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A Bleak Outlook For European Automakers May Sap The Credit Strength Of Auto Captives In 2013

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Table Of Contents

Ratings On Auto Captives And Automaker Parents Remain Closely Correlated

Auto Captives Are Sensitive To The Decline In Auto Sales Volumes

Economic Risks Put Pressure On The Sector's Capitalization

Captives Should Maintain Low Credit Risk Profiles Over The Medium Term

External Support Should Mitigate The Reliance On Market Funds

Related Criteria And Research

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A Bleak Outlook For European Automakers May Sap The Credit Strength Of Auto Captives In 2013

Standard & Poor's Ratings Services expects European auto captives' operating performances to be able to withstand the current dire auto market conditions in Europe this year. But their ratings will continue to be correlated with their parents'.

We believe improved net interest margins, lower loan impairment charges, generally good cost control, and continued access to independent sources of funding have more than offset the negative impact of lower new business volumes opportunities for auto captives--subsidiaries whose primary business is financing their automaker parents' products. But we believe a captive would not be able to stand on its own without sustained new business from its parent. Consequently, over the past five years, about four-fifths of our rating actions on auto captives have mirrored those on their parents, with the balance relating mainly to stand-alone issues.

Looking ahead, the weakening European economic environment could lead us to take negative rating actions on some auto captives in 2013. In our base-case economic scenario, we project a 0.1% contraction in GDP in the eurozone (European Economic and Monetary Union) this year, followed by modest growth in 2014, but our worst-case scenario envisages a 1.6% contraction in 2013. The close correlation between ratings on auto captives and their parents means that we could downgrade captives if we downgraded automakers or, in some cases, if we changed our view of the captives' stand-alone creditworthiness as a result of weakening capitalization, deteriorating quality of assets, or lower ability to access new funds.

Overview

- We believe auto captives' links with the highly cyclical auto industry to be a structural weakness.
- We recognize that auto captives have resilient profitability, typically low credit risk, strong capitalization, and that they generally manage funding and liquidity risk well.
- We might revise downward some ratings or stand-alone credit profiles this year because of the weakening economic environment and the current bleak outlook for the European auto market.

Ratings On Auto Captives And Automaker Parents Remain Closely Correlated

We currently anticipate that our ratings on auto captives will remain closely correlated with those on their parents, which can either uplift or constrain the ratings on the captives. In some instances, a captive's rating may differ from its parent's ratings depending on the captive's own creditworthiness, its degree of insulation, or the potential for government support (see table 1).

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Table 1

Correlation Between Auto Captive And Carmaker Ratings

Captive	FGA Capital SpA	RCI Banque	Banque PSA Finance	FCE Bank PLC	Volkswagen Bank GmbH*	Volkswagen Financial Services AG
Shareholders	50% Fiat 50% Crédit Agricole	100% Renault	100% Peugeot-Citroën	100% Ford Motor Company	100% Volkswagen	100% Volkswagen
Carmaker shareholder rating	BB-/Stable/B	BB+/Stable/B	BB/Negative/B	BB+/Positive/NR	A-/Positive/A-2	A-/Positive/A-2
Other shareholder rating	A/Negative/A-1	-	-	-	-	-
Captive rating	BBB-/Negative/A-3	BBB/Negative/A-2	BBB-/Negative/A-3	BBB-/Positive/NR	A-/Positive/A-2	A-/Positive/A-2
SACP of the captive	bb+	bbb-	bbb-	bbb	a-	bbb
Captive rating compared to carmaker parent rating	Capped three notches above	Capped two notches above	Capped two notches above	Capped one notch above	Equalized	Equalized
Other captive rating considerations	Captive rating includes one notch of Crédit Agricole support	Captive rating includes one notch of government support	Captive rating includes one notch of government support	-	-	-

SACP--Stand-alone credit profile. *The rating on Volkswagen Bank does not currently include any additional parental support because the 'a-' SACP is already at the level of the parent's rating. If Volkswagen Bank's SACP falls below the parent's ratings, we might apply additional notches of support to equalize the rating with Volkswagen AG. Source: Standard & Poor's.

We generally equalize the ratings of an auto captive with those on its parent. This means that we view the default risk of the subsidiary as being indistinguishable from that of the parent. We believe the parent has economic incentives to support its captive because the latter contributes to improving sales and generates additional earnings at group level, among other benefits. For this reason, we equalize the ratings on Volkswagen Financial Services with those on Volkswagen AG, even though we believe Volkswagen Financial Services has lower stand-alone creditworthiness than its parent.

An auto captive with higher intrinsic creditworthiness than its parent and independent, diversified, funding could benefit from a favorable rating differentiation. This is because in Europe:

- National insolvency laws generally limit the extension of bankruptcy proceedings from the parent to the subsidiary.
- Banking regulation limits parental influence by requiring minimum capital and liquidity ratios, and limiting exposure to the parent.

We therefore generally allow a one-notch rating differential for regulated entities. As a consequence, we rate FCE Bank, RCI Banque, and Banque PSA Finance higher than their parent.

We may extend the rating differential by one additional notch when we believe there's a likelihood of extraordinary government support in the future. The potential government support we would factor into the ratings depends on the combination of our opinions on:

- The bank's systemic importance within the country;
- The government's tendency to support private-sector commercial banks in this country; and

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- The government's creditworthiness.

We believe the failure of an auto captive is not likely to have adverse consequences on a country's financial system, owing to their small size. But it could still harm a country's auto industry by threatening jobs, for example. We believe this is the case in France, and our ratings on RCI Banque and Banque PSA Finance benefit from one notch of support from the French government.

We would rarely go beyond a two-notch difference between an auto captive and its parent. For this, we would need to see that the captive was significantly insulated from parental influence. We currently believe this is the case for FGA Capital, due to Fiat's limited 50% ownership, the shared governance with Credit Agricole, and the strong funding and liquidity support it receives from Credit Agricole under the joint venture agreement.

How We Rate Auto Captives

We rate European auto captives under our criteria for rating banks because they all have bank status or are regulated like banks. We use a building block approach to determine their ratings.

We start with the anchor. We use our economic risk and industry risk scores of our Banking Industry Country Risk Assessment (BICRA) methodology to determine it. The anchor is a combination of the bank's weighted average economic risk by credit exposures and the industry risk score of the country where it's domiciled and regulated.

We then adjust the anchor based on our assessment of four bank-specific factors to arrive at the auto captive's stand-alone credit profile (SACP). The four factors are business position, capital and earnings, risk position, and funding and liquidity (see table 2). We use different comparative groups for each factor:

- We compare auto captives' business positions with banks that have similar industry risk. The group therefore also includes full-service banks.
- The capital and earnings scores compare auto captives with all banks globally.
- For risk position, we generally compare auto captives with entities that have a similar product mix.
- The funding and liquidity scores combine our separate assessments of funding and liquidity to determine the final rating impact of this factor. We compare auto captives' funding profiles with the average of all banks within their home country. We compare their liquidity to all banks globally.

To arrive at the final rating, we adjust the SACP based on our view of:

- The potential for extraordinary government support.
- The influence of the group, whether positive or negative.

Unlike most core subsidiaries of larger groups, we typically rate European auto captives higher than their parents. This reflects the blend of regulated status and favorable national insolvency laws that partly insulate them from operational difficulties at their parent, their proven ability to access funding independently of their parent, and their typically higher stand-alone creditworthiness.

