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Key Credit Factors For Financial Services Finance Companies

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Key Credit Factors For Financial Services Finance Companies

*(**Editor's Note:** We republished this criteria article on Dec. 19, 2014, to add "Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers," published May 7, 2013, to the list of related criteria. This article outlines our methodology for deriving short-term ratings, which we apply to financial services companies.)*

1. Standard & Poor's Ratings Services is revising its global methodology for rating financial services finance companies (FSFC). This update follows our request for comment (RFC), "Request For Comment: Key Credit Factors For Financial Services Finance Companies," published Sept. 11, 2014, on RatingsDirect. For a summary of the changes made relative to the RFC, see "RFC Process Summary: Standard & Poor's Summarizes The Request For Comment Process For The Nonbank Financial Services Companies And U.S. Business Development Companies Criteria," published Dec. 9, 2014. These criteria should help market participants better understand our approach to analyzing the key credit factors (KCFs) for the FSFC industry. This KCF should be read in conjunction with our corporate criteria (see "Corporate Methodology," published Nov. 19, 2013) and our "Nonbank Financial Institutions Rating Methodology," published Dec. 9, 2014. This article also is related to our criteria article "Principles Of Credit Ratings," published Feb. 16, 2011.
2. For companies in scope, these criteria supersede "Rating Finance Companies" and "Finance Company Ratios," both published March 18, 2004.

SCOPE OF THE CRITERIA

3. Standard & Poor's rates finance companies globally either under its nonbank financial institutions (NBFI) criteria or according to the criteria outlined in this KCF, depending on the primary risks the finance companies face.
4. We apply the criteria in this article to FSFC. We believe FSFC' greatest risks relate more to their ability to generate cash flow than to the amount of capital they may need to withstand credit losses. In this manner, FSFC are similar to nonfinancial corporations in that they are less likely to default because of a deterioration in the credit quality of their assets than because of a decline in their EBITDA. (For more details, see "Industry And Idiosyncratic Risks For Finance Companies Are Generally Higher Relative To Banks," published Aug. 13, 2014.)
5. For companies whose greatest credit risks, we believe, relate to asset quality, funding and liquidity, and tangible capital--some of the primary risks that banks face--we apply our NBFI criteria (see "Nonbank Financial Institutions Rating Methodology," published Dec. 9, 2014).
6. Subsectors of finance companies that meet the description in paragraph 4 and thus are in scope of these criteria include:

- Consumer finance companies: Companies that provide small-dollar loans, check cashing services, and other related consumer services, generally to consumers with little or no access to traditional commercial banks.
- Originators and servicers: Companies that originate and service loans (such as residential mortgage, commercial

mortgage, and student loans) but retain minimal credit risk in terms of on-balance-sheet investments in mortgages or loans.

- Auto fleet services companies: Companies that provide fleet management services, including vehicle inventory management, fuel monitoring, vehicle maintenance, fuel card payments solutions, and other related services.
- Real estate services: Companies that provide financial and professional real estate services, such as investment management, property services, brokerage, and research.
- Money transaction processors: Companies that facilitate money management transactions, including money transfer, bill payment, and other related money transaction services.
- Other FSFC: Companies that provide various commercial and consumer finance products.

SUMMARY OF THE CRITERIA

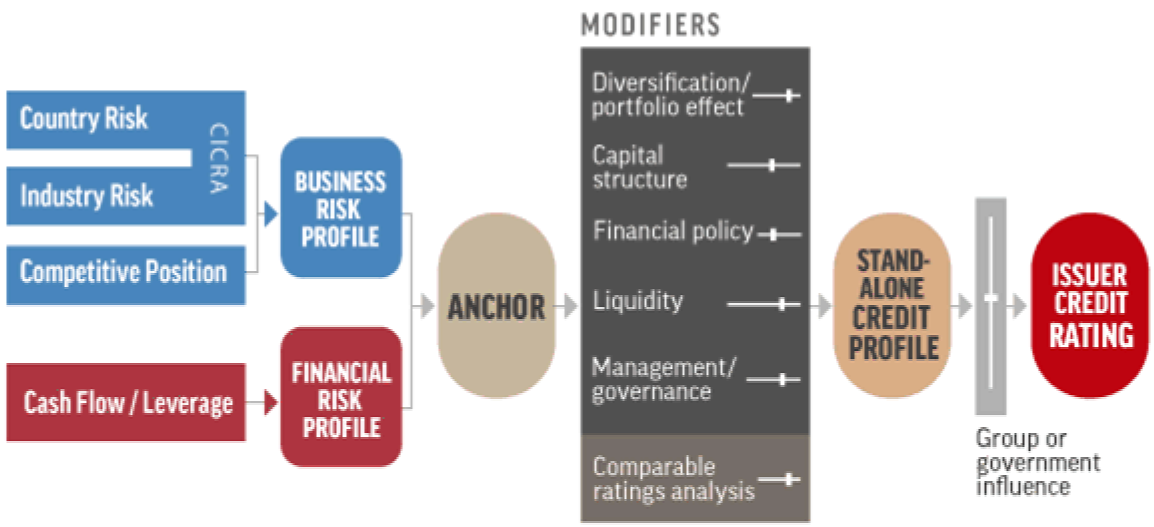
7. The foundation for determining a stand-alone credit profile (SACP), which we use to derive the issuer credit rating on an entity, is our "Corporate Methodology," published Nov. 19, 2013 (see chart), as well as the other criteria listed in the "Related Criteria And Research" section. We apply these criteria when rating FSFC, except as specifically stated herein. This KCF describes how we build on the corporate methodology, adapting it for the unique characteristics of the FSFC sector.

