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Captive Finance Operations

Primary Credit Analyst:

Scott Sprinzen, New York (1) 212-438-7812; scott_sprinzen@standardandpoors.com

Secondary Credit Analyst:

Rian M Pressman, CFA, New York (1) 212-438-2574; rian_pressman@standardandpoors.com

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A captive finance operation (captive) functions primarily as an extension of a corporate's marketing activities. The captive facilitates the sale of goods or services by providing debt and/or lease financing to the corporate's dealer organization (wholesale financing) or end customers (retail financing). The captive may also provide ancillary services, such as selling insurance. The captive can be structured as a legally separate subsidiary of the corporate or as a distinct operating division or business line.

The importance of having a captive finance function varies considerably across industry sectors. In some sectors (e.g., automotive, agricultural, and construction equipment), virtually every major participant offers finance support, and it would likely be a considerable competitive disadvantage for a company not to do so. In other sectors (e.g., technology), the structure of competitors varies, with some providing finance support and others relying on third parties to do so.

Corporates' financial services businesses frequently have both captive and noncaptive activities—extending financing support to the corporates' customers, but also offering financial services to unrelated parties. In such cases, the distinction between a captive and an independent finance unit is not always clear. Standard & Poor's Ratings Services previously referred to a captive finance unit as one with more than 70% of its portfolio in receivables generated by sales of the parent's or group's goods or services (see "Finance Subsidiaries' Rating Link to Parent" section of "Parent/Subsidiary Links," published in "Corporate Ratings Criteria," on RatingsDirect). However, this was meant as a general guideline, not a hard-and-fast rule. There have been a number of cases where a finance unit's portfolio was significantly less than 70% captive in nature, but where supporting the parent was still the key strategic mission of the finance unit and where the captive-related business was the most important driver of the unit's financial performance.

Rating Approach

Captive finance units organized as separate subsidiaries are rated the same as their parents in the overwhelming majority of cases, meaning we view the default risk of the subsidiary as being indistinguishable from that of the parent. The captive is typically a core subsidiary of the parent, and we generally view the parent and captive as a single business enterprise. Given the very close business and financial ties that typically exist between a captive and its parent, it may be difficult to assess the captive's credit profile meaningfully on a stand-alone basis. Even when the captive appears stronger than the parent, we are very reluctant to assign the captive a higher rating than the parent, given that:

- The value of the captive's business franchise is inextricably linked to the fortunes of its parent. The captive, by definition, depends on the parent's customer base for a substantial portion of its finance transactions;
- Were the parent to experience severe commercial setbacks, it would inevitably have an adverse effect on the origination volume and asset quality of the captive;

- Apart from the function of funding their parents' wholesale and/or retail customers, captives typically have other substantial parent-related credit exposures owing to: advances to the parent; other parent-related receivables stemming from transactions with the parent; and advances to other affiliates of the parent or to suppliers to the parent;
- Captives are sometimes funded to a substantial extent through advances from the parent;
- The parent typically has a high degree of control over the captive's management, which exercises minimal independent oversight. Although captives commonly claim that all transactions are carried out on an arms-length basis, there is little assurance that this would remain the case in a stress scenario;
- In certain jurisdictions, there is the ultimate risk that if the parent were to file for bankruptcy, the captive could also be filed into bankruptcy by the parent. But even when this legal risk does not exist, there is always the risk the parent's bankruptcy could precipitate a bankruptcy filing by the captive, given all the challenges that having a parent in bankruptcy would pose for the captive.

On the other hand, while the captive may appear weaker than the parent, there may well be compelling economic incentives for the parent to support the captive, as necessary, if:

- Providing financing support to dealers and/or end customers is integral to the overall group strategy, and the captive is operationally integrated with other group entities;
- The captive accounts for a substantial portion of the parent's assets, earnings, and/or cash flow;
- The captive uses the same name as the parent; and
- The captive taps some of the same funding channels as the parent. For example, when the two have overlapping bank groups.

Notwithstanding the alignment of captive finance company and parent ratings, captive finance company debtholders may still be markedly better off than parent debtholders with respect to ultimate recovery in a liquidation or reorganization (barring substantive consolidation in bankruptcy, which is a rare occurrence). This is due to the relatively high quality and durable value of finance assets compared with most types of corporate assets. Still, bankruptcy would impair timeliness of payments.

Table 1 lists our rated North American-based captives, along with their corporate parents. In all cases but one (GMAC LLC) there is rating parity between the parent and subsidiary.

Table 1

Ratings Approach				
	Type	Long-term counterparty credit rating	Outlook	CP rating
American Honda Finance Corp.	Captive	N.A.	N.A.	A-1
Honda Motor Co. Ltd.	Parent	A+	Stable	A-1
Boeing Capital Corp.	Captive	A+	Stable	A-1
Boeing Co.	Parent	A+	Stable	A-1
Bombardier Capital Inc.	Captive	BB	Negative	NR
Bombardier Inc.	Parent	BB	Negative	N.A.
Caterpillar Financial Services Corp.	Captive	A	Stable	A-1
Caterpillar Inc.	Parent	A	Stable	A-1
Deere (John) Capital Corp.	Captive	A	Stable	A-1
Deere & Co.	Parent	A	Stable	A-1
Ford Motor Credit Co (FMCC)	Captive	B	Negative	B-3

