is important for a FinCo to retain the confidence of investors and counterparties. A simple measure of capital is the difference between a FinCo’s assets and liabilities. A larger difference makes it more likely that liability holders would be paid in full, if the FinCo were to be wound up. In practice, a FinCo’s capitalisation is more complicated. Adjustments to capital are necessary, because this difference may not reflect the resources that would actually be available. Capital may have to be adjusted for potential calls on capital that are not reflected in the FinCo’s assets. As FinCos are highly levered (or geared), the level of capital can vary substantially with only a modest change in the values of its assets or liabilities.

Links to Other Building Blocks
Strong earnings power reflected in resilient underlying earnings provides the best protection for bondholders, as these resources can absorb the impact of adverse events without invading capital. An important consideration in assessing the need for capital is the scale of losses that a FinCo could absorb out of income before provisions and taxes on a current basis, as well as in a stressed environment. Also considered is the ability of the FinCo to generate capital from operations to sustain balance sheet growth, make strategic acquisitions and accommodate required capital expenditures, as well as management’s practice in prioritizing capital adequacy relative to meeting shareholder expectations regarding return on equity. Besides these connections to the other building blocks, the ability of a FinCo to raise new capital is also likely to reflect the strength of its franchise. Strong capital also bolsters the confidence of debt holders, counterparties and other creditors helping to strengthen funding stability and reducing the risk of an increased liquidity pressure. Strong capital enables a FinCo to remain solvent despite losses, continue to operate and return to profitability.

The analysis of a FinCo’s capitalization generally considers:
- The scale and structure of a FinCo’s capital and its ability to protect the FinCo and its liability holders.
- The adequacy of this capital in light of the FinCo’s risk profile and earnings power.
- The FinCo’s management of its capitalisation, the assessment of its risk profile, need for capital, evaluation of its businesses risk and allocation of capital to ensure appropriate management of business risk
- Capital flexibility including the FinCo’s capacity to generate capital, policies on dividends and share buybacks.
- Where appropriate, the analysis also considers the importance of the regulators in determining the adequacy of a FinCo’s regulatory capital and how well the FinCo meets these requirements.
- Determining size of the FinCo’s capital cushion above required levels, whether internal, regulatory or DBRS’s.

Measuring a FinCo’s Capital and its Structure
- **Equity Capital** The primary component of a FinCo’s capital is its book equity, which is the difference between its reported assets and liabilities. This capital generally equates to common equity and preferred shares.
- **Common Equity** DBRS views common equity as the best protection for a FinCo’s obligors and other counterparties, as a FinCo can readily absorb losses through common equity and continue to function.
- **Preferred Shares** Preferred shares as equity also provide protection for liability holders, but they cannot readily absorb losses. A FinCo’s quality of capital is viewed as weaker the more it relies on preferred shares.
- **Hybrid Securities** Hybrid securities are instruments that have characteristics that are between preferred shares and subordinated debt instruments with mandatory payments and fixed maturity. The principal driver for the use of hybrids is their acceptance for regulatory calculations of Tier 1 capital and the analysis views them positively in so far as they contribute to a FinCo meeting the regulators requirements. DBRS does not give equity credit to hybrid instruments for FinCos.
- **Contingent Convertible Instruments** These instruments, commonly called CoCos, have various triggers that result in the conversion of the instrument. Most of the conversions are to common shares based on specified exchange ratios subject to floor prices. But some conversion terms have a specific recovery rate that can be as low as zero, and some conversions are reversible. The underlying instrument is generally preferred shares or subordinated debt, but can be senior debt. Thus, CoCos are different from most of the existing hybrids, although some hybrids do contain contingent conversion features. So far, these instruments have been issued by financial institutions seeking to bolster their regulatory capital. Depending on their specifications, CoCos may count towards Tier 1 capital regulatory requirements, but not all CoCos meet the necessary specifications and may only count towards Tier 2 capital.
- **DBRS views those FinCos whose capital is predominantly common equity with limited preferred and hybrid securities as having higher quality capital, making them better positioned for a given level of capital to ride out an adverse environment.**
Adjusting Finance Company Capital for Selected Asset Valuations

Certain adjustments to a FinCo’s capital may be made to provide a better assessment of the resources that would be available to protect debtholders and other counterparties in a deteriorating environment. Where feasible and appropriate, adjustments are made for selected assets whose value is likely to deteriorate.

Adjustment for Intangibles

Reducing the value of intangibles is the prime example of this type of adjustment. Tangible common equity assumes that goodwill and certain other intangibles have little or no value under the rationale that the additional value ascribed to goodwill is likely to be dissipated by a FinCo’s deterioration. Thus, tangible common equity reflects a FinCo’s capital under stressed conditions. For FinCos subject to bank regulations, the regulatory capital rules ascribe no value to goodwill and certain other intangibles. Deferred tax assets are another area where adjustments may be made, if the analysis indicates a FinCo would have difficulty in realizing these tax benefits by generating sufficient profits in the future, particularly if this is made less likely in a stressed scenario.

Volatility from Mark to Market Accounting

Another challenge in assessing the adequacy of a FinCo’s capital is the increasing volatility that may result from accounting rules that are expanding the extent to which FinCo balance sheets are marked to market. Currently, accumulated other comprehensive income (AOCI) impacts common equity, but only flows through income, if it is determined to be “other than temporarily impaired” (OTTI). Illiquid assets are another area that could result in adjustment of capital for potential valuation reductions. Certain liabilities are also being marked to market. The potential for procyclical adjustments can be a concern in the analysis. Depending on the composition of a FinCo’s businesses and balance sheet, DBRS may incorporate the additional risk from future valuation changes in components of the bank’s balance sheet.

<table>
<thead>
<tr>
<th>Quality of Capital Ratios (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred securities/total equity</td>
</tr>
<tr>
<td>Goodwill and other intangibles/total equity</td>
</tr>
</tbody>
</table>

Capital Ratios and the Adequacy of a FinCo’s Capitalisation

A variety of measures are employed to evaluate the strength of a FinCo’s capitalization. The complexity of measuring capital and assessing a FinCo’s risk profile limits each measure. There is no single measure that captures all the elements that determine a FinCo’s capitalization. To illuminate different perspectives on a FinCo’s capital position, the analysis employs a matrix approach using various measures to help establish how well a FinCo is capitalised. These measures are identified and discussed below. Under this approach, the analysis considers a FinCo’s capitalization by looking at the FinCo’s position across these measures. The simplest cases are those where a FinCo that is weak on all measures or strong on all measures. In many cases, however, there is a mix across the various measures that have to be considered in concluding on the FinCo’s overall capitalization. This conclusion also takes into account a variety of other aspects of the FinCo’s position, including ability to generate organic capital from earnings and the overall risk profile of the FinCo.

Total Equity / Total Assets The simplest capital ratio is the ratio of total equity to assets, which indicates how well a bank is protected from insolvency due to a decline in the value of its assets on a book value basis, where total equity includes both common and preferred equity.

Common Equity / Total Assets This ratio stresses the amount of common equity that could be used to absorb losses versus a decline in the value of its assets on a book value basis.