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Table 2

Auto Captive Rating Score Snapshot

	Volkswagen Bank GmbH	Volkswagen Financial Services AG	RCI Banque	FCE Bank PLC	Banque PSA Finance	FGA Capital SpA
Ratings	A-/Positive/A-2	A-/Positive/A-2	BBB/Negative/A-2	BBB-/Positive/NR	BBB-/Negative/A-3	BBB-/Negative/A-3
SACP	a-	bbb	bbb-	bbb	bbb-	bb+
Anchor	a-	bbb+	bbb+	bbb+	bbb+	bbb
Business position	Weak (-2)	Weak (-2)	Weak (-2)	Weak (-2)	Weak (-2)	Weak (-3)
Capital and earnings	Very strong	Strong	Strong	Very strong	Strong	Strong
Risk position	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate
Funding	Average	Average	Below average	Below average	Below average	Average
Liquidity	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate

Business position--an assessment of "Weak" (-2) and "Weak" (-3), as our criteria define these terms, results in a deduction of respectively two and three notches from the anchor. Capital and earnings--an assessment of "Strong" and "Very Strong" results in an addition of respectively one and two notches to the anchor. Risk Position--an assessment of "Adequate" is neutral for the anchor. Funding and liquidity--an assessment of "Average" for funding and "Adequate" for liquidity is neutral for the anchor, but an assessment of "Below Average" for funding and "Adequate" for liquidity results in a deduction of a notch from the anchor. Source: Standard & Poor's.

Auto Captives Are Sensitive To The Decline In Auto Sales Volumes

We don't see auto captives' business positions improving significantly in the next two years because we see this factor as a structural weakness for all the auto captives we rate in Europe. Auto captives' limited business diversification cancels out their revenue resilience, in our view.

Auto captives' business profiles are constrained by their ties with the highly cyclical auto industry. A captive has an almost exclusive business relationship with a single auto manufacturer that includes the following factors:

- They support vehicle sales and promote customer loyalty for their parent;
- Their product offering is mainly limited to retail auto loans, wholesale loans to finance dealers stocks, and fleet leasing for corporates or small and midsize enterprises; and
- Their potential market is constrained by the number of cars sold by the parent and bought on credit, and their penetration rate.

We expect all automaker parents of the European auto captives we rate to post unit sales declines in Europe of at least high single-digits in 2012 apart from Volkswagen AG, whose sales will likely remain flat. According to LMC Automotive, a provider of auto industry data, the market for light vehicles in Western Europe will contract to about 13 million in 2012, or 73% of the total European market (see Chart 1). Auto captives have a different geographic spread from their parents and are actually around 2.5 times, on average, more exposed to Western Europe than their parent companies.

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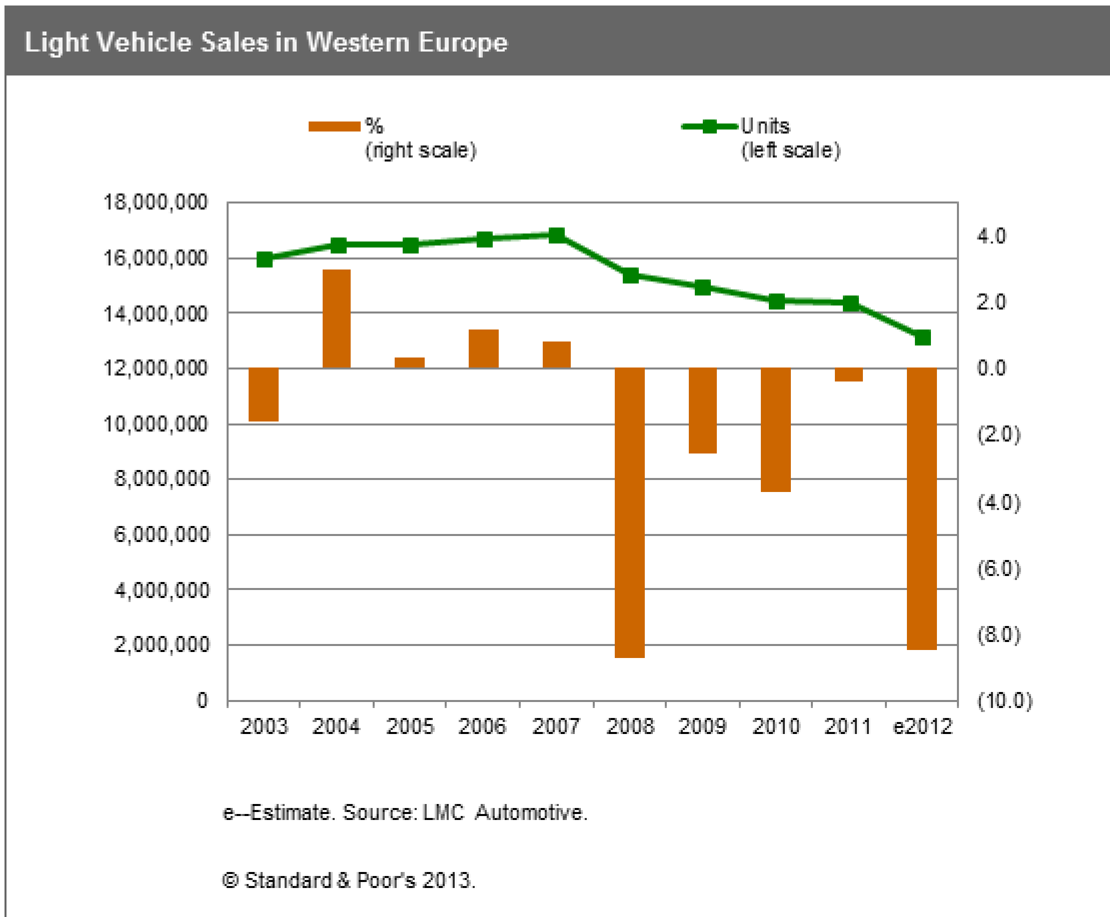
Chart 1



e--Estimate. Source: LMC Automotive.

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We acknowledge that auto captives have demonstrated more stable revenue generation than their parents since 2007. The recurrent nature of credit activities means a written loan will typically generate revenues over two to four years, whereas a vehicle sale will be a one-off revenue for the parent. Interest income revenues are even more stable because auto captives generally aim to secure their margin at loan initiation. For example, while Fiat SpA auto revenues plunged by 16% in 2009 and 27% in 2010, the revenues of its captive finance company, FGA Capital SpA, increased by 4% and 6% for the same years (see chart 2).