Table 1

Ratings Approach (cont.)				
Ford Motor Co.	Parent	B	Negative	B-3
GMAC LLC	Captive	BB+	Developing	B-1
General Motors Corp.	Parent	B	Negative	B-3
Harley-Davidson Financial Services	Captive	N.A.	N.A.	A-1
Harley-Davidson Inc.	Parent	A+	Stable	N.A.
IBM Credit Corp.	Captive	A+	Stable	A-1
International Business Machines Corp.(IBM)	Parent	A+	Stable	A-1
Navistar Financial Corp.	Captive	BB-	Watch Negative	N.A.
Navistar International Corp.	Parent	BB-	Watch Negative	N.A.
Nissan Motor Acceptance Corp.	Captive	BBB+	Stable	A-2
Nissan Motor Co. Ltd.	Parent	BBB+	Stable	A-2
Nordstrom Credit Inc.	Captive	A	Stable	N.A.
Nordstrom Inc.	Parent	A	Stable	A-1
PACCAR Financial Corp.	Captive	AA-	Stable	A-1+
PACCAR Inc.	Parent	AA-	Stable	A-1+
Pitney Bowes Credit Corp.	Captive	A+	Stable	A-1
Pitney Bowes Inc.	Parent	A+	Stable	A-1
Toyota Motor Credit Corp.	Captive	AAA	Stable	A-1+
Toyota Motor Corp.	Parent	AAA	Stable	A-1+
Xerox Credit Corp.	Captive	BB+	Watch Positive	NR
Xerox Corp.	Parent	BB+	Watch Positive	B-1

Ratings as of April 12, 2007. N.A.--Not applicable.

Exceptions

An exception to the usual approach of rating a captive finance company the same as its corporate parent can occur when the captive is a regulated entity, the relevant regulatory/legal framework tightly restricts parental influence, or the national insolvency laws limit the extension of bankruptcy proceedings from the parent to the subsidiary (See "Regulation Benefits Ratings On European Automakers' Captive Finance Subsidiaries," published May 18, 2006, on RatingsDirect). In such a case, for the captive to be rated higher than the parent, we must also be convinced the captive is positioned (e.g., in terms of its credit and funding exposures) such that it likely could sustain a bankruptcy by the parent, since this is ultimately what a relatively higher rating on the captive signifies. Even so, we believe the close business ties between the parent and captive limit the degree of insulation afforded the captive, and we generally cap any rating differential at one notch. Table 2 lists our rated regulated captive finance subsidiaries, along with their ultimate parents. Currently none of these regulated captives are based in North America--all are in Europe.

Table 2

Ratings On Regulated Captive Finance Subsidiaries And Their Ultimate Parent			
	Rating	Carmaker	Rating
Banque PSA Finance	A-/Negative/A-2	Peugeot S.A.	BBB+/Negative/A-2
FCE Bank PLC	B+/Negative/B-3	Ford Motor Co.	B/Negative/B-3
RCI Banque	A-/Stable/A-2	Renault S.A.	BBB+/Stable/A-2
Volkswagen Bank GmbH	A/Stable/A-1	Volkswagen AG	A-/Stable/A-2

Table 2**Ratings On Regulated Captive Finance Subsidiaries And Their Ultimate Parent (cont.)**

Ratings as of April 9, 2007.

Another type of exception can occur when the parent sells a majority stake in the captive to a third party, ceding management control to a significant extent while ensuring that the captive's ongoing customer financing requirements are provided for by entering into operating agreements with the captive. In such a case, the captive ceases to be a subsidiary in a legal, accounting, or economic sense. The former parent has only a limited ability to influence the actions of the captive, and cannot act unilaterally to file the captive into bankruptcy. Here, again, the business ties between the captive and the former parent remain a critical rating factor. However, such a case is analyzed like that of any supplier with an extreme customer concentration, and while the credit profile of the former parent is a critical rating factor, we do not consider there to be a fixed link between the ratings on the two.

GMAC LLC, which plays a crucial role in financing General Motors (GM) vehicles for consumers and dealers worldwide, falls into this category. In a transaction that closed on Nov. 30, 2006, GM sold a 51% ownership stake in General Motors Acceptance Corp. (which was subsequently renamed GMAC LLC) to a consortium headed by private equity firm Cerberus. As a result of this transaction, GMAC LLC was able to achieve a significant degree of ratings separation from GM, while still retaining its role as financier for its former parent (see "GMAC LLC Upgraded To 'BB+/B-1' Pending GM's Sale Of Stake To Cerberus, Outlook Developing," published Nov. 27, 2006, on RatingsDirect).

In theory, there is another type of exception in which the captive is wholly owned but the parent is diversified and the captive supports a business—or operates in a geographic market—that is not viewed as core to the parent. Here, the captive could be rated significantly lower than the parent. In practice, however, rated debt issued by such captives frequently is guaranteed by the parent, so that the captive can benefit from the parent's relatively lower cost of funds.

Assessing Captive Finance Operations

Even when the ratings on the captive and parent are the same, the two are not analyzed on a consolidated basis. Rather, the analysis segregates financing activities from corporate/industrial activities and analyzes each separately, reflecting the differences in business dynamics and economic characteristics, and the appropriateness of different financial measures.

We have developed a methodology to segregate the financing activities from the industrial businesses of corporates with captive finance operations. This methodology is indifferent to the legal structure (i.e., whether or not the finance operations reside in a separate subsidiary) and to the accounting for the finance operations.