Tangible Common Equity / Tangible Assets (TCE/TA) This ratio deducts goodwill from common equity as well as from total assets to provide a better measure of the adequacy of capital adjusted for the potential that goodwill and other intangibles are written down in a stressed environment.

Regulatory Capital Ratios

Regulatory capital ratios reflect two types of adjustment:

- Adjustments to book capital to provide a better measure of capital in protecting a FinCo’s liability holders
- Using the risk weighting of assets to provide better measures of the risks that capital must protect against. The resulting risk weighted assets (RWA) is a better measure of a FinCo’s risk profile than simple assets that include allocations for risks that are not “on-balance sheet”, such as commitments, market risk and operational risk.
These ratios are generally applicable to FinCo’s that are banks or have banking subsidiaries and so are treated as banking organisations by the regulators.

**Tier 1 Ratio (Tier 1 Capital/RWA)** Tier 1 regulatory capital excludes most intangibles and AOCI; this AOCI exclusion is changing under Basel III and other regulatory changes. However, Tier 1 capital includes qualifying hybrids, subject to certain limits.

For a FinCo’s RWA, credit risk is calculated by utilizing weights by asset type based on credit risk. Average risk assets get 100% weighting. Low risk assets get weightings below 100%, while high risk assets get percentages above 100%. RWA equivalents are assigned for off-balance sheet exposures, such as commitments. RWA equivalents are generated for market risk and most elements of operational risk, but not strategic or reputational risks. This process continues to be refined over time, evolving from the relatively simple process under Basel I, to the more complex and more inclusive processes under Basel II, and more refinement under Basel III.

**Core or Common Tier 1 Ratio (Common Tier 1 Capital/RWA)** This ratio only includes common equity components of Tier1 capital to focus on the loss absorbing capabilities of capital for banks as going concerns.

**Tier 1 Leverage (Tier 1 Capital/Exposure Measure)** This ratio assesses leverage against exposure that is not risk adjusted. It has historically been used in the U.S., where the exposure measure has been tangible assets. With more concern about leverage, a form of these ratios is now being implemented under Basel III. It is generally more constraining than the other Basel capital ratios, as assets are not risk-adjusted. Currently, this leverage ratio is defined as the ratio of Tier 1 capital divided by a non-risk based measure of total exposure. The current regulatory minimum is established at 3%. The exposure measure includes more than just total assets, for example, it also includes off-balance sheet exposures such as commitments. It also permits limited netting of derivative exposure with the same counterparty. The specifics for the Basel III leverage ratio continue to evolve. While full implementation is still some years away under Basel III, some countries are implementing more quickly with their own variations of the specifications.

**Tangible Common Equity/RWA** Taking advantage of the regulatory risk weightings, DBRS considers the ratio of tangible common equity to RWA. Reflecting DBRS’s preference for common equity over hybrids as a cushion for bondholders and other senior creditors, this ratio excludes the hybrid securities that are given full weight by the regulators, up to certain limits, but incorporates AOCI, which reduces capital if it is negative.

**Cushion over Regulatory Requirements** A useful yardstick for capital adequacy is the scale of a FinCo’s cushion above regulatory requirements. With increased concerns about the adequacy of banks’ capitalisation at a time of uncertainty about asset values and future credit costs, regulators have elevated their requirements for banks to maintain higher capital ratios than in the past and have built in capital cushions to help banks cope with stressed environments. Systemically important banks also face capital add-ons to ensure that their regulatory capitalization reduces the systemic risk that they pose. Increased use of stress testing by regulators has added the potential for regulators to require increased capital for banks to cope with the stressed scenarios. Thus, banks generally are required to be better capitalised. The analysis evaluates the capital requirements for a bank that take into account its particular characteristics and the regulatory requirements as warranted, as well as considering the potential impact or results of any stress tests.

Leverage varies greatly between participants in the finance company sector. DBRS assesses the level of required capital in the context of the company’s risk profile as determined above. All other things being equal, the higher the risk profile of the balance sheet and/or more volatile the earnings profile of a finance company the lower the tolerance DBRS has for leverage.

Along with the quantity and quality of capital, a company’s capital management plans are an important consideration in the rating process. DBRS considers management’s targets for leverage, capital ratios and capital distribution. Indeed, DBRS reviews management’s practice of paying dividends and its stock repurchase activity. A high dividend payout rate could be constraining, as shareholders may come to expect the same amount of dividends in the future irrespective of the company’s earnings. Moreover, DBRS considers a company’s asset growth rate compared to its internal capital generation retention rate. As these growth rates can be volatile on a short-term basis, DBRS looks to long-term trends and views companies with asset growth rates in excess of capital retention rates as likely to be riskier with more leveraged balance sheets, potentially weaker provisioning levels and substandard investment in the firm’s infrastructure and businesses, particularly its origination, servicing and risk management systems.
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Very Strong</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Passable</th>
<th>Weak</th>
<th>Very weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital cushion and the ability to absorb losses</td>
<td>Capital levels and ratios provide an exceptionally robust buffer to absorb unexpected outsized losses with leading capital levels and ratios amongst the peer group, and well-below peer group leverage</td>
<td>Capital levels and ratios provide an strong buffer to absorb unexpected outsized losses with upper tier capital levels and ratios amongst peers, and below to low leverage relative to peers</td>
<td>Capital levels and ratios provide an ample buffer to absorb unexpected sizeable losses with upper tier capital levels and ratios amongst peers, and low to mid leverage relative to peers</td>
<td>Capital levels and ratios provide a solid buffer to absorb losses with mid-tier capital levels and ratios amongst peers, and mid to high leverage relative to peers</td>
<td>Capital levels and ratios provide a limited buffer to absorb losses with mid-to-lower tier capital levels and ratios amongst peers, and very high leverage relative to peers</td>
<td>Capital levels and ratios offer minimal to very little protection against losses with weak to poor capital levels and ratios, and very high leverage relative to peers</td>
</tr>
<tr>
<td>Mix &amp; Quality</td>
<td>Capital is completely comprised of tangible common equity</td>
<td>Capital is comprised almost entirely of tangible common equity, with small levels of non-core equity elements, such as intangibles and preferreds</td>
<td>Capital contains a low level of non-core equity elements, such as intangibles and preferreds</td>
<td>Capital contains a moderate level of non-core equity elements, such as intangibles and preferreds</td>
<td>Capital contains a material level of non-core equity elements, such as intangibles and preferreds</td>
<td>Capital contains a sizeable level of non-core equity elements, such as intangibles and preferreds</td>
</tr>
<tr>
<td>Generation and Flexibility</td>
<td>Powerful and consistent internal capital generation ability and/or appropriate dividend/share repurchase policy provides flexibility aligned with business and capital needs</td>
<td>Robust and reliable capital generation ability and/or an appropriate dividend/share repurchase policy aligned with business and capital needs</td>
<td>Strong and generally consistent capital generation ability and/or an appropriate dividend/share repurchase policy aligned with business and capital needs</td>
<td>Adequate but less consistent internal capital generation ability, and/or a more aggressive dividend/share repurchase policy</td>
<td>Limited and inconsistent internal capital generation ability and/or an inappropriate dividend/share repurchase policy</td>
<td></td>
</tr>
</tbody>
</table>
IV. Rating Considerations Beyond the Five Building Blocks

In addition to the five interconnected building blocks, DBRS also notes that the following considerations can be critical considerations in the final rating for a finance company.