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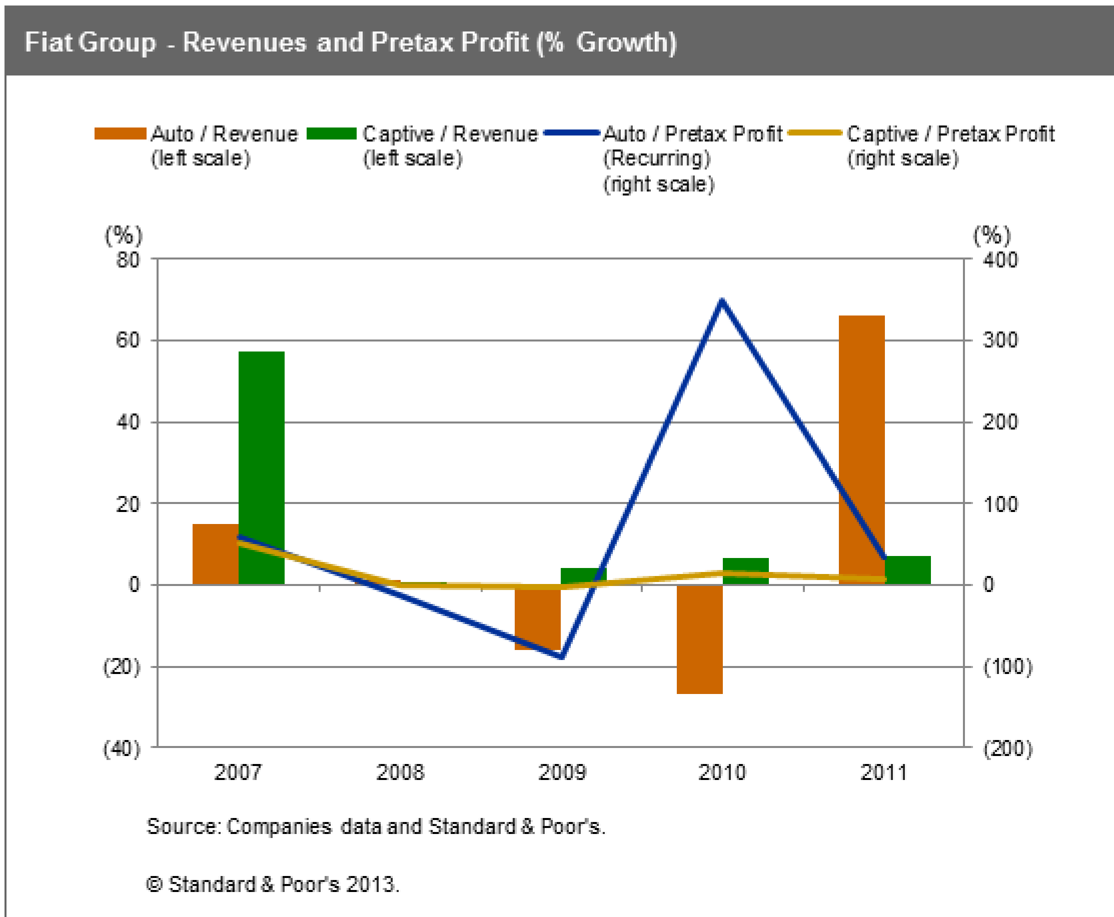
Chart 2



We believe noninterest income generated by auto captives also somewhat contributes to the resilience of their revenues. Noninterest income partly mitigates, in our view, the negative consequences of potential increased funding costs on interest income. Noninterest income notably includes fees for car insurance, maintenance contracts, extended warranties, and also fees for various other banking and insurance services. We estimate that noninterest income represents on average a fifth of auto captives' revenues, but this share is unequal among the European auto captives we rate (see chart 3).

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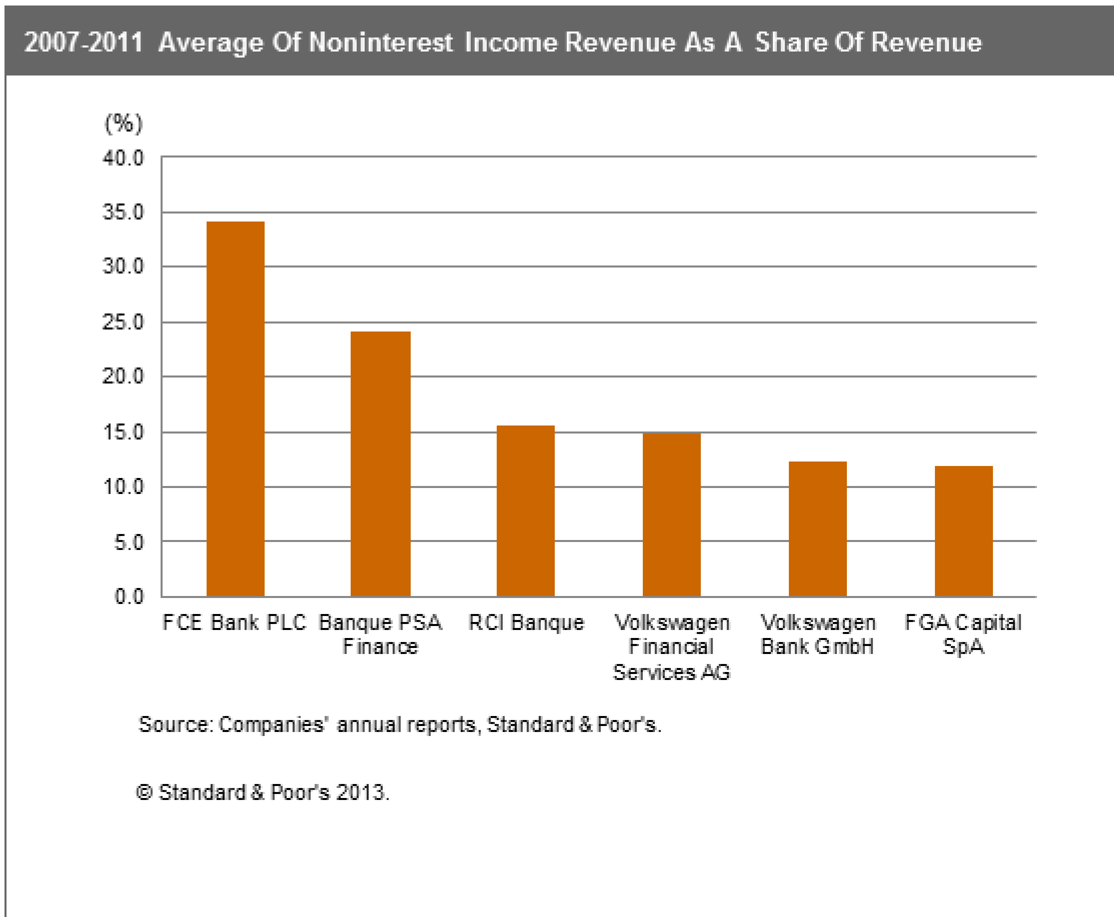
Chart 3



Another factor lending stability to the captives, in our view, is the somewhat imperfect correlation between their retail credit production and parental car sales. The so-called "penetration rate" is a ratio auto captives generally use to measure what proportion of cars sold by their parent they finance (see chart 4). The increase of Banque PSA Finance's penetration rate over the past 10 years, for example, has mitigated the effect of declining car sales at Peugeot S.A. As a result, the number of new vehicles being financed by Banque PSA Finance has been less volatile than the number of new registrations of Peugeot and Citroën cars in the countries covered by the bank.