The approach is to create a pro forma captive unit to enable finance-company analytical techniques to be applied to the captive finance activity, and correspondingly appropriate analytical techniques to the "pure" industrial company. Finance assets and appropriate amounts of debt and equity are allocated to the pro forma finance company; all other assets and liabilities are included in the parent/industrial balance sheet (see table 3). Similarly, only finance-related revenues and expenses are included in the pro forma finance company income statement (see table 4).

Table 3

Captive Finance Adjustments To Balance Sheets						
(Mil. \$)	--2005--			--2004--		
	Year-end consolidated balance sheet	Adjustments to remove captive finance assets from industrial balance sheet	Adjusted industrial balance sheet	Year-end consolidated balance sheet	Adjustments to remove captive finance assets from industrial balance sheet	Adjusted industrial balance sheet
XYZ Corp. Balance Sheet						
Cash	50		50	50		50
Accounts receivable	100		100	100		100
Customer notes receivable	400	(400)	0	350	(350)	0
Inventory	200		200	200		200
Total current assets	750		350	700		350
Property, plant and equipment	250		250	250		250
Total assets	1,000		600	950		600
Debt	700	(350)	350	660	(306)	354
Stockholders equity	300	(50)	250	290	(44)	246
Total debt and equity	1,000		600	950		600
Total debt to capitalization (%)	70		58	69		59

In this example, it is assumed that the captive finance operations are fully consolidated in the group financial statements. The hypothesized rating on the group is 'BBB'. Captive finance assets are comprised of 400 customer notes receivable at year-end 2005, and 350 at year-end 2004. Based on our analysis of the quality of these assets, we believe they can support leverage of 7:1 (debt to equity) at the 'BBB' level. Thus, all the finance assets are eliminated from the consolidated balance sheet, as are debt and equity in proportion of 7:1, to produce the adjusted industrial balance sheet.

Table 4

Captive Finance Adjustments To Income Statements			
(Mil. \$)	XYZ Corp. 2005 income statement	Adjustments to eliminate interest expense and earnings associated with finance operations	Adjusted industrial income statement
Revenues	2,000	(60)	1,940
Operating expenses	1,600	(12)	1,588
Operating income	400	(48)	352
Depreciation and amortization	200		200
Earnings before interest and taxes	200	(44)	156
Excess finance company EBIT		4	4
Adjusted EBIT			160
Interest	60	(29)	31
Income taxes	30		
Net income	110		
EBIT to interest (x)	3.3		5.2

Table 4

Captive Finance Adjustments To Income Statements (cont.)

In adjusting the income statement, the revenues and expenses associated with the finance operation are determined. Often, this information is available in the notes to the statements and can be used directly. When it is unavailable, these amounts are estimated as a function of the average captive finance assets. Common "revenue factors" and "expense factors" used are 15% and 3%, respectively, although these should be modified based on the assets being leveraged. The net of the finance operations' revenue and expenses is the finance operation operating income. For the sake of simplicity, all other operating costs and nonfinancial costs are ignored. Accordingly, the operating income of the finance subsidiary is the same as its EBIT. Often, as in this example, the estimated finance company EBIT exceeds the EBIT required to maintain a prudent credit profile. In this case, this excess EBIT is considered to be available to the parent. The company's average interest cost is calculated using total consolidated interest expense and average consolidated debt. In this case, $60 / ((700 + 660) / 2) = 8.8\%$. The resulting rate is used to calculate the interest expense associated with the debt allocated to the finance operations ($8.8\% \times ((350 + 306) / 2) = 29$), and this interest expense is deducted from total interest expense. It is assumed at the 'BBB' rating level that the finance operations are expected to generate EBIT earnings sufficient to cover interest expense of $1.5 \times (1.5 \times 29 = 44)$. This amount of EBIT is deducted from consolidated EBIT to arrive at the adjusted industrial earnings. If the adjusted industrial financial measures are viewed as inconsistent with the assumed 'BBB' rating, the process is repeated using other assumed ratings as the starting point.

The debt and equity of parents and captives are apportioned and reapportioned so that both entities will reflect similar credit quality. A tentative rating on the two companies is assumed as a starting point. Next, a leverage factor is determined that is appropriate for the captive at the tentative rating level, based on the quality of the captive's finance assets, and typically using the same capital charges employed in our analysis of independent finance companies and banks. Adjustments are made to reflect the performance of a given subportfolio. In addition, factors such as underwriting, charge-off policy, portfolio concentration or diversity, and operating risk are considered.

With the appropriate leverage determined, the analyst calculates the amount of equity required to support finance company credit quality at the assumed level, and the proper amounts of debt or equity are allocated to the captive. No new debt or equity is created.

Next, the analyst eliminates the parent's investment in the captive to avoid double leveraging. The captive is an integral part of the enterprise, not an investment to be sold. While its assets can typically be more highly leveraged than the industrial assets of the parent, the methodology takes that into account when determining the amount of equity that is apportioned to support its debt.

Finally, the analyst determines the levels of revenues and expenses to reflect the captive's receivables and debt. The higher the tentative rating, the greater the level of imputed fixed-charge coverage and ROA.

Following the segregation of the finance activity, the industrial company profile may not be consistent with the tentative rating. The methodology is repeated, using parameters of a higher or lower rating level. Several iterations may be needed to determine a rating level that reflects the credit quality of both operating and financing aspects of the company.