The Corporate and 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 and ownership. DBRS begins with the ownership structure and the degree of separation between a parent company and its finance arm. For wholly- or partially-owned finance companies, 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 intrinsic assessment 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. Where an unconditional guarantee is in place, DBRS will likely rate the finance company the same as the parent (assuming a higher-rated parent). Where support is minimal, then little or no parental support is factored into the rating. Refer to DBRS’s “Rating Parent-Holding Companies” and DBRS Criteria – Support Assessments for Banks and Banking Organisations for additional detail.

Bank Ownership / Relationships to parent organisations:
A FinCo that owns a bank charter may have the ability to utilize generally more stable deposit funding to the extent that it can originate and sell its loans to the bank or originate its loans within the bank. These activities are constrained by regulatory requirements that vary across countries by type of lending. The analysis also considers the stability of the deposits raised by the bank, as deposits raised by a full service bank are typically more stable than those attracted simply by paying relatively high rates with limited banking services. If meaningful in relative size, the bank can add significantly to a FinCo’s funding diversity; but the ability of the bank to provide funding to its FinCo parent is typically constrained by regulation. Banking subsidiaries may also provide avenues to add business lines to the franchise that provide additional diversification and/or regulation that are viewed positively in terms of the DBRS credit assessment.

A finance company that is owned by a banking organisation that is systemically important may benefit from external support from the sovereign or other authorities that strengthens the overall credit assessment of the banking-organisation parent. In most cases, the benefit of internal support will hinge largely on an assessment of how important the finance subsidiary is to the parent organization. In exceptional cases, if any external support is factored into the rating of the finance company, it would reflect the systemic importance of the finance company and the likelihood of external support as evaluated under the DBRS Criteria – Support Assessments for Banks and Banking Organisations.
V. Impact Of Related Methodologies and Criteria – Final Rating and Ratings for Specific Securities

Once DBRS has determined the intrinsic assessment for the FinCo, there are several other methodologies and criteria that may be applicable in determining the final Issuer Rating and all ratings for specific securities. Some of the more frequent criteria used for FinCos are as follows:

Rating Holding Companies and Their Subsidiaries (January 2014)
• The criteria discusses the DBRS approach to rating parent/holding companies, which will in some cases also have implications for the ratings of the subsidiaries that are held by the parent organization.
• The application of this criteria means that most Holding Companies are rated one notch below the rating of the Operating Finance Company, should both borrowing entities exist.

Global Methodology for Rating Banks and Banking Organisations (July 2014) and DBRS Criteria for Support Assessments for Banks and Banking Organisations (January 2014)
• As noted in the introduction of this methodology and section III above, where appropriate, DBRS will use the Global Banking Methodology and the Support Assessment criteria along with this methodology when assessing FinCos with banking operations. In the absence of meaningful support related to a banking relationship, ratings on FinCos are based primarily on the intrinsic strength of the rated entity.

Impact of Sovereign Ratings (March 2011)
• DBRS credit ratings are subject to consideration of the sovereign risk of the country in which the issuer of the security is domiciled. This is not only because of the central government’s wide-ranging powers, but also because of the extensive influence of the central government on taxation, business profitability and employment decisions.
• As a general rule, these powers and controls suggest that FinCos should be rated no higher than the relevant central government. It would be unusual for a predominantly domestic FinCo to be rated above the sovereign local currency rating, given the linkages between the financial sector and the government. Government regulations and other actions have a direct impact on financial institutions and could constrain a financial institution’s debt servicing capacity. In the case of FinCos that are not predominantly domestic, it is possible that the linkages noted above may represent less of a concern, and this can allow for ratings to exceed the domestic sovereign rating. (For additional information, see DBRS commentary “Sovereign Ratings Provide a Benchmark for other DBRS Credit Ratings – March 2011”).
APPENDIX A – Captive Finance Companies

RATINGS FOR CAPTIVE FINANCE COMPANIES ARE TYPICALLY VERY CLOSE TO THE PARENT

The strength of the parent is typically a key consideration and often a limiting factor for establishing the credit strength of a captive finance company (CFC). DBRS defines a CFC as an entity whose main purpose relates to providing financing for customers to buy the products of the operating parent or in the case of retail companies, facilitate sales from the parent company’s stores. Typically, the finance entity is a wholly owned subsidiary of the parent.

By their nature, CFCs have at least three risks that are normally not present at their parent operating entities: high leverage, interest rate sensitivity and credit risk. However, if these are well managed, the “stand-alone” credit strength of the CFC may be stronger than its parent due to several potential advantages:

- CFC earnings may be less sensitive to economic and industry conditions, as the interest spread business has at least some annuity-like characteristics provided the CFC appropriately aligns its funding and lending characteristics, such as maturities and interest rate flexibility. In contrast, the parent may face less flexible costs for production and staff benefits (pensions, healthcare etc.) that may impact its profitability and its rating, but not its ability to manufacture and sell its products.
- The underlying assets being financed by the FinCo’s lending portfolio are typically well diversified, relatively liquid, easily identifiable and mobile. More mobile assets, such as loans or leases, are ones that can have the servicing transferred or even the asset itself transferred to another owner. The parent typically has a high proportion of assets that are non-liquid and have specific uses related to the parent’s operations.
- Given that the average age the financial assets held by the CFC are typically much shorter than the physical assets of the parent, the CFC’s balance sheet is typically more liquid than that of the parent.

However, in rating the CFC, DBRS gives considerable weight to the strength of the parent because of the following considerations:

1. The CFC is heavily dependent on the parent as its receivables are generated by the sale of the parent’s manufactured products or customer purchases at the parent’s store location. Given that the primary business of the CFC relates to the products of the parent, it would typically be affected by problems at the parent. Any major challenges at the parent could threaten the operations and asset values of the CFC and under worst-case scenarios (defaulting or a bankruptcy filing), it is difficult to envision a situation where the CFC would be able to continue as an ongoing operating entity, if the parent could no longer manufacture or closes store locations. As a result, a defaulting action by the parent could potentially result in the same action by the CFC.

2. For CFCs that are not regulated or are only lightly regulated and wholly-owned, the operating company has some power in terms of areas such as dividends and intercompany transactions. As such, difficulties at the operating entity could easily translate into balance sheet and other pressures for the CFC.

3. The parent and its CFC typically have a high degree of sharing in areas such as strategy, management, marketing, and in some instances, financing incentives/subsidies. In general, the parent provides a high level of support to the CFC and the level of interdependence and business ties between the two entities means that their long-term prospects are closely linked.

These factors meaningfully limit the degree to which even strong CFCs can be rated above their respective parent companies.

CIRCUMSTANCES WHEN CFCs COULD BE RATED LOWER THAN THE PARENT

A CFC would typically be rated lower than its parent under the following circumstances:

1. There is no guarantee from the parent for the CFC’s debt and other support agreements, such as keep wells, are considered inadequate in some respect.