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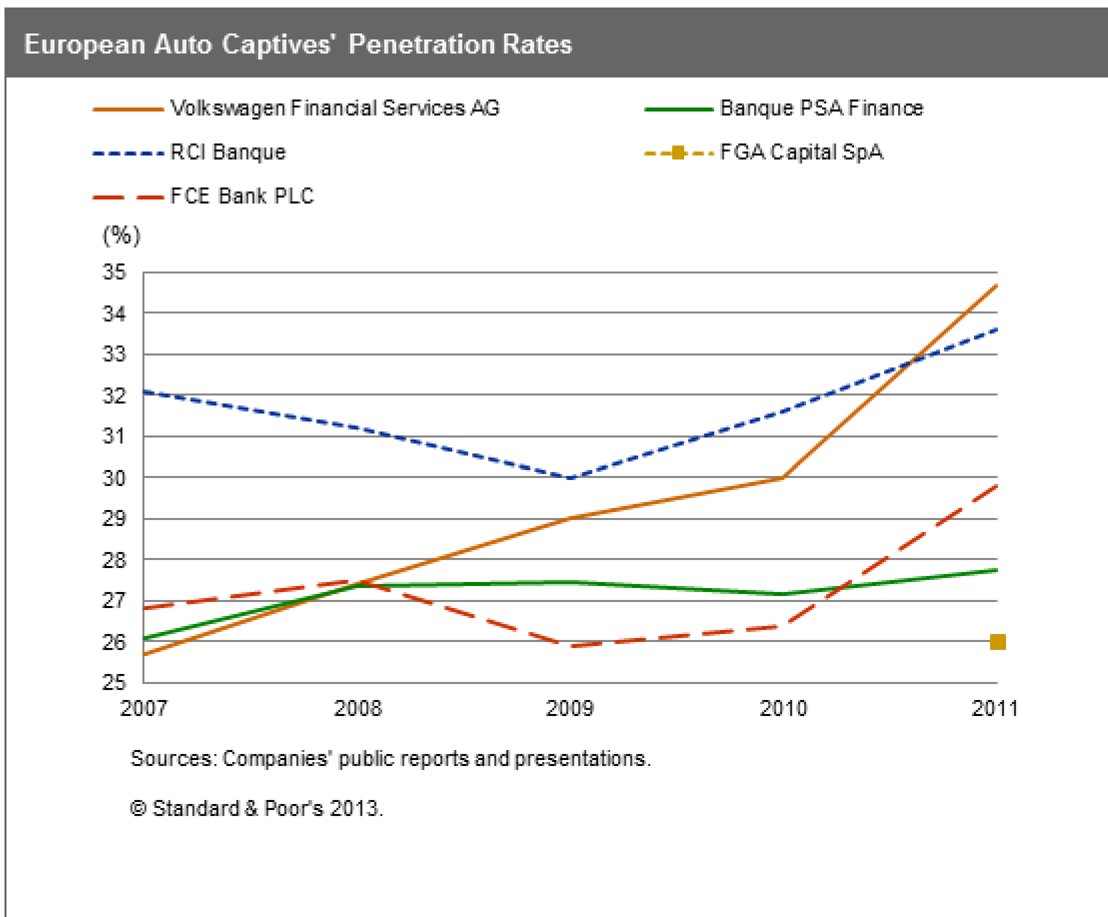
Chart 4



We also observe that auto captives can increase the coverage scope of their parents' geographic presence or expand their brand offer. RCI Banque's annual credit production has partly increased since 2009 as the bank is financing an increasing share of Nissan and Dacia car sales in Europe, while the two brands' sales volumes are increasing and they are gaining market share. Similarly, FGA Capital is distributing car loans for Jaguar Land Rover, which is unrelated to the Fiat group, and represents about 15% of its loan volumes. In contrast, over 99% of FCE Bank's net receivables now come from the financing of Ford vehicles, up from 60%-65% five years ago, primarily as a result of Ford's divestment strategy.

Economic Risks Put Pressure On The Sector's Capitalization

There is a risk that auto captives' capitalization as it stands today may not be sufficient to tackle the increased economic risks we see in Europe. However, we still consider capitalization to be a credit strength for the captives we rate. As of Dec. 31, 2011, our average risk-adjusted capital (RAC) ratio, which is our preferred measure of capitalization, was 11.1% for the sector, much higher than the average of about 6.4% for top European banks. We forecast that our RAC ratios will remain above 10% in the next 18-24 months (see chart 5).

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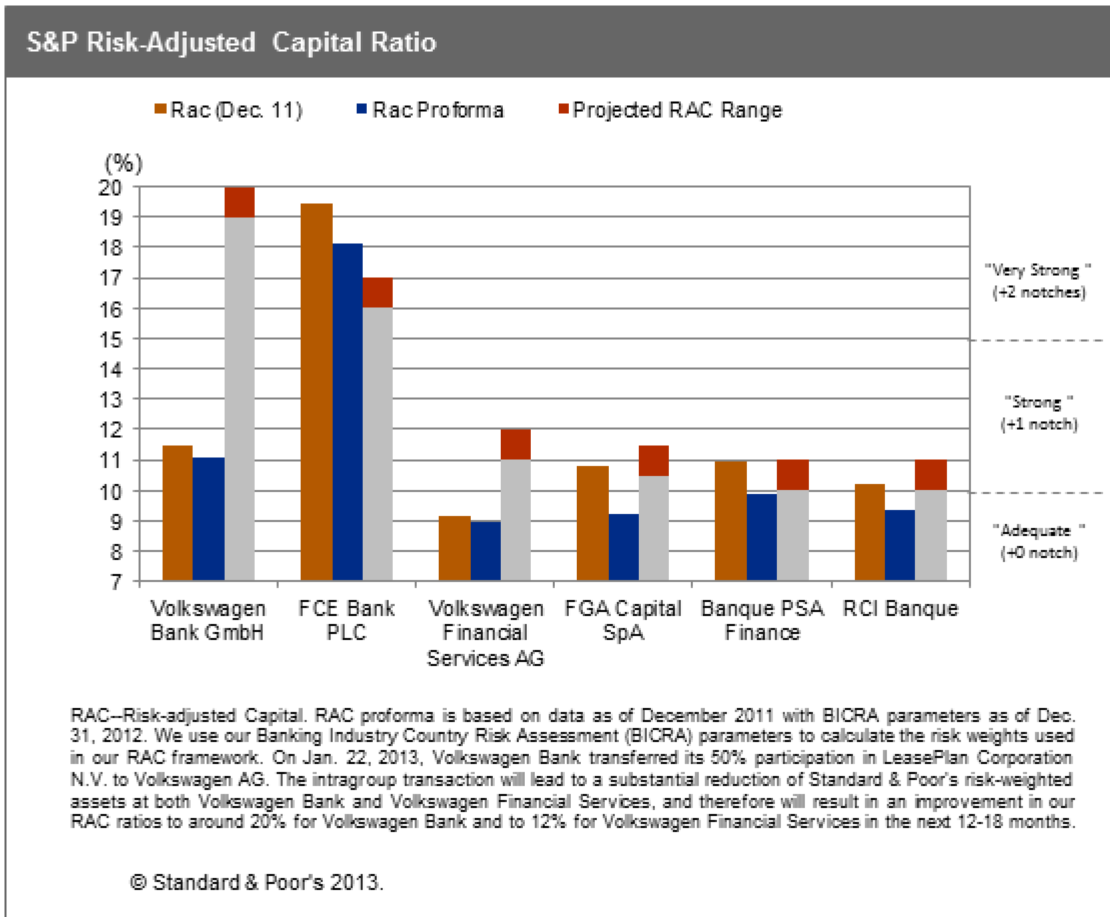
Chart 5



We place greater analytical emphasis on our projected RAC ratio range than on regulatory ratios in our assessment of capitalization. We believe the comparability of the regulatory Tier 1 ratio is blurred because of national discretions, methodological differences, and differences in banks' internal estimates. Our RAC ratio measures capitalization in a consistent way for all the banks that we rate globally, and therefore generally differs from auto captives' regulatory Tier 1 ratios (see chart 6). The difference is partly due to the risk weights we use in our RAC framework, which are our own and generally more severe than the regulators'.

