MOODY'S
INVESTORS SERVICE

SECTOR COMMENT

Key rating drivers for European car financiers

Table of Contents:

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Summary

This sector comment discusses the key rating drivers for four European auto-captive finance groups that were affected by rating actions on 18 January 2013.[1] The rating actions concluded the review that we initiated on the sector, on 19 October 2012.

Our review focused on the combined pressures from (1) the general adverse impact of the deterioration in macroeconomic conditions in Europe, in particular on the auto manufacturing industry; (2) concentrated exposures to car dealers, which we consider to be highly correlated with the industrial parents' risk profiles; (3) high reliance on market funding, which can be subject to sudden changes in investor confidence; and (4) some reliance on bank credit lines, the availability and terms of which could be compromised by funding pressure on the banking industry and the prospect of regulatory changes.[2]

The four European car financiers are structurally vulnerable, to varying degrees, to the current difficult operating conditions in Europe, and to the automotive market in particular. The new rating levels reflect our view that these institutions will continue to face adverse operating conditions throughout 2013 and likely beyond.

The ratings of all auto captives are constrained by their lack of business diversification, large exposures to car dealers, their reliance on confidence-sensitive wholesale funding and in some cases by their inherent credit linkages with their lower-rated industrial parents. These are characteristics more commonly associated with non-investment-grade ratings, as shown by the rating levels of certain other non-bank auto finance companies with similar business models. Even if the operating environment improves, the banks' narrow business focus would suggest a standalone credit assessment no higher than the 'baa' category.

However, we have taken into account certain mitigating factors, including good capitalisation levels, sound profitability and a greater degree of asset and liability matching than those of traditional retail and commercial banks. Moreover, unlike many other vendor finance companies, the four institutions have banking licenses or equivalents, and for this reason they are subject to similar regulatory standards as other credit institutions and to ongoing supervision. This oversight, together with access to central bank refinancing facilities, provides a certain level of protection to creditors.

1 The standalone credit strength and long-term ratings of RCI Banque (D+/baa3; Baa3, stable) were downgraded while the standalone assessment and long-term ratings of Banque PSA Finance (Banque PSA; D+/ba1; Baa3, negative) were confirmed. Equally, the standalone credit strength of VW Bank GmbH (VW Bank; C-/baa2, stable; A3, positive) was lowered while its long-term ratings were not on review. Further, the long-term issuer rating of FGA Capital S.A. (FGA Capital; Baa3, negative) was confirmed.

2 For review announcement, see : "[Moody's reviews ratings of four European captive auto finance institutions]", published on 19 October 2012.

In accordance with our Joint-Default-Analysis (JDA) approach,[3] the ratings of some auto captives incorporate our expectations for parental as well as systemic support. Typically, the relatively simple nature of auto captives' business models as well as their size relative to the banking systems within which they operate do not suggest any meaningful systemic importance. As such, our ratings for the vast majority of bank and non-bank auto finance companies do not incorporate rating uplift from systemic support. The notable exception is Banque PSA Finance, as its Baa3 long-term debt and deposit ratings now includes one notch of systemic support. This followed the announcement of the French government's funding assistance for Banque PSA Finance as a means of stabilising the franchise of the bank's parent, Peugeot S.A. (PSA; Ba3, negative), given the latter's economic relevance as a major car manufacturer and employer in France. We therefore now consider that there is a similar probability of systemic support from the French government for RCI Banque, in the event of need. However, the probability we assign to support being provided is insufficient to translate into uplift for RCI Banque's long-term ratings, given its current D+/baa3 standalone credit profile. Nonetheless, we believe that there would inevitably be limits on the willingness of the authorities to support bondholders of a small financial institution.

Overview of the European car financiers' ratings

EXHIBIT 1

Ratings as of 3 February 2013

Firm name	Country	Industrial Parent (LT rating and outlook)	LT deposit / issuer rating	Outlook LT deposit / issuer rating	Standalone credit assessment	Parent/ccop/ RLG support (notches of uplift)	Systemic support (notches of uplift)
Banque PSA Finance	France	Peugeot S.A. (Ba3, negative)	Baa3	negative	D+/ba1	-	1
RCI Banque	France	Renault S.A. (Ba1, stable)	Baa3	stable	D+/baa3	-	-
Volkswagen Bank GmbH	Germany	Volkswagen AG (A3, positive)	A3	positive	C-/baa2	2	-
FGA Capital S.p.A.	Italy	Fiat S.p.A. (Ba3, negative)	Baa3	negative	n/a	n/a	n/a

Source : Moody's

[3] See "Moody's Consolidated Global Bank Rating Methodology", published in June 2012.