2. The CFC’s key metrics are not considered strong, so that the stand-alone strength of the CFC would be considered as below the rating of the parent.

3. The financing provided by the CFC for the parent’s products would not be considered as a “core” activity to the parent. A “core” activity or product line would be one which a parent would have major difficulty continuing without, and would make every effort to support so that the finance operation could be maintained.
Any product lines outside of those with the parent are not important sources of strength.

CIRCUMSTANCES WHEN CFCs COULD BE RATED HIGHER THAN ITS PARENT

Despite the aforementioned factors, there are cases in which a CFC’s rating could be higher than that of its parent. In most cases, the difference would be limited to one notch. To exceed this limit, the CFC would have to be less than 50% controlled by the parent and there would have to be some comfort that the CFC had a franchise that would not be meaningfully damaged by major challenges at the parent. To achieve this, the CFC would likely need meaningful product lines beyond those related to the parent. These situations are expected to be infrequent and would be considered on a case-by-case basis.

In most cases, the CFC would not be eligible for a rating more than one notch above its parent. To determine when the one notch benefit is applicable, DBRS uses the following considerations (assuming that the one-notch benefit would be warranted by the relative strength of the CFC on a stand-alone basis.) The following factors are not meant to be exhaustive. Other relevant factors would also be examined on a case-by-case basis.

(1) The value of CFC’s assets and the ability of the CFC to independently pledge its assets to secure funding without interference from the parent

DBRS considers the value of a CFC’s assets under various negative scenarios and the likelihood that creditors of the CFC would have first claim on its assets. Strength in both areas increases the possibility that the CFC’s IA, could be higher than that of its parent. Relevant factors to consider would typically include:

- Creditors of the CFC have first claim on its assets (Are there criteria used by a bankruptcy court to determine if the CFC is an extension of the parent and not a separate company for the court proceedings, i.e., legal ring fencing?)
- Are there any present or potential abilities for the parent to infringe on this first claim ability through intercompany transactions, dividend policies or other means?
- Is there an expectation that under a worst-case scenario, the parent would be restructured rather than liquidated? (This has an impact on the value of the CFC’s assets. Both wholesale and retail asset values would be much higher in a restructuring versus liquidation.)
- Value retention of the financed assets (with recognition for both retail and wholesale) under bankruptcy/restructuring or liquidation type scenarios
- CFC’s finance receivables are liquid, mobile and diversified.

(2) The relationship between the CFC and the parent

The greater the extent to which the CFC and its parent operate in unison, the less support there is for considering the CFC as “separate” and assigning it a higher rating than the parent. Relevant factors to consider would typically include:

- Support agreements or cross-default covenants in existence between the CFC and the parent (with support including keep well type agreements).
- Preponderance of financing incentives, intercompany obligations or transfer pricing arrangements between CFC and the parent.
- With respect to transfer pricing arrangements, are they established: i) on market terms ii) on a subordinate basis relative to other debt iii) with any demand or acceleration provisions?
- Ownership structure, ability for this ownership to change.
- CFC’s dividend policy, the level of payout, and CFC’s flexibility to adjust the dividend payout independently.
- CFC is separate from parent with respect to functions such as strategy, systems and marketing?
- CFC has a separate board which includes independent directors.
- CFC has a mix of third party and wholesale receivables.
- The size of the CFC relative the parent.

(3) The stand-alone strength of the CFC

If the CFC has no ability to maintain its operations should the parent encounter default, bankruptcy or liquidation-type scenarios, there is less rationale for rating the debt of the CFC higher than that of its parent. Relevant factors to consider would typically include:

- Allowing for the relationship with the parent, is the CFC profitable? Specifically, does the parent make up the differential needed to ensure the commercial terms for the CFC’s portfolio reflect market terms and values (i.e., any implicit subsidy is financed by the parent not the subsidiary)?
- To what extent does the CFC have profitable operations not related to the parent’s products?
• If the parent were to cease manufacturing products, what is the likelihood that the CFC would be able to remain a going concern? What is the ability of the FinCo to manage any resulting decline in residual values that could be significant? Is there availability of spare parts to keep existing products functioning? Are there third parties that could fill the gap with new products?
• Does the CFC have appropriate bank lines and securitization ability separate from the parent?
• How strong are the capital and asset quality metrics, and future expectations of such at the CFC (with appropriate adjustments for off-balance sheet aspects)?

(4) The level of ratings in the credit spectrum
Lastly, DBRS considers the rating level of the operating entity, as it is typically more difficult for a CFC to be rated above the parent when the parent itself is highly rated because the strength of the parent’s brand, market position, earnings and other characteristics that underpin the parent’s rating are too important to the underlying rating of the CFC.
APPENDIX B – Auto Finance Companies

Within the larger sector of finance companies, auto finance entities have a number of differentiating factors that DBRS considers in its analysis. In some cases, the additional factor is new and in other cases it will be an extension or carry a more critical weighting in the overall analysis. Auto finance companies have various characteristics in common regardless of whether they are captives or non-captives. Here DBRS primarily address those common characteristics that feed into the basic analytical framework discussed above. The discussion in Appendix C addresses issues related specifically to captives, including auto finance company captives. These various factors are integrated into the analysis of the individual building blocks and considered when combining the blocks to derive the final rating.

These considerations for auto finance companies include the following:

- Given certain characteristics of servicing and collections in the automotive finance space, DBRS evaluates the origination and servicing platforms in assessing the risk management capabilities of auto lenders. DBRS also considers the ability of the company to manage forecasted lending volumes by reviewing staffing levels and training programs in place for servicing and collection personnel, compliance with and ability to respond to changing regulatory requirements, and overall, investment in these critical areas of operation. Moreover, DBRS looks at a company’s past ability to navigate economic downturns by reviewing actions taken in response to deterioration in asset quality and the resulting impact on credit performance.

- Any company in the auto finance business is also 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. If full residual value is not realized at disposition, a loss can result. As such, the disposition of repossessed automobiles has become a business within a business for many lenders. Successful remarketing means quickly and efficiently disposing of the vehicle at a price close to the residual value. Accordingly, DBRS reviews the company’s remarketing strategies and its success with these strategies to understand the company’s effectiveness in selling repossessed and off-lease assets, as this can have a significant impact on profitability. To this end, the captives may have made effective use of their network of dealers, specifically through dealer auctions. While the overall used vehicle market is a key driver of loss given default on a repossessed vehicle, DBRS also assesses the auto finance company’s remarketing capabilities, their efficiency and the timeliness of asset disposals, as these factors also play an important role in the ultimate recovery and timing of that recovery. DBRS reviews these factors in light of the performance of the company’s peers and industry trends.

- 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. For captives, or by agreement with the manufacturer, the manufacturer may compensate the finance company for early terminations, making this risk subordinate to the strength of the parent. Losses against residual value is an important factor in opining on the risk of the companies’ residual setting policies, as well as determining the adequacy of reserves.

- Securitization provides access to funding and is considered a good low-cost alternative within the funding structure, while improving a company’s asset-liability matching profile as assets are typically match-funded for life. Nevertheless, an over reliance on asset-backed funding markets can pose challenges, if access to the capital markets is restricted for any reason. Moreover, significant use of securitization can result in a highly encumbered balance sheet that constrains financial flexibility.