8. We start by combining our industry risk and country risk assessments to determine a Corporate Industry and Country Risk Assessment (CICRA). The industry risk assessment is a general assessment of the business and financial risks applicable to all FSFC globally. The country risk assessment depends, in part, on the national footprints in which an FSFC operates.

9. For the business risk profile, we assess competitive position, which encompasses company-specific factors that can add to or subtract from the global industry and country risks, and then combine that with the CICRA. The financial risk profile is the outcome of decisions that management makes in the context of its business risk profile and its financial risk tolerances. This includes the size and stability of cash flow an FSFC can achieve relative to its financial obligations.

10. We then combine an FSFC's business risk profile assessment and its financial risk profile assessment to determine its anchor (see table 3 of "Corporate Methodology"). Additional rating factors can modify the anchor. These are: diversification/portfolio effect, capital structure, financial policy, liquidity, and management and governance. Comparable ratings analysis is the last analytical factor to determine the SACP on an FSFC. Finally, we derive the issuer credit rating by incorporating any impacts of potential group or government influence, any guarantees, as well as our rating above the sovereign criteria.

Corporate Criteria Framework



11. We apply a different framework for NBFI because we believe that NBFI are more likely to default as a result of weaknesses in their balance sheets--rather than from an inability to service their debt obligations with operating cash flows. For instance, companies that we rate under the NBFI criteria often come under credit stress when a decline in the credit quality of their assets weakens their capital bases, their access to funding, and ultimately their liquidity.

12. FSFC may be prone to some of the same risks as NBFI--but to a lesser degree. As a result, these criteria, based on the corporate framework, incorporate an analysis of funding, credit quality, and tangible capital. However, these criteria place a greater emphasis on the analysis of cash flow--relative to debt and interest expense--than the NBFI criteria do.

IMPACT ON OUTSTANDING RATINGS

13. For an update to our anticipated impact on outstanding ratings, see "RFC Process Summary: Standard & Poor's Summarizes The Request For Comment Process For The Nonbank Financial Services Companies And U.S. Business Development Companies Criteria," published Dec. 9, 2014.

EFFECTIVE DATE AND TRANSITION

14. These criteria are effective immediately, except in markets that require prior notification to, and/or registration by, the local regulator. In these markets, the criteria will become effective when so notified by Standard & Poor's and/or registered by the regulator. We intend to complete our review of our FSFC ratings within the next six months.

METHODOLOGY

Part I: Business Risk Analysis

A. Industry Risk

15. Within the framework of Standard & Poor's criteria for assessing industry risk (see "Methodology: Industry Risk," published Nov. 19, 2013), we view FSFC as having "moderately high risk" (which equates to an assessment of 4). This view of industry risk reflects our assessment across all FSFC sectors listed in paragraph 6 and is meant to capture the average level of industry risk, while recognizing that certain subsectors may demonstrate more or less risk. We capture these differing degrees of risk within our company-specific assessments. Although the industry risk assessment in our corporate methodology reflects two factors--cyclicality and competitive risk and growth--we do not include a cyclicality assessment in our analysis of FSFC. We derive the industry risk assessment for FSFC based on their competitive risk and growth assessment. We do this because, unlike many of the corporate sectors, for which we use global Compustat data to generate a cyclicality score, the FSFC sector lacks sufficient financial data to compute the cyclicality of industry revenue and profitability.