Key drivers for recent rating actions on European car financiers

Deteriorating macro fundamentals

We expect auto captive banks to be negatively affected by the anticipated difficult economic conditions in Europe, as is the case for European banks more generally. In our view, the poor economic backdrop will test the captives' independence and financial resilience, as it will likely result in weakening asset quality and therefore higher provisioning costs, although there has been limited deterioration to date. Together with higher funding costs in most cases, we expect this to weigh on profitability.

Expected decline in vehicles sales will test captives' independence and financial resilience

» European car financiers' main business is to provide financing solutions to end-user customers (both individuals and corporate fleets) as well as to the dealer networks. We expect the current macro environment to impact the European auto industry, which will likely experience sluggish demand in 2013, and we forecast that western European light-vehicle demand will contract in 2013 by 3%.[4]

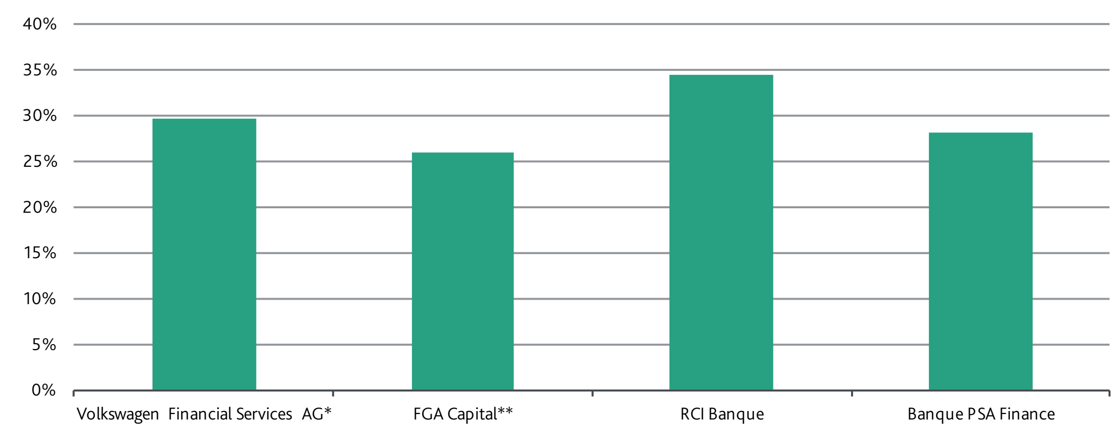
» The four auto captive institutions are a key component of their industrial parent's strategy, as they finance between 26% and 34% of new vehicles sold to end-user customers (see exhibit 2). In a scenario of a severe decline in car sales, Original Equipment Manufacturers (OEMs) could use their captives as a tool to promote vehicle sales.

» The obvious potential for conflict of interest is mitigated by regulatory requirements that impose independent risk-management and underwriting criteria, while appointments of independent supervisory board members improve corporate governance. In our view these mechanisms are beneficial but nevertheless have only limited effectiveness in insulating the captives' credit profiles from their parents. Captives do not have the flexibility to alter their affiliations with their parents, and they remain truly subject to the OEMs' ultimate control of vehicle marketing and sales strategies as well as to the value of collateral against which they lend.