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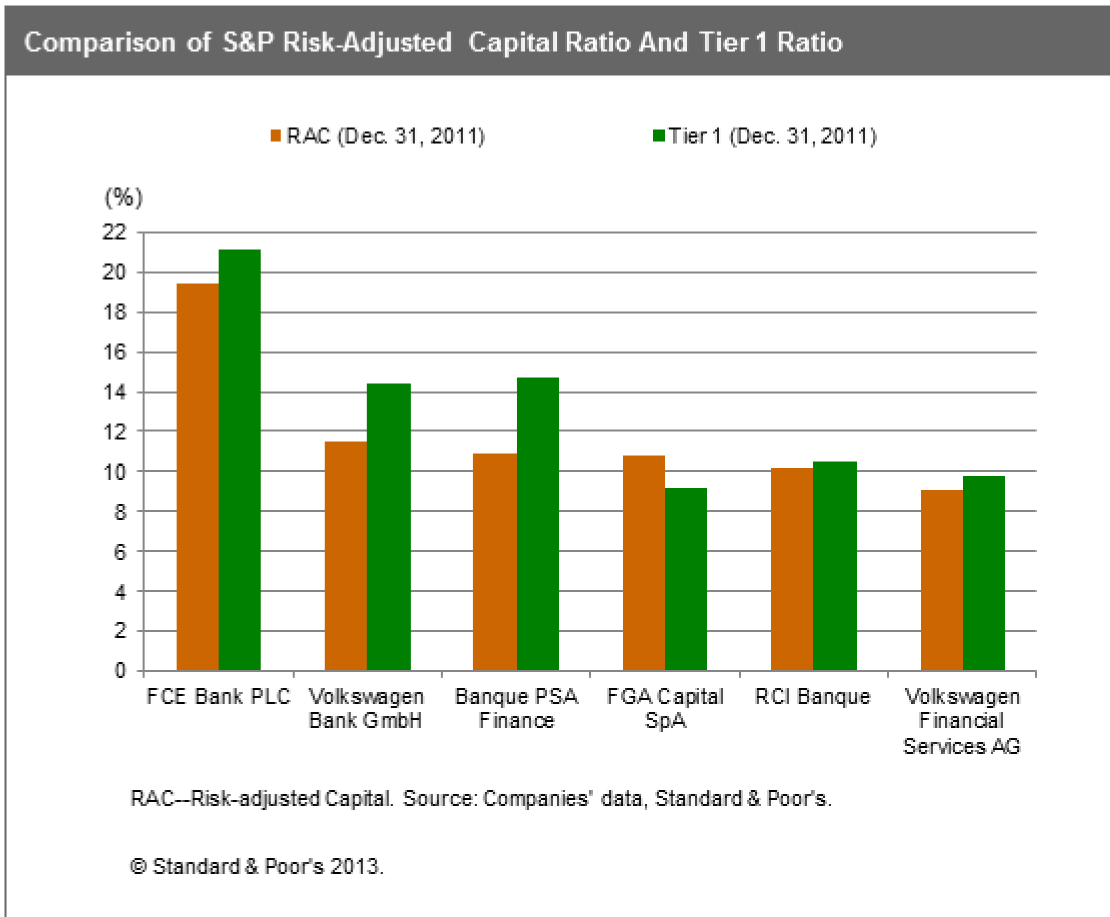
Chart 6



Our RAC ratio is also designed to capture future risks that might arise within a forecast worsening economic environment. We believe a higher capitalization is warranted in a more uncertain environment, as the probability of unexpected losses increases when risks increase. Consequently, the risk weights used in our RAC framework evolve with our views on the economic risks in the countries to which the auto captives are exposed (see chart 7).

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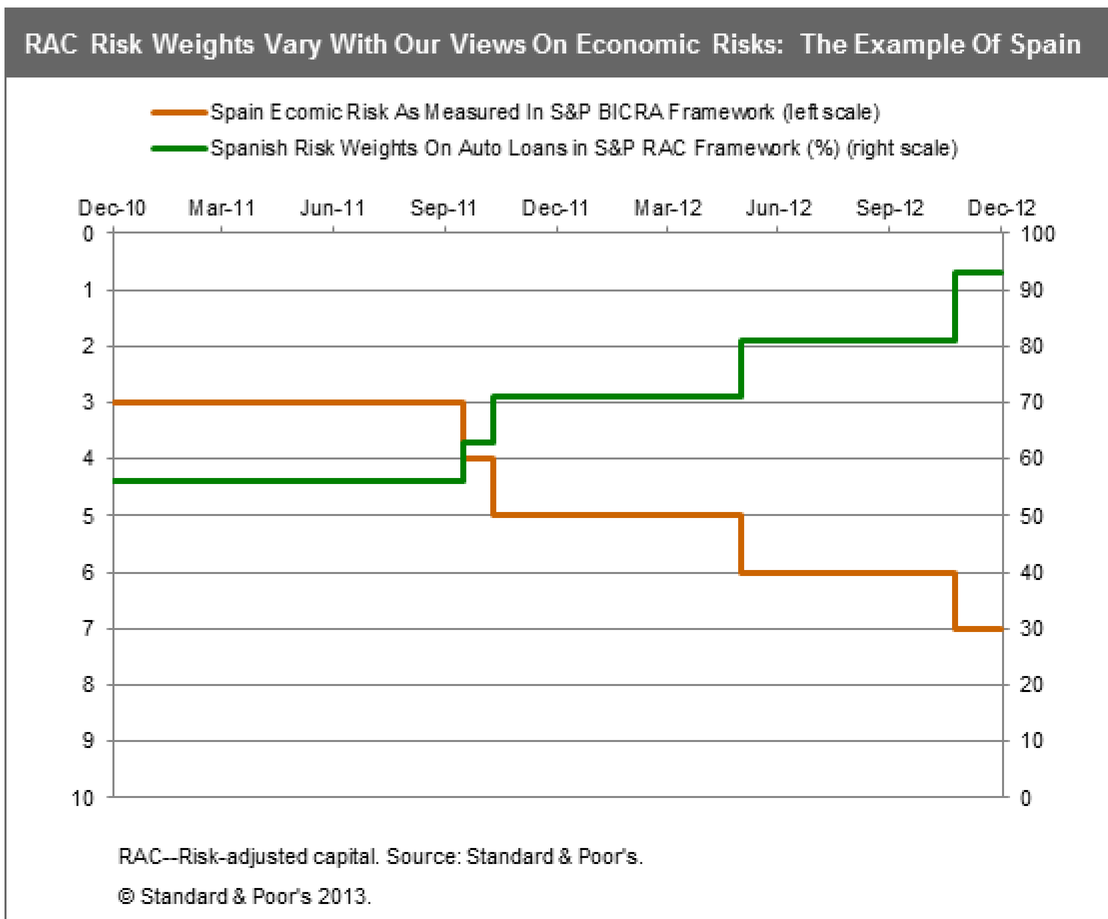
Chart 7



We believe automaker parents are supportive of high capital positions at their captives. Auto captives maintain a regulatory capital level significantly higher than that requested by regulators. What's more, the parent companies are generally willing to contribute through capital injections or to accept reduced dividends. For example, Volkswagen Financial Services' equity was strengthened by an injection of €650 million to capital reserves by the parent company in 2011. Maintaining a sound financial position at the auto captive can enhance investors' confidence and help stabilize funding. This allows the auto captive to continue financing its parent's car sales. It also helps stabilize earnings, which contributes to the consolidated group's results.

We consider auto captives to have generally weak quality of earnings because:

- Earnings are structurally dependent on a single business provider tied to the highly cyclical auto industry. Sustained depressed parent auto sales can challenge the ability of the auto captive to maintain the size and quality of its loan book in the medium term.
- Earnings may not totally reflect the intrinsic creditworthiness of the auto captive. For example, a significant portion of FGA Capital's margin comes from the low-cost funding that French retail bank Credit Agricole S.A. provides.