- Where a meaningful business relationship exists with a manufacturing company or parent company, support can be explicit. The most common form is a subvention program. For example, rate support is provided when the manufacturer offers its customers discounted financing through FinCos, while the FinCo is paid the market rate. This provides the FinCo with a steady supply of new originations, while the finance company assists the manufacturer in selling product. DBRS looks to the level of subvention received from the manufacturer through the various programs. DBRS's view is that the FinCo should retain underwriting control and must be compensated for any additional risk that it is taking as a result of the program.

- Asset concentration is a rating factor when reviewing independent monoline automotive lenders. DBRS views those entities with a broader range of products being financed and markets where they are active more positively than lenders whose focus is more “niche” oriented.

Floorplan and Dealer Financing
Additional analysis is conducted for those Auto FinCos that are involved in financing dealers’ floorplans and providing other financing:

- DBRS determines a FinCo’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 typically buy back the inventory should a dealer become financially stressed or default, the manufacturer’s credit profile is a key factor in the ultimate level of losses realized. 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, and ultimately rebound to the finance company should dealers fail.

• DBRS looks at the FinCo’s ability to service this relatively servicing-intensive asset class. DBRS reviews the FinCo’s processes by which it monitors delinquent accounts and the status of collateral, in which the FinCo typically has a security interest. Because of the importance of the collateral in floorplan lending, DBRS reviews the FinCo’s audit function that monitors the dealers, which is considered a critical element of servicing. Audits include on-site visits and monthly inventory audits. Although dealer floorplan lending business is dominated by the captive FinCos, DBRS’s view is that non-captive lenders can effectively manage a floorplan loan portfolio and compete in this business line.

Summary:
As a general concluding statement, the liquidity and funding of the auto finance industry has potentially positive elements that can improve credit quality relative to FinCos that deal with less liquid assets, but only to the extent that management and other strengths are properly in place.
APPENDIX C – Rental Car Companies

Within the larger sector of finance companies, the rental car company sector has a number of differentiating characteristics that DBRS also considers in its analysis and factors into the building blocks. Some of these factors are common to the previously discussed auto finance sector. These characteristics include the following:

• There are a variety of unique challenges, strengths and differentiating skill sets within the two major market segments of “on-airport” and “off-airport”. The latter comprises home city and insurance replacement rentals. While DBRS views the on-airport market as typically having a higher degree of competition, the ultimate strength of a rental car company relates to the strengths it has in the markets that it competes in and how well it manages its challenges. DBRS generally views a company that has operations in both markets as having a stronger franchise, to the extent that it has the scale and experience to compete effectively in both segments.

• This is an industry that requires scale to achieve sufficient efficiency and profitability. DBRS regards companies that have meaningful market share and revenue generating capacity as being in a stronger position relative to companies with smaller market shares.

• The on-airport segment has certain unique requirements. It requires companies to obtain and maintain the capabilities required to rent cars from airport locations. For market share, efficiency and scale reasons, DBRS views companies who have rental agreements with the airport authorities at larger airports as being in a stronger position, although competition can also be more intense at these prized locations.

• Given that fleet costs are the most significant portion of a rental car company’s cost structure, fleet management is a crucial element in the rental car industry. Poor fleet management typically results in weak profitability and can thus offset various other strengths. DBRS sees value in a company that is able to manage its fleet through the business cycle, as this is a key to solid and consistent profits. The assessment of fleet management capabilities includes consideration of areas such as: the ability to adjust fleet size to market demand, good pricing on purchases and disposals, good maintenance and, when required, the ability to extend the service life of the fleet. Good fleet management is also demonstrated through utilization rates, which reflects the ability of the company to maintain a favorable ratio of vehicles in service to vehicles in the fleet, noting that this must be balanced with maintaining some flexibility to provide vehicles as needed.

• Companies in the rental car industry have the choice of what portion of their fleet they can purchase with the option to return them to the manufacturer (program vehicles), and what portion they own, referred to as “risk” vehicles. The “risk” fleet carries several additional risks, including residual value exposure. However, there are also benefits to the extent that this choice can be effectively managed. Amongst the benefits, typically, “risk” vehicles have lower acquisition costs from the OEMs than program vehicles and generally allow rental car companies greater flexibility in adjusting the time they hold vehicles in the fleet during economic cycles.

• As with auto finance companies, management of residual value exposure and the state of the used vehicle market are major considerations for the rental car industry. DBRS reviews a company’s mix of fleet compared to rental demand patterns as well as trends in the used vehicle market for potential exposure to vehicle types with weakening or historically more volatile resale values. Further DBRS considers a company’s strategy for disposing of fleet vehicles, its track record in managing disposals and the resulting gains or losses on such sales.

• The rental car industry is cyclical, particularly so for the on-airport segment. Transaction volumes in the on-airport segment vary with the volume of air travel, which can be meaningfully impacted by the economy, weakening in business and/or consumer confidence and also by global events. This cyclical nature may result in earnings and cash flow volatility. DBRS looks to management’s ability to manage this volatility, particularly through their ability to downsize fleets and headcount, and mitigate residual value exposures in downturns with relatively low costs, as a key rating consideration. DBRS notes that, increasingly, the rental car companies are seeking to grow their off-airport market business segment to partially mitigate this volatility in the on-airport segment, as demand in the off-airport segment is less correlated to the overall economy.

• Given the extensive dealing with consumers and business customers, the strength and diversification of brands is often a meaningful differentiating factor. In some cases, brand strength helps maximize revenues by segmentation in pricing between business and leisure travel rentals. Service is also an important area of consideration. Moreover, robust and sophisticated IT systems are required to handle reservations on a global scale, while monitoring fleet availability and optimizing fleet utilization. DBRS reviews a rental car company’s current platforms and forecasted investments in these critical systems.

• The rental car industry is a capital intensive business with substantial capital required to maintain and grow a fleet. Further, the cost of building and maintaining rental locations especially at airports adds additional capital needs. DBRS has a tolerance for higher leverage, so long as the debt is funding revenue generating assets or in support of revenue generating assets. DBRS has less tolerance
for acquisition related debt that reduces financial flexibility and is supporting non-hard assets, such as goodwill. When considering leverage, DBRS looks to Debt-to-EBITDA. Adjusted EBITDA may be used to reflect significant non-recurring revenues or expenses.

- DBRS considers debt service coverage when considering a rental car company’s leverage. Given that depreciation is such an important cost of business for the industry, DBRS looks to EBIT/interest expense as one measure of debt service. In this calculation DBRS does not exclude asset-backed debt related interest given the importance of this funding market for a majority of the industry participants. In addition, DBRS considers corporate EBITDA-to-corporate interest expense in considering debt service ability for unsecured bondholders. Corporate EBITDA is calculated as EBITDA after fleet depreciation and fleet-related interest expense. However, as depreciation is such a large cost to rental car companies and to adjust for differences in fleet depreciation policies at the various companies, DBRS will also look at EBITDA-to-interest expense relative to peers.