16. In addition, many finance companies often have short track records or are prone to materially altering their strategies depending on market conditions. For instance, the number of finance companies we rate fell significantly during 2008-2010, and rose again during the recovery, and in many cases with different business strategies. Although this makes it difficult to measure cyclicality, we believe it illustrates the volatile nature of FSFC, which is reflected in our overall assessment of industry risk.

1. Competitive risk and growth

17. We assess competitive risk and growth of the FSFC industry as "moderately high risk" (see table 1 in "Methodology: Industry Risk," published Nov. 19, 2013). To measure competitive risk and growth, we assess four subfactors as "low," "medium," or "high" risk (see table 1). These subfactors are:

- Effectiveness of barriers to entry;
- Level and trend of industry profit margins;
- Risk of secular change and substitution by products, services, and technologies; and
- Risk in growth trends.

Table 1

Assessing Competitive Risk And Growth

Subfactor	Assessment
Effectiveness of barriers to entry	High risk
Level and trend of industry profit margins	Medium risk
Risk of secular change and substitution by products, services, and technologies	Medium risk
Risk in growth trends	High risk

Table 1

Assessing Competitive Risk And Growth (cont.)	
Subfactor aggregation result	
Competitive risk and growth	Moderately high risk (4)

a) Effectiveness of barriers to entry

18. We assess the effectiveness of barriers to entry as "high risk" for FSFC because barriers to entry are generally low, and a wide diversity of companies offers similar and competing services in the industry. Most FSFC subsectors tend to be highly fragmented, and pricing can be competitive. Although some companies may achieve competitive differentiation, they are not sheltered from new entrants' evolving strategies. In a limited number of cases, however, barriers can be more robust.

19. Regulatory requirements, economies of scale, customer relationships, and access to capital are typically the most prevalent barriers to entry in the industry. Less frequently, technology may also constitute a barrier to entry. Where they exist, these barriers can protect existing market participants from new competition. However, the prevalence of these factors is not uniform across the industry.

b) Level and trend of industry profit margins

20. Profit margins for the FSFC sector are under moderate pressure because of market share and business volume fluctuations, and we assess the level and trend of the sector's profit margins as "medium risk." FSFC' ability to sustain margins is generally dependent on expense management, which for some companies compensates for revenue volatility. For example, companies with personnel compensation that has a large variable component, such as commission-based compensation, can better sustain margins should demand decline.

21. The nature of the products offered or services performed affects the flexibility of the expense structure. Companies that don't have a retail presence, offer less complex products or services, and generate greater fee-based revenues generally have more flexible expense structures in that they can align costs with demand. On the other hand, a retail network or a complex product generally will require higher fixed costs and investments.

22. Some FSFC subsectors are exposed to seasonality (such as holiday shopping, tax refunds, school years, or home purchases). Most subsectors are exposed to regulatory compliance costs, which are difficult to forecast and could create profit margin volatility.

c) Risk of secular change and substitution by products, services, and technologies

23. We view the risk of secular change and substitution by products, services, and technologies as "medium risk." Most FSFC provide their customers with financial products or services that traditional banks either don't offer or offer on a limited basis. We view such products and services as having minimal substitution risk from outside the industry. Although technological displacement is a risk factor, we believe that any change would be gradual and that the industry is positioned to meet these challenges.

d) Risk in growth trends

24. Demand for products that the FSFC sector offers is subject to temporary shocks because of the cyclicality of the industry, and so we assess the risk in growth trends as "high risk." For example, the level of interest rates could have an outsize impact on origination volumes in certain finance industries. Elsewhere, unemployment levels can influence

the demand for certain consumer financial products.

25. Many firms in the FSFC sector supplement organic growth with growth through acquisitions, which entails operational and financial risks. Some notable risks include integration risks and acquisitions at high multiples of expected cash flows. A poorly executed integration may weaken a company's business and financial profiles. Moreover, acquisitions at high valuation multiples often assume significant future growth, which increases uncertainty about projected leverage. Post-acquisition integration expenses can also hurt earnings growth.

B. Country Risk

26. In assessing country risk for FSFC, we use the same methodology that we do for corporate entities (see "Corporate Methodology"). We generally determine exposure to country risk using revenue or EBITDA, rather than fixed assets, because most FSFC don't have large amounts of fixed assets. Also, profitability is tied more to finding borrowers--whose creditworthiness is influenced by macroeconomic conditions--than it is to investment in plants, property, or equipment.