EXHIBIT 2

Penetration rates comparison on new vehicles financing

as of June 30, 2012



Source: Annual Reports, Interim Financial Statements, Information provided by the issuers
**Penetration rate for Volkswagen Financial Services AG, including China*
***Penetration rate for FGA Capital S.p.A. as of 31 December 2011*

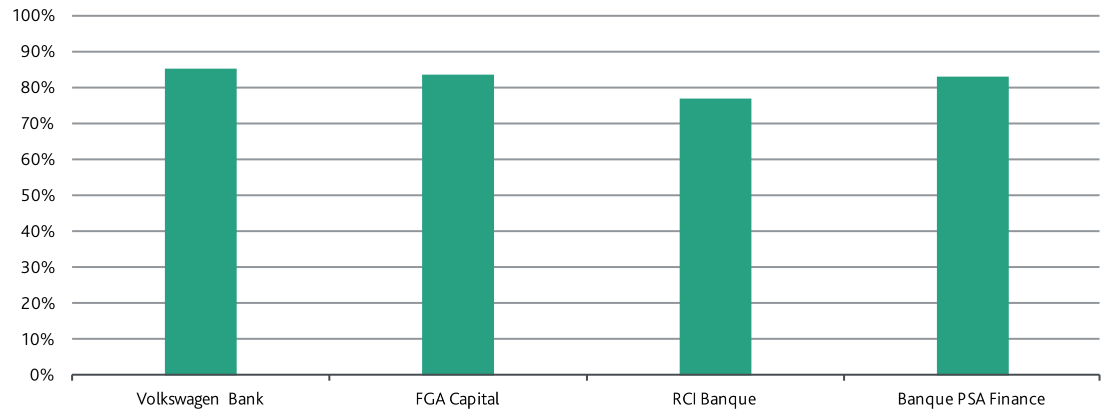
[4] See Moody's report "Global Automotive Manufacturers: Sluggish European Demand Continues To Weigh On Global Auto Sales Growth", published on 17 September 2012.

» Captive institutions lack income-stream diversification, and are highly dependent on their parent's sales volume, as evidenced by their reliance on net interest income from their car-financing activities. Although all these institutions have developed related services – such as loan payment insurance, vehicle maintenance contracts and car insurance products – their monoline franchises would limit their ability to generate earnings in case of a severe stress in the automotive industry.

EXHIBIT 3

Net interest income % net banking income

as of June 30, 2012



Source: Issuers' Interim Financial Statements

» As a mitigating issue, we note that such institutions have a predominantly variable cost base. In some cases, a portion of costs are shared with their industrial parent, providing them with some flexibility to adjust to sudden reductions in business volumes.

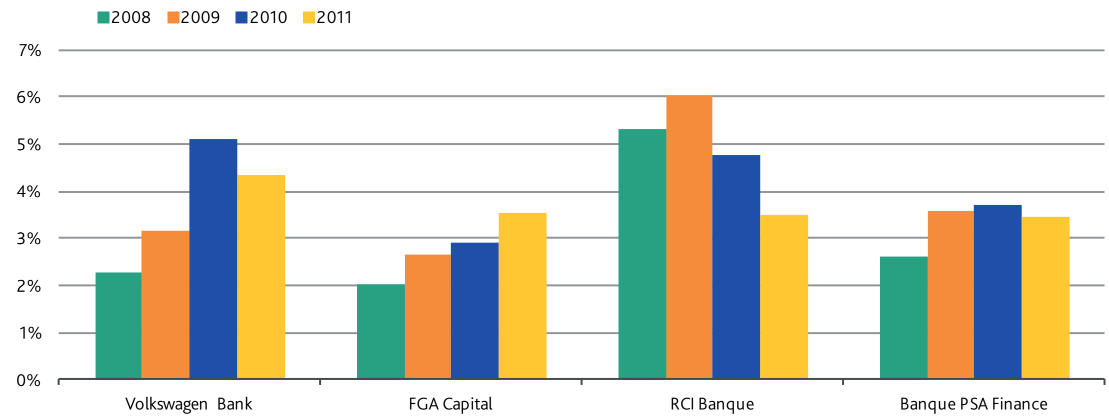
» With the evolution of deposit franchises – primarily launched to diversify the funding sources and reduce the dependence on wholesale funding – these banks will have the opportunity to develop non-car-related retail banking activities. This has been the case at VW Bank, where its expanding direct banking division services more than one million private customers; this adds moderate operating diversification to its auto-finance business. However, the development of such activities requires some time to be sufficiently large to provide any material diversification benefit in the overall earnings profile.