- Overall fleet management and a company’s ability to generate revenue by effectively deploying its fleet are important considerations in the ratings. DBRS uses revenue per unit per month as a key metric. DBRS recognizes that there is seasonality in the industry. Accordingly, quarterly trends in this metric are usually less important than year-over-year variations, as well as differences in trends relative to peers. Further, DBRS looks at pre-tax income-to-average fleet by units as another metric of fleet utilization and as an indicator of whether the company is earning an appropriate return on these assets.

- Operating efficiency is an important component of overall profitability. DBRS calculates operating efficiency as direct operating expenses plus selling, general and administrative expenses as a percentage of revenues in its peer comparisons.
APPENDIX D – Aircraft Leasing Companies

Reflecting the unique aspects of the aircraft leasing industry, this sector has a number of specific factors that DBRS considers in its analysis. Some of these factors are in addition to the basic analysis. Others are either an extension of existing factors or carry more weight in the overall analysis.

These considerations for aircraft leasing companies include the following:

- **Aircraft fleet characteristics** Given that a high-quality, high-value fleet of aircraft is critical for stable and predictable revenue generation, but also likely to be a potential base for outsized losses, DBRS considers a well-diversified fleet that is consistent with the company’s operating strategy as an important rating consideration. Indeed, there are a wide number of potential strategies an aircraft leasing company may choose including by aircraft type, geographic region and/or airline type. DBRS evaluates the company’s mix of aircraft by manufacturer, body type, model and age. Generally, DBRS views those fleets that are younger and balanced by manufacturer and model more favorably, as younger aircraft tend to have the latest technology and fuel efficiency making them more desirable and easier to place when off-lease or repossessed, thereby supporting residual values.

- **Capabilities in Redeploying and Disposing of Aircraft** Any company in the aircraft leasing business will ultimately need to redeploy or dispose of off-lease aircraft and aircraft repossessed in a timely, efficient manner to realize the maximum value. Accordingly, DBRS reviews the company’s record in placing aircraft upon return and the average down-time. DBRS looks to the lessor’s record of lease renewal with current customers. Renewals reduce the cost and disruption of placing an aircraft with a different airline, which may require changes to cabin configuration resulting in time on the ground for the aircraft and lost revenue generation. DBRS also reviews an aircraft lessor’s procedures for repossessing aircraft from distressed customers and its record of successfully removing aircraft from airlines facing difficulty. DBRS reviews these factors as they relate to a company’s peers and to industry trends.

- **Specific Earnings Metrics** Aside from the metrics noted above in the general earnings section of this methodology, DBRS reviews the ability of aircraft lessors to generate adequate returns on their fleet. DBRS looks to an aircraft lessors revenue per unit and lease margin as percentage of fleet book value in judging a company’s ability to earn appropriate returns. DBRS also reviews an aircraft lessor’s gain on sale of aircraft as a percentage of total revenues in assessing the quality of earnings. DBRS considers those aircraft leasing companies that are less reliant on gains on sale for revenues than peers as having superior earnings quality.

- **Diversity of Airline Customer Base** Diversity of a lessor’s customer base is critical to avoiding outsized losses should an airline face difficulty. As such, DBRS reviews an aircraft lessor’s customer list for any notable concentrations. Moreover, given the cyclical nature of the airline industry, which can lead to losses amongst airlines across a certain geographic region or country, DBRS reviews the geographic spread of the customer base and views those that are more globally diverse positively.

- **Skills in Airline Customer Relationships** Success in the aircraft leasing business depends on the FinCo’s ability to understand and meet the needs of its airline customers. More successful companies are better at understanding the trends in the industry, the specific characteristics and needs of each airline, and the company’s ability to deliver the aircraft for lease to meet the customer’s needs. The business requires considerable skills in anticipating trends and demand that can be very specific to each airline, but also have regional trends.

- **Management of Aircraft Order Books and Pipeline** In the past, aircraft lessors have experienced financial trouble when their aircraft order books with the manufacturers became too large and the lessors were unable to finance or place the aircraft when delivered. DBRS monitors the order pipeline for aircraft lessors and considers the mix of the aircraft, delivery dates and the percentage placed over the next three years. Further, DBRS will review an aircraft lessor’s liquidity position and ability to meet aircraft deliveries expected over the next 18 to 24 months.

- **Underwriting, Surveillance and Recovery Capabilities** Credit risk arises from an airline being unable to meet its monthly lease commitments or maintain its reserve payments. DBRS reviews an aircraft lessor’s underwriting policies for new airline customers. Given that a distressed airline may not only miss monthly lease payments, but ultimately return aircraft to the lessor, DBRS looks favorably on those aircraft lessors with broad customer bases and reviews the concentration of the fleet by airline. Further, DBRS considers the company’s systems for surveilling and monitoring their customers for any signs of weakening performance. Also, DBRS assesses the company’s policies for dealing with distressed airlines and the decision timeline for pulling aircraft out of a distressed customer’s fleet. Included in this assessment is a review of a company’s history of mitigating losses with customers who have entered bankruptcy.
• *Funding Strategies and Execution given unique funding needs* Given the capital intensive nature of the business, access to funding and ample liquidity are paramount for success in aircraft leasing and an important consideration in the rating. As noted above, DBRS looks at an aircraft leasing company’s ability to accept and pay for near-term aircraft deliveries with cash and available liquidity on hand, including committed funding facilities in place and the available capacity under such facilities. Regarding funding, DBRS considers the company’s ability to regularly access funding markets, as well as the diversity of its funding. Further, DBRS evaluates an aircraft lessor’s funding philosophy related to secured or unsecured funding, as well as its view on matching the duration of funding to the remaining lease term of the fleet being financed. While secured funding typically has a lower cost than unsecured funding, the lien placed on the aircraft under a secured financing can constrain a leasing company’s operating flexibility. In the case of the aircraft leasing company repossessing an aircraft, the Company’s ability to relocate the aircraft to another jurisdiction under a new lease could potentially be restricted by the lien resulting in an extended period of AOG and no cash flow from the asset.

• *Aircraft Maintenance Monitoring* Maintenance of aircraft is critical not just for safety, but to protect the value of the aircraft. DBRS reviews the maintenance monitoring function of the aircraft lessors business, as well as the technical assistance group. DBRS views those companies with strong technical groups, which have extensive background in airline maintenance and an engineering pedigree more favorably.
APPENDIX E – Container Leasing Companies

Within the larger sector of finance companies, the container leasing industry has a number of differentiating factors that DBRS also considers in its analysis. In some cases, the additional factor is new and in other cases it will be an extension or carry a more critical weighting in the overall analysis.

These considerations for container leasing companies include the following:

- **Container Fleet Characteristics** Given that a high quality fleet of containers is critical for stable and predictable revenue generation, DBRS considers a well-diversified fleet that is consistent with the company’s strategy as an important rating consideration. DBRS reviews the company’s mix of containers by type and age. DBRS considers fleets that are younger more positively, as younger containers tend to be in the best condition making them more desirable to shipping companies and other customers and easier to place when off-lease or repossessed, thereby supporting residual values and earnings. DBRS also reviews the portfolio of containers for the proportion that is owned versus managed, as well as the percentage of containers on long-term lease with shipping companies and other customers. Accordingly, DBRS generally views those portfolios with a greater percentage of containers on long-term lease to shipping lines and other customers and a higher proportion that is owned rather than managed more favorably, because these characteristics are more supportive of stable revenue generation and predictable earnings.