Captive-Specific Aspects

Once the finance activities are appropriately segregated, the analysis proceeds along the same lines as with independent finance companies. Key areas of the analysis include business risk, credit risk, market risk, liquidity risk, leverage, profitability, and accounting (see "FI Criteria: Finance Company Rating Analysis Methodology Profile," published March 18, 2004). Given the special role of a captive finance business, certain considerations take on particular significance, and these are discussed in detail below.

Business risk

The franchise value of the captive is inextricably linked to that of the corporate (referred to here as the parent) to which it is tied. Therefore, the business risk inherent in this franchise factors heavily in our assessment. Economic cycles, competitive trends, and technological changes that affect the parent will inevitably have an effect on the

captive's business risk.

A separate consideration is the skill of the captive in supporting the parent's business. One important measure of this is the trend in and absolute level of financing penetration—the percentage of the parent's revenues or sales transactions that are financed by the captive. In assessing penetration levels, one must be cognizant of the effect of discounts offered by the parent in the form of low interest rate finance incentives or subsidized lease terms. Such subvention programs are generally offered by the parent exclusively through the captive, and so serve to artificially bolster the captive's market share.

Captive-exclusive subvention programs are the clearest manifestation of the competitive advantage that accrues to the captive by being the parent's primary provider of financial services. The affiliation with the parent and exclusivity of the lending arrangement may shield the captive from competitive pressures an outside financier would face. On the other hand, by nature, a captive has a narrower business focus than the typical independent finance company, and quite possibly a greater degree of customer and geographic concentration.

Historically, a number of captives have pursued diversification strategies to lessen their dependence on the parent's business. However, diversification will not result in reduced business risk if it is poorly executed or results in the financing of unrelated products that may be exposed to increased competitive pressures.

Credit risk

The concentrations inherent in a captive's asset portfolio increase overall credit risk. This is especially true of wholesale portfolios, which are necessarily concentrated in terms of products, customers, and geography. In contrast, retail portfolios tend to be less concentrated (typically having more customers with smaller balances) and therefore less correlated with the fortunes of the parent.

It is important to be alert to any signs of the captive compromising its underwriting standards to provide a sales boost to the parent. If the parent is undergoing stress, the temptation to pressure the captive to do so could be intense, regardless of prior representations about the "arms-length" nature of the relationship.

The level of direct credit exposure to the parent must also be assessed. Certain captives act as banks for the parent, other affiliates of the parent, and/or suppliers to the parent. This type of exposure generally arises due to the captive's competency in obtaining funds in the capital markets. The captive may issue debt in the public markets (or act as an intermediary for the parent in those markets) and lend the proceeds to the parent.

Another important captive-specific factor is the value of credit risk mitigation provided by the parent to its captive. This mitigation is usually some type of full or partial guarantee against credit exposure. Typical variants include:

- Residual value guarantees;
- Receivables purchase agreements;
- First-loss deficiency; and
- Rental guarantees.

The value of these guarantees may be substantial; however, they must be analyzed in the context of the resources the parent can bring to bear if it needs to fulfill its obligations. Obviously, the specific terms and conditions of the guarantee must be assessed. The potential for recourse back to the captive must also be factored into the analysis. Table 5 lists a sampling of parental support agreements for a selection of rated captives.

Table 5

Examples Of Parental Support Agreements	
	Type of frmal support
Boeing Capital Corp.	Partial and full guarantees, including first-loss deficiency guarantees, residual value guarantees, and rental loss guarantees
Caterpillar Financial Services Corp.	Receivables purchase agreements and loan guarantees
Deere (John) Capital Corp.	Agreements to maintain a minimum level of income, net worth, and ownership
Ford Motor Credit Co.	Agreements to maintain a minimum level of income, net worth, and ownership
GMAC LLC	Payment guarantees on certain third-party commercial assets
IBM Credit Corp.	Residual value guarantees
PACCAR Financial Corp.	Insurance and residual value guarantees
Toyota Motor Credit Corp.	Credit support agreements (to maintain 100% ownership and minimum net worth)

Market risk

While the industrial owners of captives usually have close familiarity with the management of foreign exchange exposures, the measurement and management of interest rate risk (IRR) require different risk management competencies. As part of our assessment, we evaluate the level and trend of IRR and its impact on profit and equity. Similar to that of any financial institution, the means by which management measures the impact of interest rate changes, its tolerance for risk, and the techniques employed to mitigate these risks are reviewed. Mitigation techniques include the use of derivatives such as swaps, forwards, or options. Many captives significantly reduce IRR without the costly use of derivatives by match-funding customer receivables or removing asset portfolios from the balance sheet through the use of securitization vehicles.

Liquidity risk

As with independent finance companies, a lack of retail deposits typically forces captives to rely on market-sensitive funding, including CP, unsecured term debt, and bank funding. Alternatively, depending on the type of finance asset in question, the captives can also avail themselves of the securitization and whole loan sale markets.

Like independent finance companies and banks, captives have a large funding appetite. And, similarly, they generally "play the yield curve," with short-term borrowings funding long-term assets. For captives, though, there are heightened risks from reliance on market-sensitive sources of funding. In particular, any deterioration in the financial or operating performance of the parent will similarly taint the capital market's view of the captive, which in turn could have an acute negative impact on funding flexibility. Headline risk can similarly trigger this reaction, even when it is not accompanied by financial deterioration. In a worst-case scenario, funding mechanisms that had been previously relied upon may become unavailable and the operations of the captive may be seriously impaired. Moreover, captives do not necessarily have leeway to curtail underwriting during a period of stress, given the ramifications this could have for the parent. Therefore, the diversity of funding mechanisms and the adequacy of contingent liquidity sources factor heavily into our assessment of captive liquidity risk.

