Article Title: ARCHIVE | Criteria | Corporates | Industrials: Regulated European Subsidiaries of Automakers May Be Rated Slightly Higher Than Parent Data: When assessing different companies within a group, Standard & Poor's generally caps ratings on subsidiaries at the level of their operating parent. However, the example of several European captive finance subsidiaries (CFSs) of major automotive groups illustrates the circumstances under which a slight rating differentiation is justified, enabling the assignment of ratings above those of the parent. The following conditions are considered essential for such a differentiation in ratings: The CFS is a regulated entity; There is a regulatory and legal framework that limits parental influence; There are insolvency laws that do not entail the extension of bankruptcy proceedings from the parent to the subsidiary. Standard & Poor's believes that these general preconditions exist for the automotive CFSs that it rates in France, Germany, and Sweden.This has to be supported, however, by a stronger stand-alone creditworthiness, reflecting the CFS' own business risk and financial profile. Indeed, favorable legal and regulatory frameworks are not in themselves sufficient to justify a difference in the ratings. The subsidiary must deserve a higher rating on its own merit. Moreover, the extent of the rating difference is limited by the actual business relationship between the two entities. Standard & Poor's would generally limit any rating differential to one notch, reflecting the close ties between the two entities. When Standard & Poor's rates unregulated captive finance companies whose main activity is the financing of their parent company's sales to customers, the parent company and its CFS are generally considered as a single business enterprise and are thus given the same rating. This methodology reflects the likelihood in most jurisdictions that the default of the parent entity would inevitably entail the bankruptcy of the CFS. It also reflects the tight links between the two entities, with the CFS playing a major role in its parent's marketing policy, and the parent providing its subsidiary with the bulk of its activity. (A complete description of these principles and their application in Standard & Poor's analytical process can be found in the article entitled "Corporate Criteria--Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link to Parent" published on RatingsDirect, Standard & Poor's Web-based credit analysis system, on Oct. 28, 2004). Adapting CFS Methodology to Regulatory and Legal Environments in Europe Standard & Poor's believes that the current regulatory and legal framework in several European countries, notably France, Germany, and Sweden, removes one of the main reasons for rating equalization: namely, the strong likelihood that, if the parent company were to go bankrupt, the CFS would also go bankrupt either simultaneously or shortly after. The key considerations supporting Standard & Poor's view are set out below. Banking license or similar regulatory status. The operations of the finance subsidiary must require a banking license or similar regulatory status. This legal status involves compliance with specific regulations such as: Minimum capital levels (including the European Solvency Ratio and the forthcoming Basel II accord on capital adequacy, or specific capital ratios set by the regulators at a higher level). Minimum standards regarding risk management and internal control; limits on large exposures, including limits on loans to shareholders (maximum of 25% of the capital base, or even deduction from regulatory capital); Maintenance of certain liquidity standards, as well deposit-protection schemes where required. Moreover, regulated financial institutions are monitored by banking supervisors on an ongoing basis, including on-site inspections and off site reporting. Controlling shareholders of banks are required to comply with "sound banking policy" rules. If deemed necessary, the banking authorities may issue specific injunctions to a bank in order to remedy inappropriate situations and enforce compliance with banking regulations. In extreme cases, this could even involve a change of management at the bank, without the agreement of the parent company. In many countries, regulators are expected to adopt a more protective stance as pertains to financial institutions that have a banking license, particularly deposit-taking institutions. Bankruptcy law. The bankruptcy laws must restrict the extension of a parent's insolvency proceedings to its regulated subsidiary. The insolvency of one group member must not entail the failure of the whole group, and the assets of the non-bankrupt individual group member must not be liable to seizure by creditors elsewhere in the group. For instance, in France, the extension of insolvency proceedings from one group member to another generally occurs only when the second entity is itself insolvent; when the integration of both entities is such that it is impossible to differentiate between their respective assets and liabilities; or when there is evidence of fraudulent management. In Germany, the insolvency proceedings against a bank can only be requested by regulatory authorities.