Still, we recognize that auto captives have generally posted resilient earnings and have strong earnings capacity. To measure the profitability of a bank, we use, among other things, our ratio of core earnings to average adjusted assets

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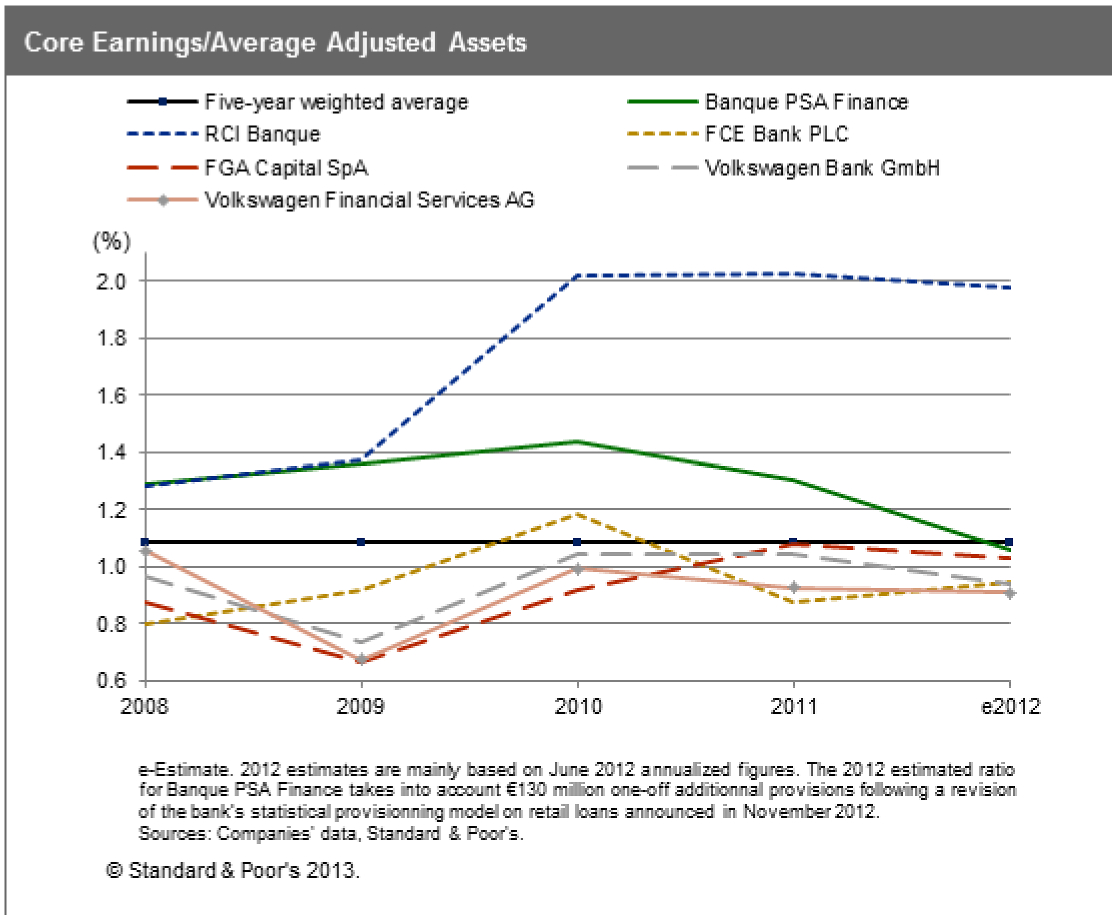
(CE/AAA), which excludes nonrecurring items and intangibles. We estimate that the CE/AAA five-year average has been 1.1% for the six European auto captives we rate, much higher than the 0.3% five-year average for top European banks (see chart 8).

Chart 8



Captives Should Maintain Low Credit Risk Profiles Over The Medium Term

We expect auto captives to maintain low credit risk profiles over the next two years. Weakening auto demand and higher unemployment rates could weaken their quality of assets. Even so, we forecast that, on average, they will maintain nonperforming loans at less than 4% and a low cost of risk of about 60-70 basis points (bps), in line with our estimated 12-year weighted average of 65 bps (see chart 9). Overall, we expect auto captives' specific risks to remain ratings neutral.

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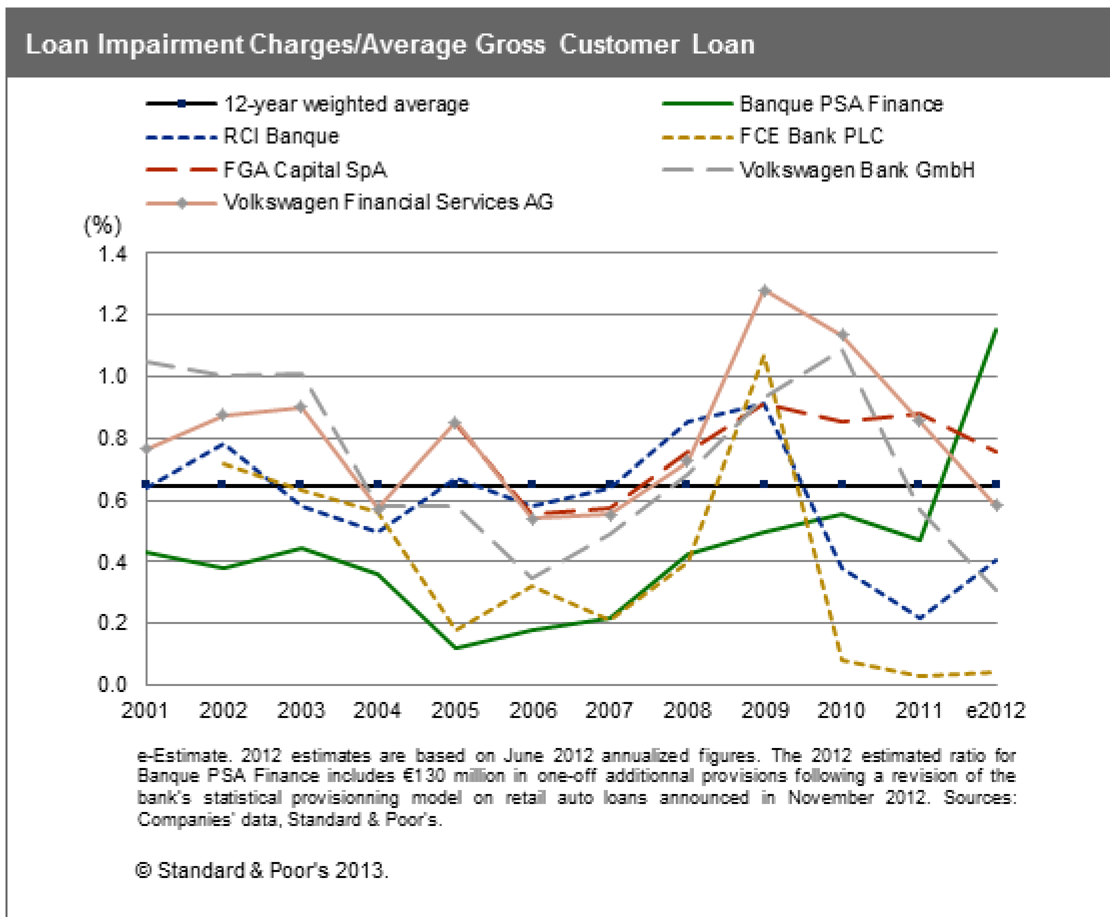
Chart 9



We view auto captives' risk positions as "adequate," as our criteria define this term. We believe our capital and earnings analysis adequately captures most of the risks. The risk position serves to refine our view of a bank's actual and specific risks as the conclusion arising from our standard assumptions in our capital and earnings analysis may not always reflect or adequately capture the specific risk characteristics of a particular bank.