Weak economic conditions pose credit risks to car financiers and limit recovery rates

» We expect European car financiers' asset quality to come under further pressure from the weak economic conditions that characterise the current difficult operating environment. In recent years, problem loans in the end-user segment have risen in most countries. This is likely to continue as unemployment rises further, resulting in a higher borrower default frequency. This is notwithstanding changes to underwriting criteria and collection processes during the financial crisis, as well as increased provisioning levels for most auto captives in recent years.

EXHIBIT 4

Problem loans % gross loans comparison



Source : Moody's Banking Financial Metrics, Issuers' Annual Reports

» As the bulk of car financiers' loan portfolios are secured by vehicles, the sluggish automotive market may negatively impact recovery rates, as the value of the repossessed vehicle may be affected.

Concentrated exposures to car dealers

Although car-dealer loan portfolios are granular, typically short-term and highly collateralised, the soundness of these exposures is highly correlated with the performance of the auto sector, in our view. In addition, we believe that the value of the vehicles, representing most of the collateral against car-dealer exposures, may decline in the event of a deterioration in the creditworthiness of the manufacturer parent. We believe our revised ratings better capture this inherent exposure to the correlated risks posed by the headwinds facing the auto industry and the importance of dealer networks in the manufacturers strategies.

High nominal exposures which amount to multiples of Tier 1 Capital

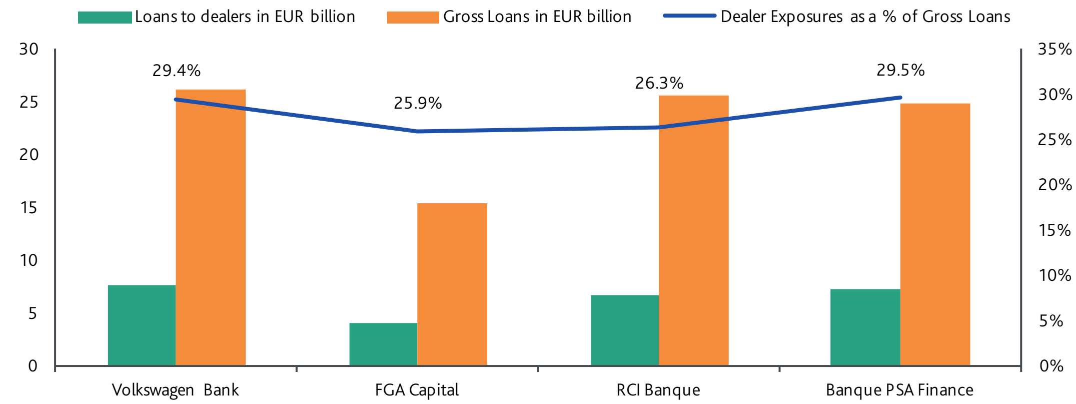
» European car financiers are highly exposed to corporate dealers, which are either part of the OEM's own distribution network, or belong to diversified industrial groups. Such exposures, accounting for about a quarter of the institutions' loan portfolios (see Exhibit 5) and multiples of their Tier 1 capital, represent a substantial aggregate risk due to this inherent correlation and the susceptibility of the manufacturer to potential stress.

The captives we rate typically provide financing solutions for new, used and demonstration vehicles, replacement parts, as well as for working-capital requirements. There is a title-retention clause on most vehicles, allowing the captive to have a direct or indirect recourse on the vehicles or spare parts on most of the stock. However, we note that 10% to 20% of the dealer exposures can relate to working-capital facilities, which are mostly unsecured loans repaid on an ad hoc basis, and that 20% of the exposures can relate to spare-parts financing, where the collateral may be less easy to re-sell.

EXHIBIT 5

Dealer exposures as a % of total loan book

as of June 30, 2012



Source: Issuers' Interim Financial Statements

Dealer networks are a key component of the OEMs' strategies

» Dealerships are key in the value chain of the broader group, as they allow the various brands to be present in all selected markets. Although we note that losses on the dealer segment have been limited to date – partly due to the captive's ability to quickly reduce its exposure to troubled dealers – we believe cutting the supply of credit to the dealer network is implausible in practice due to the distribution network's importance to the parent's sales. As a result, troubled dealerships are typically subject to restructuring agreed with the OEM, resulting in some losses for their captives. Some OEMs assume a portion of the lending risk to their dealer networks, whereby the value and reliability of this risk mitigant is a function of the creditworthiness of the corporate parent. Thus, in our view the relative importance of the risk mitigant would diminish, as and when the parent's credit-risk profile suffers.