C. Competitive Position

27. Under our corporate criteria, a company's competitive position is assessed as (1) excellent, (2) strong, (3) satisfactory, (4) fair, (5) weak, or (6) vulnerable. In assessing the competitive position for FSFC, we review the following factors:

- Competitive advantage;
- Scale, scope, and diversity;
- Operating efficiency;
- Profitability; and
- Regulatory and legislative risks.

28. The competitive position analysis is both qualitative and quantitative, and considers company-specific factors that can add to, or partly offset, industry risk and country risk. We assess the company's business strengths and weaknesses relative to peers within the industry.

29. We assess the first three factors as either: (1) strong, (2) strong/adequate, (3) adequate, (4) adequate/weak, or (5) weak. We analyze profitability through the combination of two subfactors--level of profitability and volatility of profitability.

30. We assess a company's exposure to regulatory or legislative risks as either: (1) adequate, (2) weak, or (3) vulnerable. If the regulatory and legislative risk assessment is (3) vulnerable, a company's competitive position is capped at (6) vulnerable. If the regulatory and legislative risk is assessment is (2) weak, the competitive position assessment is capped at (5) weak. If the regulatory and legislative risk assessment is (1) adequate, there are no caps on the competitive position assessment.

31. After separately assessing competitive advantage; scale, scope, and diversity; and operating efficiency, we determine the preliminary competitive position by ascribing a specific weight to each factor. The weightings depend on the

company's competitive position group profile (CPGP). We may then raise or lower our preliminary competitive position assessment based on our assessment of profitability. We then cap our assessment of competitive position if the regulatory environment is assessed as "weak" or "vulnerable."

32. The CPGP we assign to FSFC is "services and product focus" because typically these companies are consumer-facing and are service providers (see table 11 in "Corporate Methodology"). The weights applied to the three factors are:

- Competitive advantage (45%);
- Scale, scope, and diversity (30%); and
- Operating efficiency (25%).

1. Competitive advantage

33. In evaluating an FSFC's competitive advantage, we assess its:

- Business strategy,
- Brand equity and reputation, and
- Market position.

34. In reviewing business strategy, we consider the consistency of a company's strategy with organizational capabilities and marketplace conditions. We consider the degree of success (if any) in establishing leadership positions in the markets in which it competes, and in protecting or growing market share in a profitable manner without materially altering the company's risk profile.

35. In reviewing brand equity and reputation, we consider a company's brand strength, or lack thereof. We assess market share by key markets and regions, if available. We also look for trends in market share and consider the attractiveness of the key markets and regions in which a business operates. Brands commanding a clear price premium demonstrate strong brand equity and reputation. Brand strength is typically confirmed with market share gains, above-average profitability, and premium pricing. Brand equity can also come in the form of customer and supplier relationships when pricing is more competitive.

36. In analyzing market position, we review a company's market share by business line (when data are available), pricing power, customer and supplier retention, quality of business and near-term prospects, ability to weather adversity, and business track record.

37. An FSFC with a "strong" or "strong/adequate" competitive advantage assessment typically has two or more of the following, or one of the following that is particularly significant:

- Business strategy has articulated long-term plans, which have meaningful goals that are achievable.
- Business strategy is capable of supporting market share. The company's strategy may be either cost leadership or differentiation (or, in a few cases, both), and its actions should be consistent with its strategy.
- Competitors find it difficult to achieve a comparable low-cost position or to provide a comparable product or service offering. A consistent business strategy maximizes opportunities and mitigates risks relative to competitors.
- A superior track record of product or service quality leads to strong brand equity and reputation. Superior quality or cost leadership helps a company attract and retain customers.
- Favorable market position exists because of barriers to entry that effectively reduce, or even eliminate, the threat of new market entrants.

38. An FSFC with a "weak" or "adequate/weak" assessment of its competitive advantage typically has two or more of the following, or one of the following that is particularly significant:

- Business strategy that is reactive, not well defined, and shows mixed results in achieving plans. This may include a business strategy that is inconsistent or not well adapted to market conditions. An inferior business strategy misses opportunities and increases risks relative to competitors.
- Poor brand equity and reputation with products or services susceptible to extraneous factors, including aggressive actions by competitors. The inability to increase the volume of existing products or services, or the inability to expand through new products or services without materially altering the risk profile of the firm, typically reflect weakness relative to competitors.
- Unfavorable market position with a lack of barriers to entry that makes the company vulnerable to competitors' actions. A lack of differentiation, poor product or service quality, and ease of migration to a new provider typically make companies most vulnerable to competitors.