- **Capabilities in Redeploying and Disposing of Container Assets** Like any leasing company, container leasing companies ultimately need to redeploy or dispose of returned containers, in a timely, efficient manner to realize the maximum value of the asset. As such, a demonstrated ability to place returned containers in an efficient and timely manner is a key rating factor. Accordingly, DBRS reviews the company’s record in placing containers upon return and the average down-time. To further evaluate a container leasing company’s capabilities, DBRS reviews trends in the lessor’s utilization rates and residual realization ratio. DBRS calculates the latter as the ratio of proceeds from container disposal to net book value. To provide further perspective, DBRS compares these ratios to industry peers. DBRS also reviews the structure of the leases for return conditions and restrictions on the locations at which the containers are permitted to be returned. DBRS views more favorably those lease structures with tighter container return conditions and limits on the volume of containers permitted to be returned to lower tier ports.

- **Specific Earnings Metrics** Aside from the metrics noted above in the general earnings section of this methodology, DBRS reviews the ability of container lessors to generate adequate returns on their fleet. DBRS looks to a container lessor’s revenue per ten-foot equivalent unit (TEU) and lease margin as percentage of fleet book value in judging a company’s ability to earn appropriate returns. DBRS also reviews a container lessor’s gain on sale of containers as a percentage of total revenues in assessing the quality of earnings. To judge how efficiently a lessor is operating its container fleet, DBRS calculates a lessor’s cost per container per day as well as total storage, handling and maintenance expenses as a percentage of total revenues. To evaluate these metrics, DBRS looks to trends as well as compares these ratios to industry peers.

- **Diversity of Customer Base** Every container lessor has to deal with the issue of customer concentrations, since all lessors focus on the same customer base: prime-tier container shipping lines with an established track record in the business. Further, the ten largest container lines account for more than 60% of container ship capacity. Typically, DBRS will conduct a stress scenario under which a major shipping line customer defaults. This event results in a period of lost revenue while lease payments are not received from the defaulted shipping line and the container leasing company has not placed the affected containers back out on lease. Further, DBRS assumes that not all containers on lease to the defaulting shipping line are absorbed by the market but that a portion of the containers are disposed at a loss. DBRS notes that the container leasing companies mitigate the risk from this concentration of exposure through insurance policies, underwriting policies, collection capabilities, flexible costs structures, and, in extreme cases, the ability to seize fuel or ships. At the same time, DBRS recognizes that for shipping lines the containers are essential equipment and the overall cost of the containers are relatively low in their overall cost structure. Thus payments on container leases are likely to be continued, even when a shipping line is under great financial stress, potentially even in the event of a bankruptcy reorganisation. Moreover, a number of the larger shipping lines are state owned or are considered important national industries, which could result in some form of support or accommodation by governments.

- **Underwriting, Surveillance and Recovery Capabilities** Credit risk arises from a shipping line being unable to meet its monthly lease commitments. DBRS reviews a container lessor’s underwriting policies for new shipping line customers. Given that a distressed shipping line may not only miss monthly lease payments, but ultimately return containers to the lessor, DBRS looks favorably on those lessors with broad customer bases and strong restrictions in the leases on the port which can return containers. Further, DBRS evaluates the company’s procedures and processes for surveilling and monitoring their customers for any signs of weakening performance. As part of its evaluation, DBRS reviews the lessor’s IT systems and logistics management that are utilized to monitor the position of its container fleet. Also, DBRS assesses the company’s policies for dealing with distressed shipping lines and the
decision timeline for pulling containers out a distressed customer’s fleet. Included in this assessment is a review of a company’s history of mitigating losses with customers who have entered bankruptcy. For those container lessors with insurance policies against default of specific shipping lines, DBRS typically reviews the insurance policy.

- **Container Maintenance Monitoring** Repair and maintenance of the containers is critical to protect the value of the assets. Typically, upon return of the containers from the lessee, repairs and maintenance work is performed at independent equipment depot facilities. If the container is not returned in a condition that meets specified requirements, the lessee is typically responsible for repair costs. Generally, repair work is done in accordance with standards and procedures specified by the Institute of International Container Lessors. DBRS reviews the maintenance monitoring function of the container lessor’s business, including use of electronic data interchange (EDI), as well as the frequency of depot reviews conducted by the lessor.

- **Management of Container Order Book** In the past, container lessors have experienced earnings pressure during periods of container overcapacity relative to demand resulting in *per-diem* rate compression. DBRS monitors the order pipeline for container lessors and the pick-up time from order to on-hire. Given the relative quick turnaround on container orders, typically 60 to 90 days from order to delivery from manufacturer, DBRS recognizes that container lessors have the ability to rapidly respond to declines in trade volumes and accordingly container demand, by not placing orders for new containers with the manufacturers. DBRS evaluates how well a company manages its order pipeline and its track record in controlling the capacity of its container portfolio.

- **Funding Strategies and Execution given the Funding Needs** Given the capital intensive nature of the business, access to funding and ample liquidity are critical for success and an important consideration in the rating. DBRS looks at a container leasing company’s ability to pay for near-term new container deliveries with cash and available liquidity on hand, including committed funding facilities in place and the available capacity under such facilities. Regarding funding, DBRS considers the company’s ability to regularly access funding markets, as well as the diversity of its funding sources. Further, DBRS considers a company’s funding philosophy related to secured or unsecured funding, as well as its view on matching the funding to the fleet being financed.

- **Nature and Extent of Securitization and Encumbrance** Securitization provides access to liquidity and is considered a good low cost alternative within the funding structure. Nevertheless, an over dependence on the asset-backed markets can pose challenges should access to the capital markets become restricted for any reason. Moreover, significant use of securitization can result in a highly encumbered balance sheet, which constrains financial flexibility.

**Summary:**
In general, besides the standard finance company characteristics, the container leasing industry’s reliance on global trade volumes and substantial concentration exposures constrains potential ratings. However, as discussed, DBRS recognizes that the container leasing companies have a number of levers at their disposal that allow them to react to and navigate an economic downturn more easily than the global container shipping lines. Accordingly, DBRS does not have a direct relationship between the ratings of the container lessors and the ratings of their large shipping line customers, but rather factors any change in the strength of these customers into the rating of the container leasing companies.
APPENDIX F – Residential Mortgage and Home Lending Related Companies

Within the larger sector of finance companies, companies operating in the residential mortgage sector have a number of differentiating factors that DBRS considers in its analysis. In some cases, the factor is additional and in other cases it is an extension or carries more weight in the overall analysis. This section covers factors used in the analysis of both residential mortgage originators and residential mortgage servicers, but not all factors apply to each category of company. DBRS notes that in some countries, a portion of home lending is backed by guarantees rather than mortgages, but generically refers to the more common nature of home lending backed by mortgages. This Appendix focuses on mortgage companies for whom originating and selling or securitizing is an important component of their business as well as those nonbank residential finance companies that originate to hold and rely on wholesale financing.