Given the interdependence of captive and parent with regard to the flow of funds and funding capacity, we analyze liquidity on a consolidated basis, with an eye toward assessing the level of protection against near-term financial stress available to the captive. An important consideration here is the degree of reliance the captive can place on the parent's liquidity resources. The captive may have access to the same funding facilities as the parent, often with a parental guarantee. If the parent's credit quality is stronger, more funding will likely be available. Table 6 lists examples of the types of parental funding support available to a sample of rated captives.

Table 6

Parental Funding Support	
	Shared sources of funding
Boeing Capital Corp.	Parent allocates portion of its revolving credit line to captive
Caterpillar Financial Services Corp.	Shared revolving credit lines
Deere (John) Capital Corp.	Certain credit lines are available to both the captive and parent.
PACCAR Financial Corp.	Shared credit facilities

Securitizations and whole loan sales are often crucial funding channels for the captive. The ease by which the captive can tap these markets depends on the type and quality of receivables and market credibility in terms of underwriting practices, as opposed to the financial strength of the captive (or its parent). Therefore, the presence of high-quality receivables with established ABS and whole loan markets can significantly reduce funding risk at a captive. This flexibility is extremely valuable in a stress situation when traditional bank facilities and the public unsecured debt markets may become unaffordable or unavailable.

Despite the obvious benefits of the securitization markets, there are drawbacks. We would view an overreliance on securitization as a dangerous funding concentration. A high concentration of funding through securitization can cause a creeping subordination of existing unsecured debt, as the balance sheet gradually grows more encumbered. Finally, the moral recourse inherent in securitization transactions is also a concern. Any finance company that is particularly reliant on the securitization markets has an especially strong incentive to bail out troubled securitizations, given the heightened urgency for it to protect its credibility and reputation in the marketplace.

Leverage

Leverage--the amount of debt in relation to the capital base plus reserves--is a crucial ratings factor for captives.

Analytically, securitized receivables and the associated funding are generally included in all leverage calculations. If the captive regularly securitizes finance receivables that are regenerative in nature, our approach is to add back the sold receivables outstanding and a like amount of debt. One-off sales or securitizations that permanently reduce the level of finance receivables will generally not be added back unless there is recourse back to the captive.

In assessing a captive's leverage, key considerations are the financial policy of the parent as it relates to the target capitalization of the captive, the parent's approach with respect to upstreaming funds from the captive in the form of dividends and advances, and the willingness of the parent to support the captive with capital infusions and other forms of support payments as needed. It is important to understand the extent to which the parent's flexibility to avail itself of cash from the captive is constrained--if at all--by financial covenants under borrowing agreements.

Profitability

Despite the interconnectedness of the parent and its captive, the earnings trends of the two often vary. The origination volume of the captive may be correlated to the level of business activity of the parent, but even this is not always the case; if the parent is seeking to offset weakening sales by offering low interest rate finance incentives, this can drive up the captive's volume. In addition, the reimbursements received by the captive for these financial incentives can further mask its correlation to parental operational distress. Even in the case where the captive's origination activity is volatile, the layered nature of its finance assets generally produces a high degree of earnings stability compared with most corporates.

While in many cases the captive may be less sensitive to company or industry-specific factors than its parent is,

certain market factors can have the opposite effect. Dynamics such as fluctuation in general interest rates, the ebb and flow of the consumer credit cycle, and changes in finance-sector competitiveness may have a much less immediate effect on the parent's industrial business than on the captive.

For John Deere and Caterpillar, we charted annual revenue and earnings from 1991 to 2006 to provide a visual representation of the level of variation between captive and parent company results. The variation of results for both captives follows what we consider to be the expected pattern. Revenue and (especially) net income for the captive is less volatile than that of the parent, reflecting the smoothing effect of the captive's receivables portfolio. This contrasts with the more volatile parent, whose revenue more directly accelerates or decelerates with the volume of sales. Due to the nature of its receivables portfolio, it may take an extended downturn in product sales to add significant volatility to the captive's results.