» Significant losses for the captives may only occur in the event of a corporate parent default, as it would lead to lower consumer demand, reduced recovery rates and increased dealer defaults. The recent Chrysler and General Motors bankruptcies in the US, which occurred in the context of an orderly manufacturer bankruptcy, led to a reduction of their dealerships networks, without, however, leading to a cascade of dealerships defaults. Independent dealerships have in most cases a diversified revenue base providing a buffer against a bankruptcy of one of the various manufacturers they work with.

Risks on dealer loans are, however, mitigated by the quick rotation of assets and high amount of collateral

» Dealer loans are typically short term. The average payment length for new vehicle financing is 60 days, and thus dealer losses have been limited to date given the ability of the captive to reduce its exposure in case of need. Most loans are secured against the value of the vehicle financed (through a title-retention clause), and additional financial collateral, granted by the OEM or the dealers, can be posted depending on the countries and the types of exposures. However, inventory turnover is directly linked to the OEM's strategy; the inventory could potentially increase and become stale, if the manufacturer decides to continue producing in a sluggish market, in response to various pressures from unions or sale quotas.

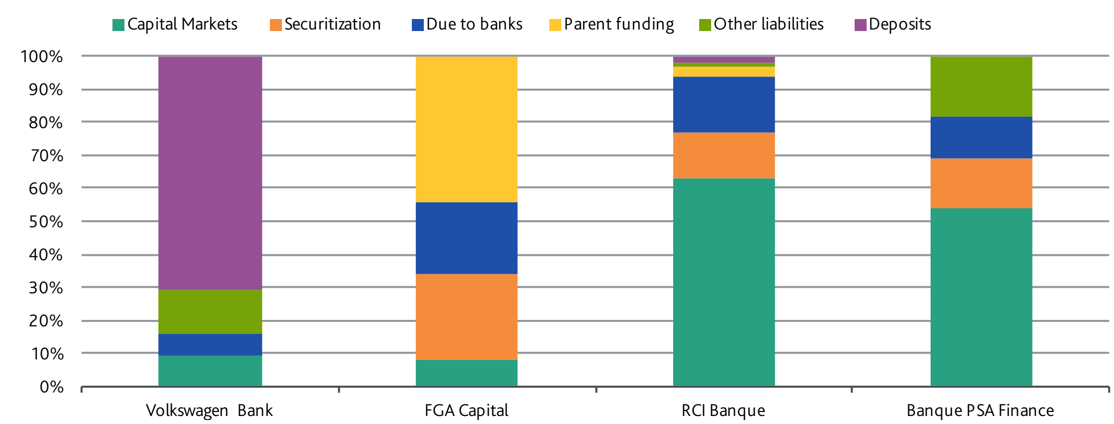
High reliance on market funding

Most of the European auto captive institutions are almost entirely reliant on wholesale-funding, which can be subject to sudden changes in investor confidence. This may ultimately result in restricted market access and increased funding costs. These captives aim to match the maturity profile of their liabilities with that of their assets, limiting maturity transformation and therefore reducing refinancing risk. However, in practice, the parent's strategic dependence on its finance subsidiary's capacity to fund its dealer network or its customers limits the theoretical ability to constrain lending and preserve the funding structure

A varying dependence on wholesale-funding, a key credit weakness

» European car financiers, with the notable exception of VW Bank, are mostly wholesale-funded (see Exhibit 6). The deterioration in market funding conditions since mid-2011 has highlighted the confidence-sensitive nature of wholesale funding, which can reduce rapidly in line with negative investor sentiment. Market disruptions increase refinancing risks for captive institutions. This could lead to a shortening of the banks' maturity profiles and higher funding costs, which would constrain loan origination. This would, in turn, affect the strength of the captives' franchises and ultimately reduce earnings generation, particularly if any funding constraints coincided with higher loan impairments.