Banking regulation limits the influence of shareholders on a CFS' financial profile, and adequate bankruptcy laws restrict the impact of a parent's bankruptcy on its subsidiary. In Standard & Poor's view, the combination of these two factors could allow a distinction to be made between the ratings on a corporate parent and its CFS. A Higher CFS Rating Requires Higher Stand-Alone Credit Quality Than the Parent While the legal and regulatory frameworks are prerequisites, they are not sufficient in themselves to justify a higher rating being assigned to a CFS than to its parent. Ultimately this relies on the assessment of the CFS' stand-alone credit fundamentals, reflecting the CFS' own business risk and financial profile. Given that CFSs often are characterized by a limited degree of earnings and business diversification and often also rely primarily on wholesale funding, these constraints have to be compensated by a superior financial profile, notably in terms of credit risk management, capitalization, and liquidity management. The dependence on the parent company's business, however, is partly mitigated by the recurrent nature of credit activities. A CFS benefits from the stability of the revenue flow from its existing loan book. This helps ensure that the CFS' cash flows are not too heavily dependent in the short-term on the parent's activity. The larger the proportion of dealer financing in overall activities, the more the risks will be closely correlated to the fortunes of the parent's manufacturing businesses. Other factors that Standard & Poor's takes into account are the various incentives for the parent to maintain a sound financial position at its CFS, as it contributes to stabilizing earnings and funding. Over the past decade, CFSs have generally posted much less volatile profitability than their respective parents. Therefore, a CFS could even be the major earning contributor in its group when the cycle of the industrial activities reaches its lowest point. Moreover, maintenance of a sound financial profile allows the CFS to attract independent funding, thus easing the pressure on the parent. Car manufacturers therefore have a direct interest in safeguarding their banking subsidiaries' financial strength. This includes allowing a high degree of earnings retention, even during a period of financial stress, and supporting superior capital levels at the CFS without meaningful repercussions on (more cash flow-oriented) consolidated corporate ratings. A CFS with sufficient financial means to perform its role as a tool to improve sales can only benefit the overall group. Any Rating Differences Between CFSs and Parent Companies Will Remain Limited If Standard & Poor's analysis of regulatory supervision, the legal environment, and the standalone merits suggest that the CFS rating would not be capped by that of the parent, Standard & Poor's believes that the rating differentiation would remain very limited and would generally not exceed one notch. This conclusion is based on the tight links between the CFS and its parent, which leaves a CFS vulnerable to developments at the parent level. The most important links are: Reputation risk: the impact on the CFS' access to the debt market in the event of difficulties at the parent. Knock-on credit risk effect: the impact on the CFS' wholesale portfolio (loans to dealers) of lower sales by the parent. Standard & Poor's views the financial condition of dealers--and hence the quality of wholesale finance assets--as very closely correlated to the health of the manufacturer. Intragroup transactions: the impact of a change in the flow of revenues from the parent (for example, a change in transfer prices, or a subsidized sale policy). Financial policy: the impact of a change in upstream dividend payments and capital policy. Risk appetite: the impact on asset quality of a greater risk appetite of the parent to promote sales. Long-term business viability: the impact on the CFS of operating difficulties at the parent that lead to shrinking business volume. In general, the more sensitive a CFS is to parental developments the less likely it is that the rating can be differentiated. For instance, a rating differential would not be justified if the CFS had material credit exposures toward its parent or if it did not maintain independent funding. The Role of Funding Most crucial is a CFS' ability to independently raise and diversify funding. Standard & Poor's therefore emphasizes the analysis of the CFS' quality and capacity of liquidity management and funding resources. In addition to the maintenance of available sources of funding not tied to cash flows from the parent's activities, Standard & Poor's also looks at the permanency of funding. A default by the parent could create temporary market mistrust that would hinder the CFS from rolling over its short-term maturities. To address this issue, the CFS is expected to conservatively manage any duration of mismatching between liabilities and assets and to maintain backup lines of credit to cover short-term issues. The benchmark is generally 100% of short-term issuance in committed medium-term credit lines from a number of major banks. Standard & Poor's examines the amounts of these lines, as well as their terms and conditions, to assess the protection against liquidity risk. Cross-default clauses, financial covenants linked to the parent, as well as any clauses tying the amortization of the CFS's credit lines to that of the parent are regarded as negative factors. With regard to liquidity, it should be noted that regulated CFSs that have bank status may access refinancing from the central bank through the discount of certain high-quality