Chart 1

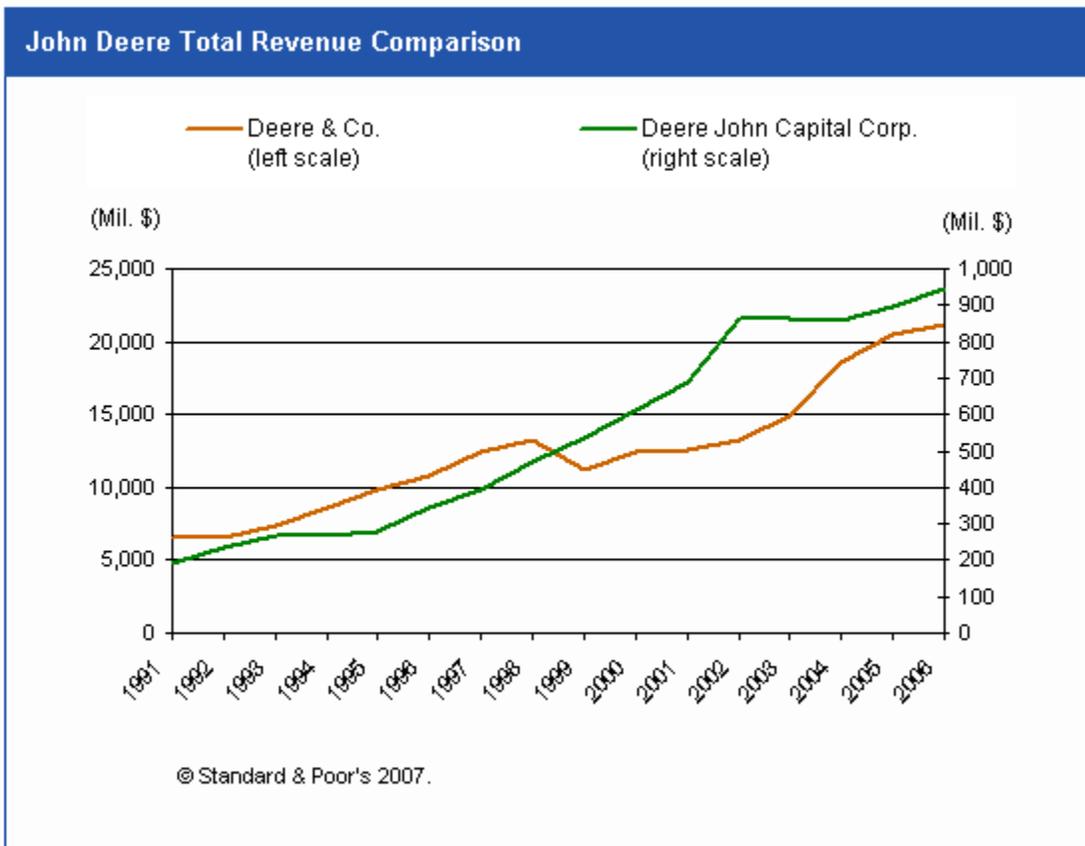


Chart 2

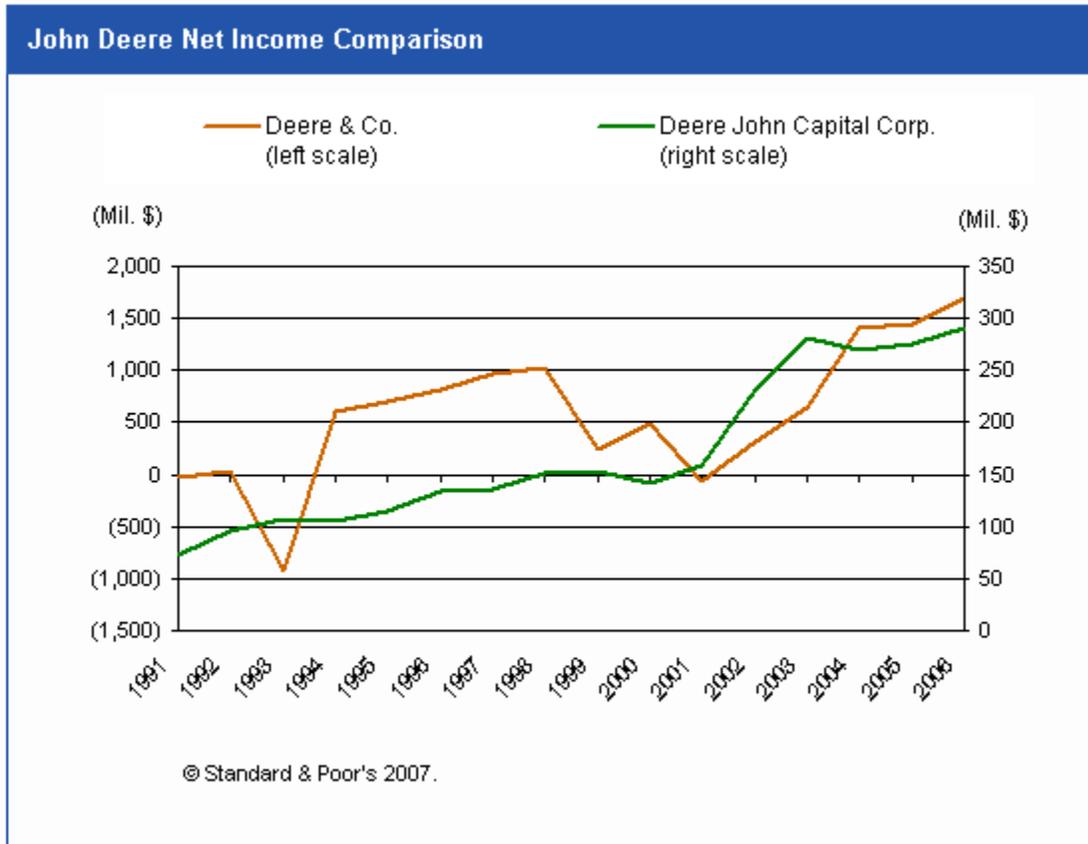