EXHIBIT 6
Funding profiles of European car financiers
as of June 30, 2012



Source: Issuers' Interim Financial Statements

Liquidity buffers, central bank borrowings and securitisation partly mitigate refinancing risk

» European car financiers hold liquidity buffers comprising cash deposits, some securities, retained securitisations that are eligible for central bank refinancing and – most importantly – undrawn committed syndicated bank facilities. These credit lines allow them to cover short-term liquidity needs in case of lack of access to market funding.

» Securitisation (including self-subscribed securitisation for central bank funding purposes), has been increasing in recent years and is expected to further increase its role within the institutions' funding profiles (see Exhibit 6). We believe that securitisation operations could reach 30% of some car financiers' funding profile in the coming years, which would mechanically increase effective subordination for unsecured bondholders, although we acknowledge that subordination would be maintained at still-acceptable levels.

Higher cost of funding expected

- Auto captive institutions typically finance their assets with longer-dated liabilities, in order to maintain a positive liquidity gap at every point in time in a run-off scenario (i.e., no new business). These firms have been able to regularly tap the capital markets in recent periods despite market disruptions. Nonetheless, further extending liability durations – notably through increased recourse to securitisation – is likely to increase funding costs. However, we note the captive's ability to pass on higher funding costs to the customers, due to the rapid turnover of the book (the average asset duration is 36 months).
- VW Bank presents a different model, since its funding profile depends more on shorter-dated client deposits, representing a higher refinancing risk in case of a reputational loss and high outflows. However, we note that the bank was able to gather deposits throughout the financial crisis without developing an aggressive price strategy. Furthermore, the bank maintains a significant liquidity buffer, comprising liquid and marketable securities as well as committed bank and parent back-up lines; we therefore regard VW Bank's liquidity profile as adequate.

Deposit-taking franchises are of varying importance

- The difficult market conditions and upcoming regulatory changes have encouraged the European car financiers to develop deposit-gathering activities. While VW Bank already had a significant retail and corporate deposits franchise, RCI Banque launched this activity in 2012 while Banque PSA Finance will do so in 2013. While bank deposits are currently attractive, especially in France, due to lower returns on other savings products that were traditionally sold to retail customers, we believe that deposits collected through the internet with high promotional rates are more likely to suffer from a lack of stickiness (stability) when the promotional period ends, as they are more price-sensitive. More generally, we believe that internet deposits potentially entail some volatility, particularly in times of higher uncertainty, or if the parent's credit standing were to deteriorate.

Reliance on banks' credit lines

Funding and liquidity reserves at these firms are, to varying degrees, dependant on (1) funding arrangements with their parents; and (2) credit facilities provided by other banks. We believe that current conditions for European banks – notably deleveraging efforts – will reduce their continued willingness to extend such credit lines. Moreover, the forthcoming Basel III regulatory changes to the treatment of interbank credit facilities will reduce the incentive to provide these lines on current terms. This would likely result in changes to the availability and pricing of funding for auto captive firms.

A main component of the captives' funding profiles and liquidity buffers

- Most captive finance institutions have a significant reliance on bank funding (see Exhibit 6), and are also dependent on syndicated or bilateral committed banking lines to constitute their liquidity buffers. These sources allow them to cover at least six months of refinancing needs, in case of lack of access to financial markets, while complying with forecasted levels of production. However, these syndicated committed facilities can be subject, in some cases, to financial covenants such as negative pledges, cross-default or MAC clauses.

Deleveraging efforts and forthcoming regulatory changes will reduce the incentive to provide such facilities

- Most European banks have developed deleveraging plans in order to reduce their market funding requirements, with accompanying targeted asset reductions. With the upcoming Basel III regulatory changes, banks will have to hold liquid assets against the undrawn lines to comply with the liquidity ratios, thereby reducing the incentive for banks to provide such lines. In our view, this will reduce their availability, add to their cost, or both, creating additional pressure on the captives.

Mitigating factors

The current ratings assigned to European car financiers take into account several mitigating factors that have reduced the magnitude of the potential downgrades. These are: (1) adequate capitalisation levels and stable earning bases; (2) match-funded profiles resulting in little refinancing risk; and, (3) bank or bank-like statuses with accompanying regulatory requirements. We also recognise that the performance of car financiers has thus far shown little correlation with that of their industrial parents.