2. Scale, scope, and diversity

39. In assessing the scale, scope, and diversity of an FSFC, we consider:

- The degree of revenue and profit diversity, as measured by customer, supplier, geography, and product or services mix, and
- The relative size of its revenue base and that of its target markets and the relative ability of business operations to withstand adverse operating conditions.

40. In reviewing the degree of revenue and profit diversity, we consider the revenue and profitability mix from the FSFC's various business sources. We assess diversity through a variety of measures, which may include customer, geographic, supplier, end-market, and product or service, depending on the information available.

41. In reviewing the size of the revenue base, or the total potential market or customer base, we consider a company's reliance on a particular customer or end-market, or on a group of customers or end-markets. In our view, participation in a variety of attractive target markets generally results in greater stability during market downturns. As such, we consider the size and diversity of a company's revenue base relative to close competitors. The overall size of a company's target markets also influences our assessment of scale, which is especially important for a company whose competitive strategy is to be the lowest-cost provider of a service (as opposed to a premium-price service provider).

42. An FSFC with a "strong" or "strong/adequate" assessment of scale, scope, and diversity typically is characterized by two or more of the following, or one of the following that is particularly significant:

- Has broad geographic diversification.
- Offers a wide variety of products or services.
- Does not rely on a particular customer or end-market, or on a group of customers or end-markets.
- Does not rely on a particular supplier, business partner, or a small group of partners.

43. An FSFC with a "weak" or "adequate/weak" assessment of scale, scope, and diversity typically is characterized by two or more of the following, or one of the following that is particularly significant:

- Has a narrow geographic focus.
- Offers a limited variety of products or services, which are sometimes correlated, and does not demonstrate the ability to expand its product or service offerings over the foreseeable future.

- Relies on a particular customer or end-market, or on a limited group of customers or end-markets.
- Relies on a business partner or a small group of partners. Indirect exposure relates to the potential volume decline because of reduced consumption following a price increase.

3. Operating efficiency

44. Operating efficiencies and economies of scale often determine how competitive an FSFC can be in offering various products. In assessing operating efficiency, we consider:

- Expense structure,
- Ability to withstand lower demand, and
- Reinvestment needs.

45. We consider a company's ability to control costs without hurting product or service quality. Flexible cost structures limit pressures on operating margins during periods of lower demand or industry downturns. Companies with scalable business models that generate consistent sales growth using a fixed expense base often exhibit greater operating efficiency.

46. In reviewing reinvestment needs, we consider the level of reinvestment necessary to maintain existing operations. Maintenance capital expenditures, as a proportion of revenue, is a common metric we use in our assessment. A company's perceived historical over- or under-investment in its operations can also influence our assessment of reinvestment needs.

47. An FSFC with a "strong" or "strong/adequate" operating efficiency assessment typically has two or more of the following, or one of the following that is particularly significant:

- Superior cost position to permit above-average profitability even if capacity utilization or demand is below ideal levels.
- Ability to adjust expenses to changes in demand without hurting product and service quality. For example, some origination and servicing companies demonstrate the ability to change staff levels to match demand through the use of full-time, part-time, and seasonal staff, even while maintaining a national presence.
- Solid investment in technology and infrastructure that supports revenue and profit growth prospects.

48. An FSFC with a "weak" or "adequate/weak" operating efficiency assessment is typically characterized by two or more of the following, or one of the following that is particularly significant:

- Limited capability to manage fixed costs and to withstand lower demand.
- Inferior cost position relative to peers', possibly from inefficient facilities or processes.
- Lack of investment in technology and infrastructure that leads to a higher cost structure and less efficient operations relative to its peers'.

4. Profitability

49. We assess profitability on the same scale of 1 to 6 that is used for the competitive position assessment. Profitability consists of two subfactors: the level of profitability and the volatility of profitability. We combine the two subfactors into the final profitability assessment using table 15 of the corporate methodology. Profitability can confirm or modify the preliminary competitive position assessment.

a) Level of profitability

50. We assess the level of profitability on a three-point scale: "above average," "average," or "below average."

51. To assess the level of profitability, we calculate an FSFC's EBITDA margin. We generally use the following EBITDA margin ranges:

- Greater than 35% is "above average,"
- 15%-35% is "average," and
- Less than 15% is "below average."