A deteriorating economic environment may not automatically translate into a lower risk position assessment, since we would take that into account through higher risk weights of assets. Our RAC ratio, the driver of our capital and earnings analysis, already factors in the secured nature of auto loans, as well as the potential for asset quality deterioration or residual value risk. For example:

- Our RAC ratio has a more favorable risk weight on auto loans than unsecured retail loan exposure. We apply a risk weight of 75% to French unsecured retail loan exposure compared with 56% for auto loans.
- We weigh exposure to countries for which we anticipate higher economic risks more severely. For example, our anticipation of higher economic risks for France at the end of last year led us to increase our risk weight on French auto loans to 56% from 51%.
- Residual value exposure on auto leases have a 50% higher risk weight than unsecured retail loan exposure. This means a 112% risk weight for French residual value exposure.

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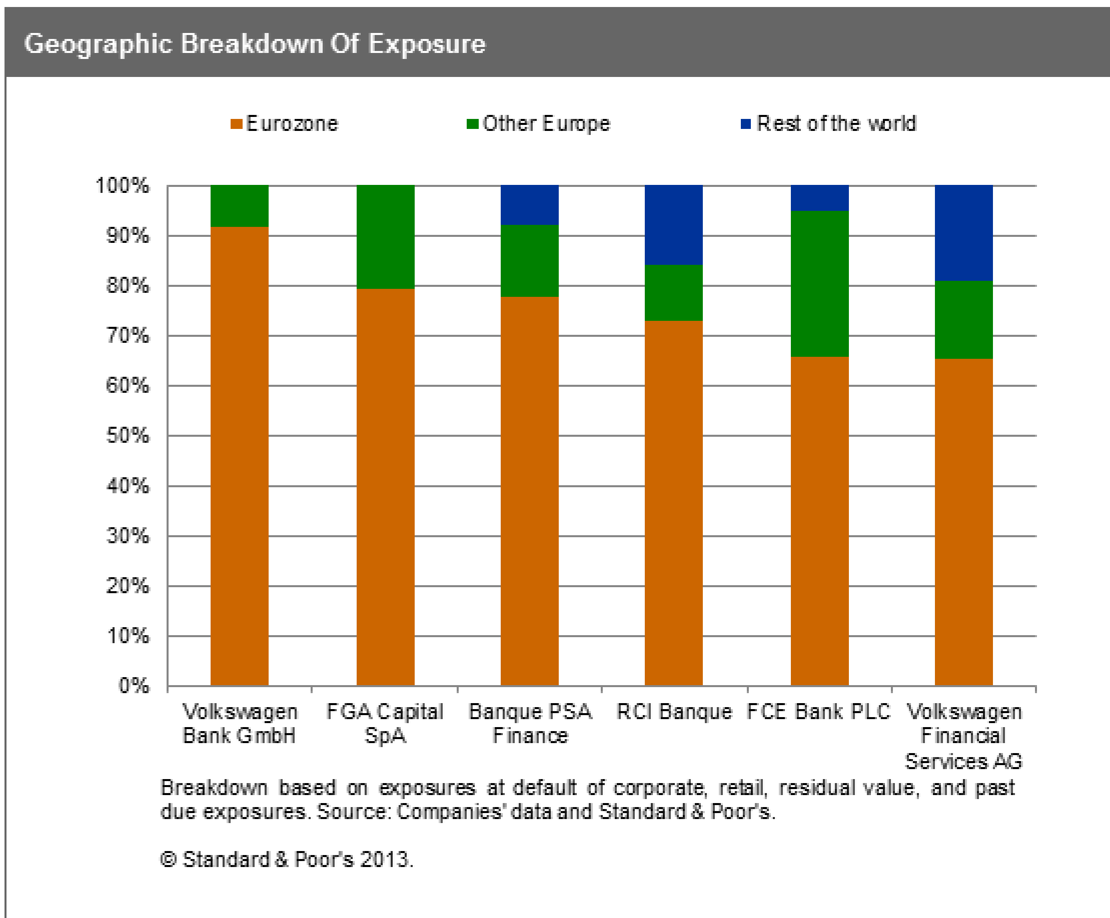
To take an example, our expectation of lower economic growth in Italy has not led us to revise downward FGA Capital's risk position. This is because we translate the potential negative effect of a weaker economy for the Italian banking sector into higher risk weights used in our RAC calculation for Italian exposures, including auto loans.

Auto captives' adequate geographic diversification has limited positive influence on the ratings. Captives' activities span an average 26 countries, and their country of origin represents only about 40% of exposure on average, and generally carries low credit risk. But the geographic spread provides little diversification benefit, in our view, because auto captives are about 75% exposed to the eurozone, where countries are linked politically and economically (see chart 10).

Chart 10



We balance the granularity of auto captives' loan books with their strong sector concentration, which stems from exposure to auto dealers. Auto captives' exposure is, on average, one-half to retail, one-third to dealers, and the rest to corporates. Their total exposure is fairly granular, being mainly toward individuals. But corporate and dealer exposures are also granular, with the 20 highest exposures representing on average a low one-half of the captives' capital. Sector concentration mainly stems from the captives' exposure to auto dealers, which is by nature highly correlated to the cycles of the auto industry.

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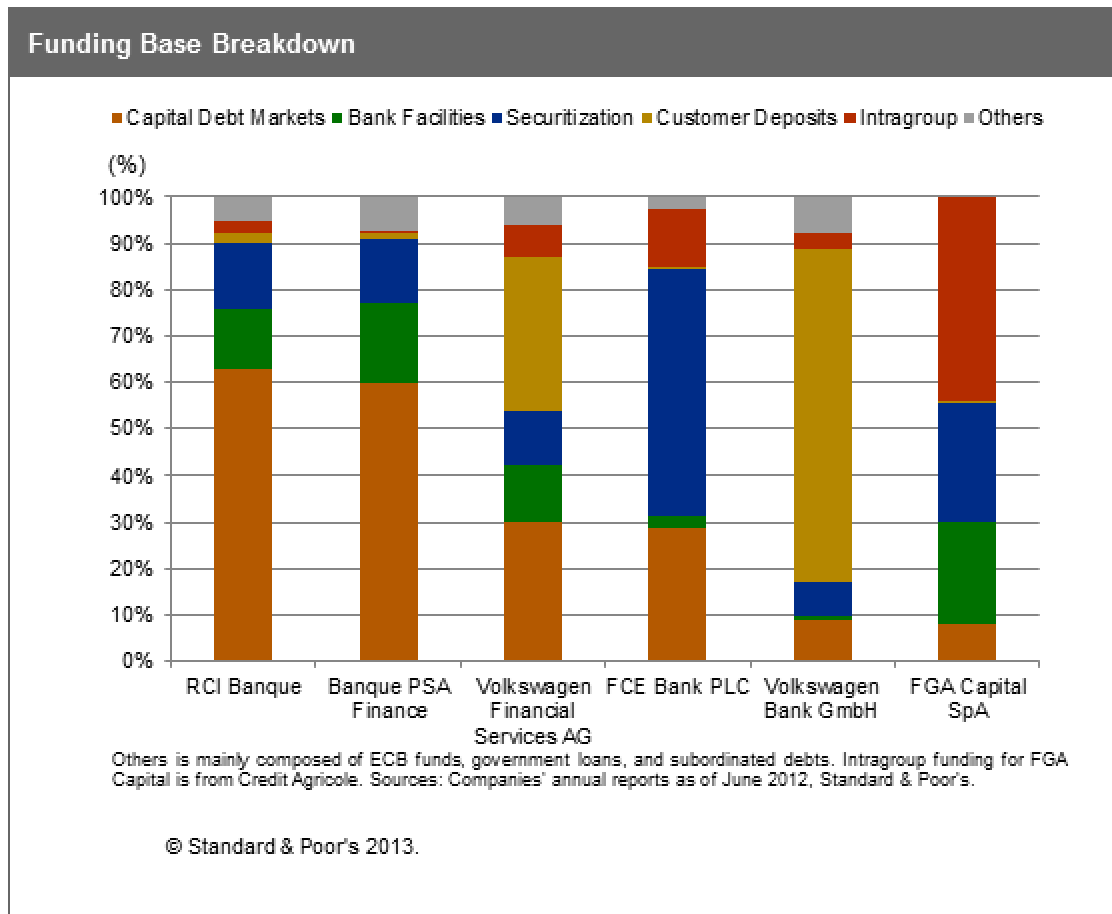
External Support Should Mitigate The Reliance On Market Funds