More than any other sector where finance companies operate, the characteristics of the residential financing and home loans market vary significantly across countries. In some countries, banks dominate the marketplace and there is little room for independent mortgage companies or specialised subsidiaries of larger organisations. In some countries, government entities or government sponsored entities play a significant role. Mortgage insurance or home loan guarantees can be an important component in some countries. On a country by country basis, DBRS takes these diverse characteristics into account when rating residential mortgage and home lending companies. Nevertheless, this appendix focuses on the rating of residential mortgage companies in countries where they are viable competitive alternatives to banks.

The additional factors for residential mortgage companies include the following:

- DBRS considers the mortgage industry to be a cyclical and volatile business line, especially in countries with more volatile housing markets and significant refinancing of mortgages. In most countries, the market is highly competitive with a number of large players and a commoditized product. Moreover, barriers to entry are generally low. At the same time, since the housing market downturn and 2008/2009 financial crisis, the residential mortgage market continues to evolve with operational and regulatory scrutiny significantly elevated in many countries. DBRS sees compliance costs as remaining elevated for the foreseeable future. Sufficient scale and operating efficiency are crucial for success in the marketplace and to support profitability. Nevertheless, smaller firms may be more nimble, better equipping them to adapt to the evolving marketplace. Accordingly, DBRS does not view small mortgage related FinCos as unable to succeed, but only as facing additional challenges with typically less resources to navigate these challenges.

- Mortgage companies with significant origination activities tend to have a lower quality of earnings, as profitability is often volatile and unpredictable due to the fluctuations in housing activity and refinancing due to changes in interest rates and economic cycles that drive origination volumes. Mortgage companies that are predominantly portfolio lenders, including such entities as mortgage REITs, have portfolios of residential mortgages loans that earn revenue from interest spread and thereby tend to have less revenue variability. DBRS views this revenue mix as superior to those mortgage companies whose revenues are predominantly transactional in nature and largely derived from origination volumes. Mortgage origination drives revenues from origination fees, warehouse spreads, and gains (or losses) from secondary market sales. DBRS favours firms with a meaningful percentage of revenues from non-production-related sources, such as third-party servicing.

- For those FinCo’s with substantial mortgage origination activities, DBRS also evaluates the FinCo’s ability to fund forward commitments. DBRS assess the diversity of the sources and the resiliency of these liquidity sources during periods of stress in the capital and/or housing markets. Moreover, given the interest rate exposure generated by these forward commitments, DBRS evaluates a FinCo’s strategy and capabilities to hedge these exposures. Further, for those FinCo’s that choose to hold the mortgages on their balance sheet, DBRS evaluates the company’s ability and the number of channels utilized to sell the mortgage production. In the U.S. these channels may include government sponsored agencies, banks, other FinCo’s and securitization trusts. Meanwhile in Europe, mortgages are typically sold to banks, building societies, or structured vehicles such as securitization trusts or covered bond facilities.

- Mortgage servicing generally provides a steady flow of servicing revenues. One important area of analysis is the ability of the mortgage servicer to manage its expenses in line with its revenues from servicing fees, especially the extent to which these fees are adjusted for the quality of the loans being serviced. The evaluation also considers how well the company can adjust its costs and operations to a changing environment, such as would cause deteriorating credit and increasing servicing costs. Any adjustments to servicing fees associated with deteriorating credit quality are a positive factor. Earnings from mortgage servicing can be volatile, where mortgage servicing rights (MSRs) are held on a company’s balance sheet. The valuation of the rights to income from future servicing fees are subject to mark to market fluctuations due to changes in assumptions about key variables such as the discount rate, prepayment rate and credit performance of the home loans being serviced, as well as the cost of this servicing. DBRS views those companies that are successful in controlling earnings volatility positively. The presence of MSRs on a FinCo’s balance sheet introduces a different, but important element of risk to the company’s earnings. MSRs can comprise a substantial proportion of assets on the balance sheet and are subject to significant valuation adjustments, which can add to the risk of earnings instability. In analyzing
this exposure, DBRS considers the size of the MSRs, the frequency and degree of any write-downs/impairments, and the assumptions used for valuation. Lastly, the originating source of the loan is a factor when assessing asset quality. Retail originations, those originated by a FinCo’s own employees, are viewed as superior in quality to those loans sourced through wholesale channels.

• Aside from the metrics noted in the general earnings section of this methodology, DBRS reviews a FinCo’s dependency on its mortgage origination to generate earnings. A firm’s dependency on new loan originations is indicated by the combination of origination fees and gains on sale of mortgage loans as a percentage of total revenues. 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.

• Credit risk and asset quality vary widely between mortgage finance companies, and largely reflect the company’s mix of business. DBRS evaluates the company’s profile given its business strategy, which may focus on higher risk lending or a mix across home loan quality of borrowers. In assessing a company’s credit quality and its performance, DBRS analyzes traditional asset quality measures, such as delinquency levels, foreclosures, and loss rates. Loan-to-value (LTVs), as well as regional and housing-type concentrations, is also considered. DBRS considers macroeconomic trends including general economic conditions, housing market trends, and the financial profile of households when evaluating the risk profile of a mortgage company.

• DBRS evaluates the company’s ability to manage its interest rate risk and to what extent a change in interest rates impacts the company’s balance sheet and earnings. Given that the value of mortgage assets can change dramatically with shifts in interest rates, DBRS closely examines a FinCo’s interest-rate exposure, overall interest rate risk management and hedging strategy and reporting.

• Given the importance of funding capacity of a mortgage entity to support current loan production, liquidity is a key factor in the rating. DBRS looks at the company’s ability to sell or securitize loans and other assets to manage liquidity. Institutions with a greater proportion of less liquid assets and/or assets with more volatile market value face greater liquidity challenges than an institution with high-quality, easily fungible assets. Prime conforming mortgage loans in the U.S. and standard mortgages in Europe are most readily convertible to cash, as the market for these mortgages is the deepest, most liquid market in the mortgage sector. Other mortgage assets are less liquid, as was demonstrated during the financial crisis, when investors exited markets of non-traditional mortgage products. In sum, investor confidence in the Company’s business model and acceptance of its loan products by the market are critical factors for a company to successfully retain access to the markets.

• DBRS evaluates a company’s ability to maintain its mortgage production and other operations from its cash and committed funding facilities to sustain its franchise for 12 months. Regarding funding, DBRS considers the FinCo’s ability to regularly access funding markets, as well as the diversity of its funding. Also, DBRS considers a FinCo’s funding approach to secure versus unsecured funding, as well as its view on matching its funding mix to the characteristics of the assets being funded.

• Mortgage lenders tend to be moderately to highly leveraged institutions. The level of capital needed is influenced by the quality of the balance sheet. Firms with larger levels of MSRs, residual interests, and intangible assets require larger levels of capital to support these assets, whose values are expected to be more uncertain.

• The tax structure of the rated entity is a factor. For instance, mortgage REITs are afforded certain tax benefits but, in return, are required to operate under defined restrictions that make capital retention more difficult. Additionally, a REIT’s likely dependency on the equity markets may hamper liquidity, especially in times of stress.