Chart 3

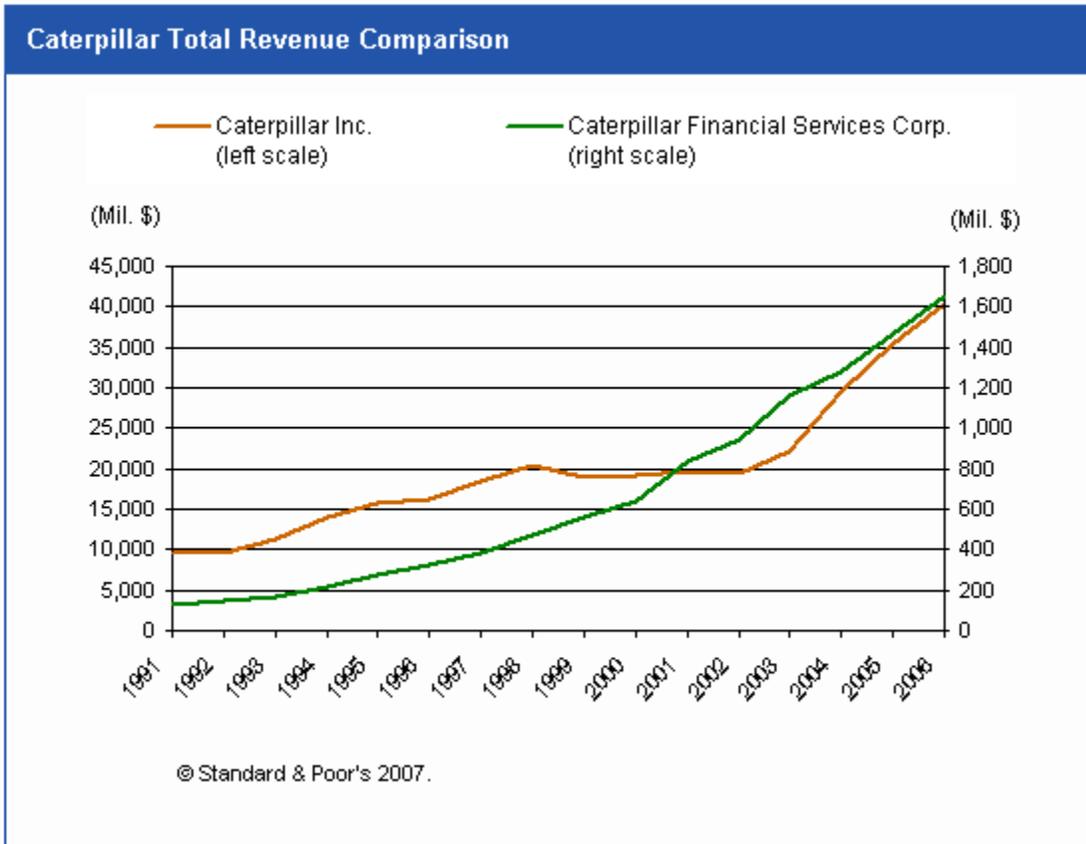
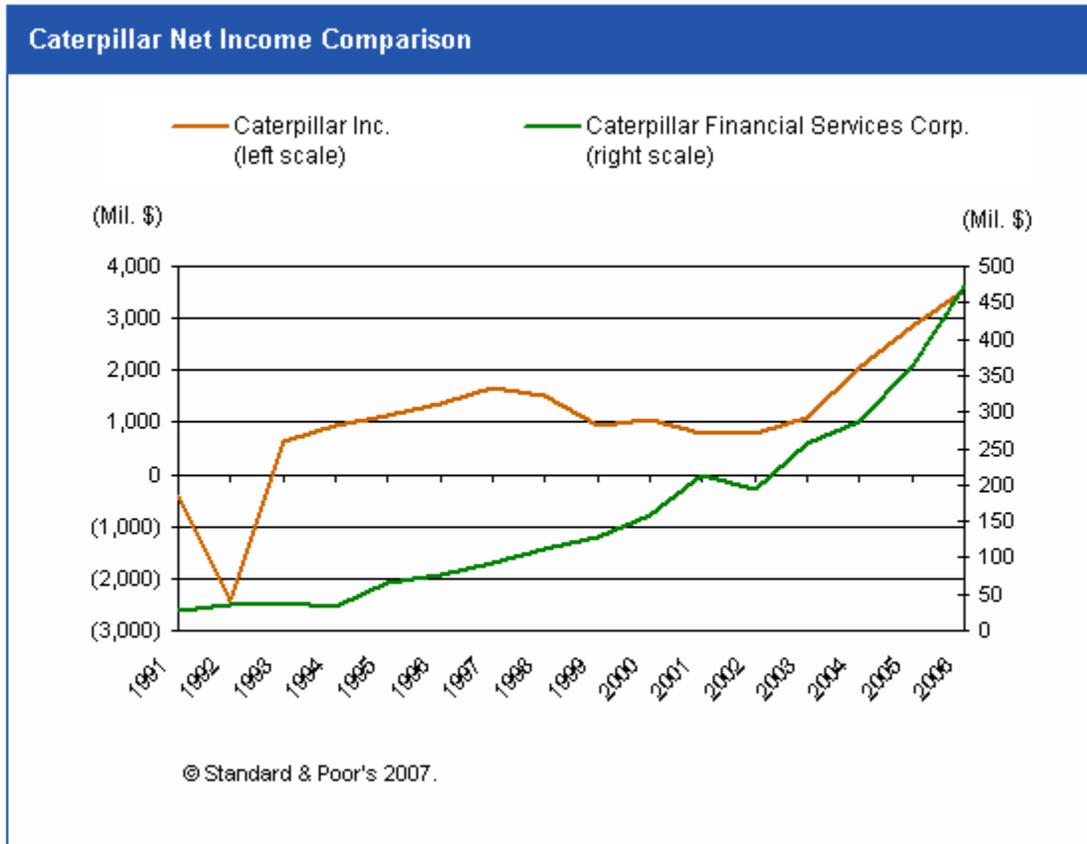