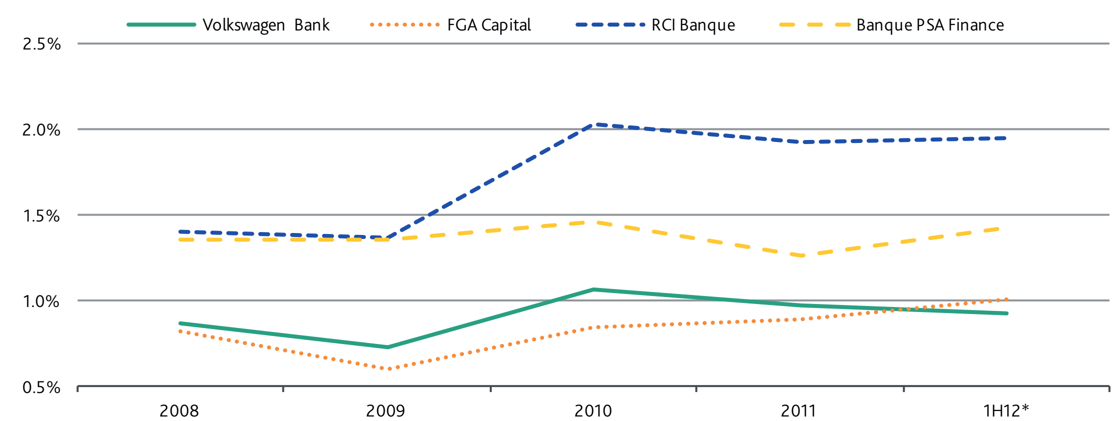
Notwithstanding this performance, we believe that the auto captives' strategic role within their industrial groups means that their standalone creditworthiness is ultimately closely tied to the credit strength of their parents, some of which are themselves vulnerable to further macroeconomic pressures through their exposure to the cyclical car market.

Adequate capitalisation and stable earnings base

European car financiers have maintained their ability to generate recurring revenues

» The captives have been able to report resilient profitability throughout the cycle, due to high margins in the auto-financing business (see Exhibit 7), and have managed to transfer the increase in funding costs to their customers, thus far. We also note positively that ancillary services have developed over the years and have reduced these firms' reliance on net interest income. Given the distribution channels shared with their industrial parents, the captives' mostly variable cost base allows them to adjust to changing production volumes while maintaining their return levels.

EXHIBIT 7
Return on assets evolution



* annualised
Source: Issuers' annual Reports, Interim Financial Statements and Moody's Banking Financial Metrics

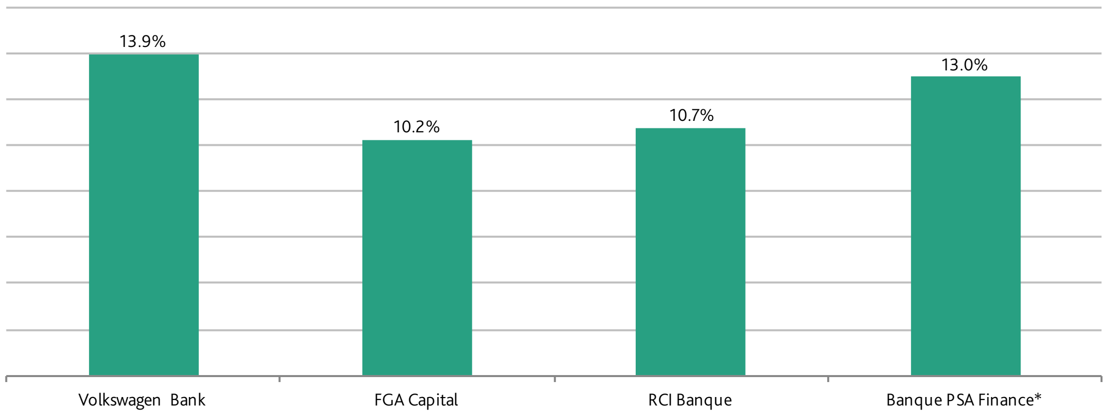
Capital levels constitute a significant buffer against credit losses

» We consider that the firms' reported capital ratios (see Exhibit 8) are adequate for their risk profiles. The captives' capital-management policies are determined by a combination of minimal targeted capital ratios – which are typically above the minimum Basel III capital levels – internal return targets and adequate dividend pay-out ratios. We note that securitisation transactions remain on the balance sheet and do not provide any capital relief.