loans, in addition to highly liquid, repo-eligible securities. The development of a securitization market in Europe is considered beneficial for CFS funding, as their assets are well suited for this type of funding, with several issuers having already taken advantage of this opportunity. Case Studies RCI Banque and Banque PSA Finance. The industrial parent of French car manufacturing group Renault is rated 'BBB/Positive/A-2', while its CFS, RCI Banque (formerly Renault Crédit International S.A. Banque) is rated 'BBB+/Positive/A-2'. This difference in ratings is based on the CFS' standalone financial profile, which deserves a higher rating than the parent's 'BBB', as well as its fully fledged bank status. RCI is characterized by satisfactory profitability, improving asset quality, and moderate capitalization. It should be noted that while the outlook on Renault S.A. was negative from Oct. 30, 2001, to Oct. 8, 2002, the outlook on RCI was also negative, reflecting the essential links between both entities. A rating downgrade at Renault would have entailed a rating downgrade of the same extent at its subsidiary--even if there were no change in RCI's standalone financial profile. Standard & Poor's ratings on the industrial parent company of France's other major auto group, PSA Peugeot-Citroën, and its CFS, Banque PSA Finance (BPF) are equalized at 'A-/Positive/A-2'. The outlook was changed to positive from stable on June 25, 2002, reflecting the improvement in operating performance of the car business. The outlook on BPF was changed accordingly, reflecting the core importance of finance operations to support the parent business. In Standard & Poor's opinion, any upgrade of the bank's rating would be driven primarily by its relationship with the parent and the resulting implicit support, rather than by its current and expected financial stand-alone performance. Nevertheless, from March 8, 1999, to Aug. 24, 2001, the outlook on BPF was stable, while that on Peugeot S.A. was negative. This reflected Standard & Poor's opinion that the bank warrants an 'A-' rating on its own, and that the rating could therefore have been maintained if the parent's rating were downgraded. The bank's financial profile is underpinned by above-average asset quality, strong profitability, above-average capitalization, and a conservative funding policy. BPF is also a fully fledged bank. AB Volvofinans. The rating on AB Volvofinans (BBB/Stable/A-2) tracked that of its owner Ford Motor Co. (Ford; BBB-/Stable/A-3) from the time that Volvofinans was acquired by Ford in June 2002 until November 2003. However, when Ford was downgraded to 'BBB-' in November 2003, the rating on Volvofinans was affirmed at 'BBB'. Volvofinans is owned 50/50 by Ford (indirectly) and the dealers of Volvo cars and trucks in Sweden, via Volverkinvest AB. The hypothetical bankruptcy of either of the owners would not automatically extend to Volvofinans. Moreover, Volvofinans is a licensed credit market company, supervised by Finansinspektionen, the Swedish financial supervisory authority (FSA). Volvofinans' legal status makes it subject to the same regulation as banks regarding capital adequacy, risk management, and reporting. It must maintain a minimum 8% capital adequacy ratio, and the FSA appoints its own auditor in addition to regular on- and off-site inspections. The Volvofinans group's financial performance was stable during the period that Ford suffered repeated downgrades. Credit risk management has been very successful, and losses have been minimized through a tight cooperation and risk sharing system with Volvo dealers. Furthermore, Volvofinans funds its financing operations independently from those of the Ford group. At the current rating level, the stable outlook reflects the expectation that Volvofinans will maintain its stable performance. It also reflects, however, a continued linkage to the Ford group ratings and the potential impact on Volvofinans either directly through Ford's ownership, or indirectly through the cooperation with Volvo Car Corp. Volkswagen Bank GmbH. Until November 2004, the ratings on Volkswagen Bank GmbH (VW Bank) and Volkswagen Financial Services AG (VWFS; (A-/Negative/A-2)) moved solely in tandem with the ratings on Volkswagen AG (VW AG; A-/Negative/A-2), with the ratings of both finance subsidiaries solely reflecting their ultimate parent's higher creditworthiness in the auto industry. However, following the gradual decline of the ratings on VW AG, the VW Bank ratings no longer benefit from any uplift compared to its own credit strength. Furthermore, several important changes at the end of 2004 will make VW Bank more resilient to developments at VW AG: The acquisition of Leaseplan, which increases the proportion of business not related to the VW brand to 30%; VW Bank's plan to strongly limit intra-group financings, including its capital market separation; and VW Bank's success in attracting customer deposits. In light of these factors, together with an adequate legal environment and insolvency protection in Germany, Standard & Poor's puts more emphasis on VW Bank's stand-alone ratings, which are currently at the same level as those on VW AG. However, should VW Bank's stand-alone credit quality evolve more favorably than that of VW AG, Standard & Poor's would limit any rating differential between the two entities to one notch. The ratings on VW Bank reflect its sound asset quality, profitability, funding, and capitalization. As VW Bank's 100% owner, VWFS, does not have the benefit of banking status under German regulation, the ratings on it would continue to be equalized with those on VW AG. Group E-mail Address FIG_Europe@standardandpoors.com