We assume that auto captives will maintain their satisfactory access to funding this year. We believe they're not completely immune to investor distrust, as most of them rely on confidence-sensitive wholesale funds. But we believe their ability to access European Central Bank (ECB) funding, or potential parental or government support, should mitigate this risk. Even so, an auto captive's funding and liquidity profile is at best a neutral rating factor, in our view.

Auto captives do not rely equally on confidence-sensitive wholesale funds (see chart 11). The diversification of wholesale funds, which we usually consider to be a weaker form of funding, mitigates their potential volatility. Auto captives' wholesale fund sources are spread between capital debt markets, bank credit lines, and securitization. The investor base is generally granular and diversified by type and country. Auto captives therefore retain the ability to switch between sources during market disturbances, and auto secured markets remained largely open throughout the crisis, unlike senior unsecured markets at certain times.

Chart 11



Others is mainly composed of ECB funds, government loans, and subordinated debts. Intragroup funding for FGA Capital is from Credit Agricole. Sources: Companies' annual reports as of June 2012, Standard & Poor's.

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The less reliant on market funds the auto captive is, the less of a drag its funding profile is for the rating. Historically, retail deposits have proved to be the most stable source of funds. We take a qualitative rather than quantitative rating

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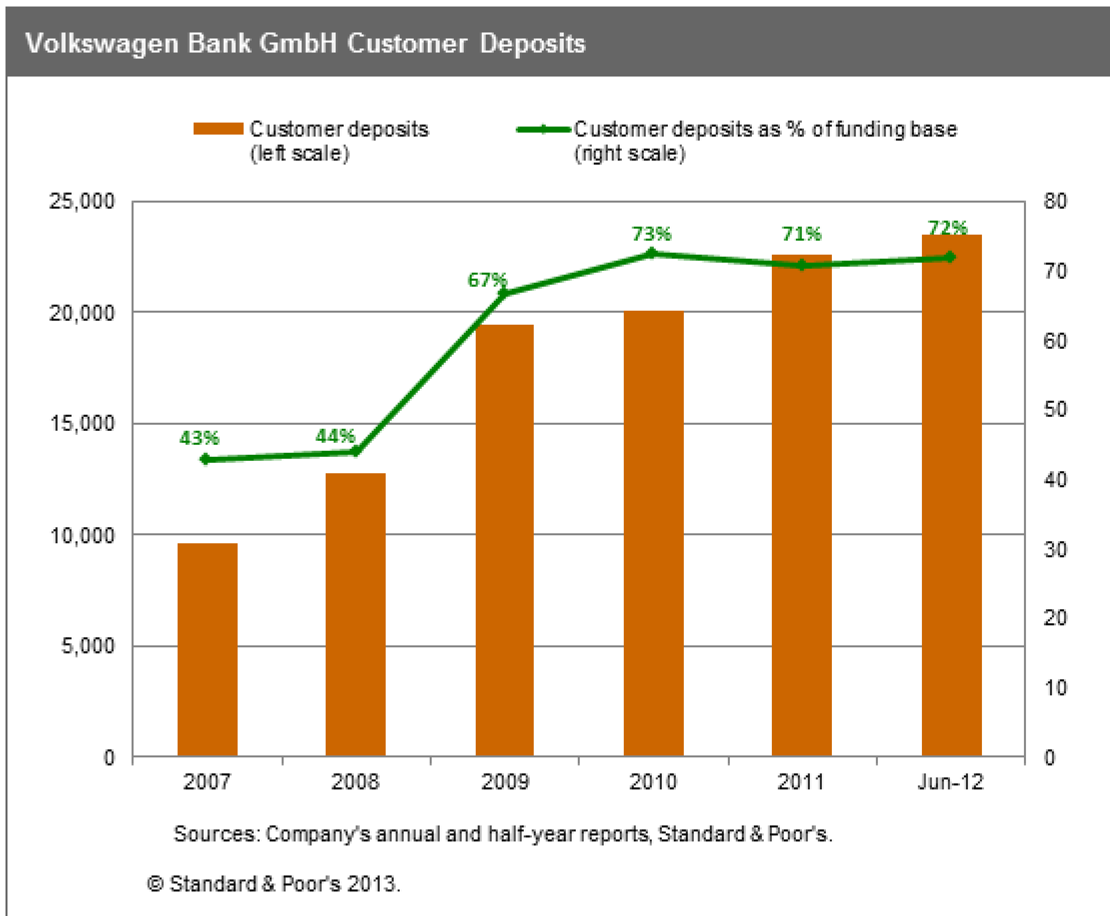
approach when analyzing deposits. We need to assess the stability of deposits over time even though they could represent a sizable share of total funding. We only considered Volkswagen Bank's deposits as a supporting rating factor in late 2010, 20 years after the bank started to collect them, after they proved resilient during the market disturbances of 2008-2009 (see chart 12).

Chart 12



We consider that all auto captives manage their liquidity prudently. They generally aim to minimize mismatches between the average maturity of their loan books and the term financing they receive. The average life of funding is generally greater than the average life of loans. Auto captives also usually have ample liquidity reserves covering more than 100% of their short-term funding. We understand that they all permanently cover their refinancing needs for at least six months, assuming no rollover of outstanding debt and while continuing to provide loans.

Auto captives' liquidity is also supported by various external support mechanisms. Their status as regulated financial institutions gives them the ability to bring assets eligible for repurchase-agreement refinancing to the ECB. Volkswagen Financial Services and FGA Capital partly rely on parental funding, and we believe RCI Banque and Banque PSA Finance would potentially benefit from government support. Such support appeared in October 2012 for Banque PSA Finance when the French government announced its intention to provide the bank with a €7 billion guarantee for bond issues in 2013-2015.

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Related Criteria And Research

- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Captive Finance Operations, Apr. 17, 2007
- Regulation Benefits Ratings On European Automakers' Captive Finance Subsidiaries, May 18, 2006
- Corporate Criteria--Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link To Parent, Oct. 28, 2004
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Top 10 Investor Questions for 2013: Global Autos And Trucks, Dec. 5, 2012

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