EXHIBIT 8

Core Tier capital ratios as of June 30, 2012

as of June 30, 2012



*Moody's estimate

Source: Issuers' Annual Reports, Interim Financial Statements and Moody's Banking Financial Metrics

» To assess the resilience of the auto captives to the current challenging macroeconomic conditions, we have applied our stress tests to the firms' earnings, assets and capital.[5] For this purpose, we have developed specific asset stress tests that capture the risk of lending to the dealer networks (detailed in Appendix 1) and which have complemented the stress tests applied to the retail loan portfolios that principally reflect our assumptions for consumer loan stresses. Overall, we believe that the auto banks' capital is sufficiently strong to absorb the losses in a highly adverse scenario of widespread dealer defaults and a significant increase in retail loan losses. In our central case scenario, the Tier 1 ratio of the four captive institutions – after the impact of our estimated losses offset against capital, reserves and our conservative earnings estimates over four quarters – range between 11.2% and 14.4%. In our stressed scenario, Tier 1 ratios range between 5.6% and 9.5%.

Bank or bank-like status provides additional level of protection to creditors

» All of these firms have bank licences, with the exception of FGA Capital,[6] which enables them to have access to direct central bank refinancing. In addition, we consider that accompanying regulatory and supervisory requirements afford a higher protection of the bondholder's interest compared to a non-regulated affiliate in the case of a default of the industrial parent.

5 For further details on our general approach on stress testing, please refer to the following special comment: "Moody's Approach to Estimating Bank Credit Losses and their Impact on Bank Financial Strength Ratings", published in May 2009.

6 FGA does not have a banking license and is established in Italy as a non-bank financial institution (regulated under Art. 107 T.U.B.). As such, it is regulated and supervised by the Bank of Italy under a regime that differs from that for credit institutions with a banking license. However, in some of the other European jurisdictions in which it operates, it is recognised and regulated as a bank.

Appendix

Expected Loss Assumptions for Auto Dealer Exposures

To analyse the potential impact on capital from dealer exposures we incorporate expected loss assumptions under two scenarios, a base case and a stressed case. Assumptions are for a three year time horizon. For each scenario we follow the following three step approach:

1) We estimate the probability of a car manufacturer distress (PD). For the base case we use the credit rating as an anchor and map it to Moody's idealised default rates. If a manufacturer has a negative rating outlook we calculate PD as an average of the current rating and of the 1-notch lower rating. For the stressed case we use the PD corresponding to 3 notches below base case.

2) We estimate the conditional probability of dealer default (Con PD) dependent on the manufacturer being in distress or not. If a manufacturer is in distress we assume this would automatically lead to a dealer default. If a manufacturer is not in distress we assume the probability of dealer default is the same as risky SMEs in each of the countries.

3) We estimate loss given default (LGD) implied by historical observations. We assume higher LGDs in case of manufacturer distress. Furthermore, in a stressed environment we assume recoveries for distressed brands will decline further.

Base Case

	Manufacturer Distress			No Manufacturer Distress			Expected Loss
	Manufacturer PD	Dealer Conditional PD	LGD	No Manufacturer Distress Probability	Dealer Conditional PD	LGD	
Renault	3.20%	100%	30%	96.8%	12%	20%	3.3%
PSA	9.50%	100%	30%	90.5%	12%	20%	5.0%
Fiat	9.50%	100%	30%	90.5%	16%	20%	5.7%
Volkswagen	1%	100%	30%	99.0%	8%	20%	1.9%

Stressed Case

	Manufacturer Distress			No Manufacturer Distress			Expected Loss
	Manufacturer PD	Dealer Conditional PD	LGD	No Manufacturer Distress Probability	Dealer Conditional PD	LGD	
Renault	12.00%	100%	40%	88.0%	21%	20%	8.5%
PSA	25.00%	100%	40%	75.0%	21%	20%	13.2%
Fiat	25.00%	100%	40%	75.0%	25%	20%	13.8%
Volkswagen	3%	100%	40%	97.0%	16%	20%	4.3%

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