Chart 4



Accounting

Under U.S. GAAP, IFRS, and other major accounting frameworks, majority-owned captives are required to be fully consolidated into the financial statements of the parent. In the U.S., most significant captive finance subsidiaries are also required to make separate SEC filings; these separate financial statements facilitate our analysis. As with other rated financial institutions, we review the accounting for conformity to industry standards. Key areas include accounting for loan-loss reserves, securitizations, and derivatives. We pay particularly close attention to large swings in assets values or numerous and significant assumption changes.

A captive's financial statements may be heavily influenced by the accounting for intercompany transactions, most of which are eliminated in consolidation. The following examples are typical of the intercompany transactions we analyze when reviewing captive accounting practices:

- Where the parent extends low interest rate finance incentives to retail customers, the loans are typically transferred to the captive at a market rate, with the parent booking the value of the discount as a marketing expense. How this transfer rate is determined can have a substantial affect on the captive's reported results.
- With retail leases, there is sometimes a risk-sharing agreement between the parent and its captive for residual lease exposures. At lease termination, the allocation could be based on a predetermined formula or the parent could guarantee the residual up to a certain level.
- Cash flow will be affected depending on how intercompany transactions are structured. For example, cash flow will differ depending on whether an auto captive's reimbursement for subvended loans is received up front or over

the life of the loan.

Ratings Criteria Checklists

Determining a captive's ownership or affiliation

In considering the degree of closeness between the parent and the finance unit, the following factors are key:

- Whether the captive uses the same or similar brand as the parent. This indicates the risk to the parent's reputation and market position should its captive perform poorly.
- Strategic importance to the parent of its ownership interest in the captive--the extent to which the parent needs a captive finance unit to carry on its core business.
- The degree of operational integration of the finance unit with the parent's business.
- How close a role the parent plays in the governance of the captive, composition of the captive's board, and parental ties of the captive's top management.
- The degree of dependence of the parent on the captive's earnings and cash flow.
- Degree of coordination in funding activities.
- Extent to which the captive provides funding directly to the parent or vice versa.
- Extent of overlap in funding channels (for example, with a bank group).
- Extent to which the parent depends on the captive's balance sheet (i.e., whether the captive holds a substantial receivable due from the parent such as what can arise due to the captive providing below-market financing terms to customers of the parent with an obligation of the parent to make up the difference).
- Whether the parent could readily replace the captive with an independent sales financing source.
- Whether the captive's financial performance would deteriorate substantially without the parent providing lending opportunities.

Forms of parental support

Operational support.

- The extent to which the captive has a privileged position vis a vis the parent's business (e.g., having the right of first refusal on any customer of the parent's or giving the captive a pipeline of prospective clients).
- The extent to which the captive benefits from company-wide support functions such as audit, IT, real estate, and legal services.

Financial support. Financial support from the parent is usually given in the form of a capital infusion, loan, or other form of commitment and is typically codified by some type of formal support agreement. Support agreements may include:

- A commitment to maintain ownership of more than half of the captive's stock.
- A guarantee to maintain certain financial thresholds at the captive. These guarantees may include maintenance of covenants, profitability levels, and a minimum amount of net worth.
- Full or partial guarantees of financing agreements made by the captive.
- Reimbursement for any tax saving achieved by the parent from consolidating the captive.

The mere existence of a support agreement does not guarantee that it will factor highly into the rating. Factors that determine the importance of formal support agreements to the rating include:

- Adequacy of parent company resources to meet the provisions of the support agreement;
- Degree of specificity inherent in the terms of the agreement;
- Degree to which the agreement is legally enforceable;
- Ability of the parent to modify the terms of or cancel the agreement; and
- Parental willingness, as demonstrated by recent history, to offer financial support to its subsidiary. This factor increases in importance if the terms of the support agreement are ambiguous or weak.

Potential downside of parental affiliation

- Extent to which captive's origination volume could be affected by a downturn in the parent's business;
- Ability of the parent to influence the underwriting practices of the captive;
- Extent to which problems at the parent (including, ultimately, a bankruptcy filing by the parent) could affect the captive's asset quality (retail loans and leases, wholesale/dealer exposure, direct credit exposures to the parent and affiliates of the parent);
- Extent to which problems at the parent could affect the funding activities of the captive;
- Ability of the parent to file the captive into bankruptcy; and
- Ability of parent-level creditors to pursue captive assets, and risk of substantive consolidation in bankruptcy.

Potential forms of insulation against parent-related risks

Government regulation, providing:

- limits on credit concentrations;
- limits on related-party transactions;
- minimum capital standards and checks on parent's leeway to upstream dividends; or
- limits on parent's ability to file subsidiary into bankruptcy.

Minority or majority third-party ownership, with:

- board representation and a role in management; or
- operating agreements formalizing arms-length nature of parent/subsidiary transactions and limiting the captive's credit exposure to the parent.

Protective financial covenants in borrowing agreements.

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