52. Given the diversity of business models and revenue sources of FSFC, some assessments of profitability are made relative to direct peers--a subset of FSFC--and in those cases, the (level of) profitability thresholds will reflect "below average," "average," and "above average" for that subsector of FSFC. Specifically, we may view level of profitability as average (and not below average) despite lower margin when volume of business (transactions) is high and profits are expected to be stable.

53. We generally calculate the level of profitability based on a three-year average: previous one year's results, our current-year forecast (incorporating any reported year-to-date results and our estimates for the remainder of the fiscal year), and our forecast for the next fiscal year.

b) Volatility of profitability

54. We assess volatility of profitability on a six-point scale, from 1 (lowest volatility) to 6 (highest volatility).

55. The lack of prudential regulation for most finance companies results in limited historical data for FSFC. Absent robust industry data, we assess the volatility of profitability qualitatively, using guidelines in paragraph 92 of the corporate criteria, instead of using a standard error of regression (SER).

5. Regulatory and legislative risks

56. Regulatory and legislative risks are prominent factors for FSFC. When assessing regulatory and legislative risks, we consider the credit implications on the FSFC and don't opine on the larger policy issue. From this perspective, regulators may introduce new legislation or change existing policy that could have significant financial consequences related to both the revenues and costs for individual FSFC or FSFC subsectors. For example, regulators could impose new regulatory reporting standards, which would increase costs, or regulators could impose limits on the maximum rates at which an individual FSFC or FSFC subsector can lend, which would reduce revenue. Our assessment balances how regulation may constrain profitability while at the same time enhancing profit stability.

57. Depending on the operating environment, new rules could incrementally constrain the profitability of business activities, for example, by limiting the interest rates permissible to be charged to clients or by limiting the range of clients that a finance company could help finance. Regulatory or legislative changes could also result in higher compliance costs.

58. We do not view regulatory and legislative risks as a potential positive to competitive advantage. We recognize that regulation could help to stabilize volatility of FSFC, but that would be reflected in the financial risk profile if it were to occur. Given their typically negative impact on competitive ability, regulatory and legislative risks cannot be assessed above "adequate." An FSFC with an "adequate" assessment is not exposed to regulatory policies--existing or

prospective--that meaningfully constrain profitability. When regulation reduces competition, we do reflect these benefits directly in the specific company's competitive advantage, as opposed to the overall sector.

59. An FSFC with a "weak" regulatory and legislative risk assessment is typically characterized by two or more of the following, or one of the following that is particularly significant:

- Subject to regulatory scrutiny, sometimes in a loosely regulated industry, and profitability could be constrained if new policies were implemented.
- Exposed to regulatory and legislative changes, but in some cases, diversification by product or geography partially mitigates these risks.
- Has a track record of government policy and regulation that constrain profitability or alter the standards for business conduct.

60. An FSFC with a "vulnerable" regulatory and legislative risk assessment typically has two or more of the following, or one of the following that is particularly significant:

- Subject to ongoing regulatory scrutiny, and profitability will likely be constrained if new policies were implemented.
- Exposed to regulatory and legislative changes, with limited diversification by product or geography.
- Has a track record of government policy and regulation that significantly constrain profitability or alter the standards for business conduct.

Part II: Financial Risk Analysis

A. Accounting And Analytical Adjustments

61. In assessing the accounting characteristics of FSFC, we use the same methodology that we do for corporate entities. Our analysis of a company's financial statements begins with a review of the accounting to determine whether the statements appropriately measure a company's performance and position relative to its peers, as well as corporate entities. To allow for globally consistent and comparable financial analyses, our rating analysis may include quantitative adjustments to a company's reported results. These adjustments also enable better alignment of a company's reported figures with our view of underlying economic conditions, and they help to create a more accurate picture of a company's ongoing business. Adjustments that pertain broadly to all corporate sectors, and to these sectors, are discussed in "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013.

B. Cash Flow/Leverage

62. In assessing the cash flow/leverage for FSFC, our analysis uses the same methodology we use for corporate entities (see "Corporate Methodology"). We assess cash flow/leverage on a six-point scale, ranging from (1) minimal to (6) highly leveraged, by aggregating the assessments of a variety of credit ratios, predominantly cash flow based, which complement each other by focusing on a company's cash flows in relation to its obligations.

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1. Core ratios

63. For each company, we determine two core ratios--debt to EBITDA and funds from operations to debt--in accordance with "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013.

2. Supplemental ratios

64. In addition to our analysis of a company's core ratios, we consider two supplemental ratios--EBITDA to interest expense and debt to tangible equity--to develop a fuller understanding of a company's credit risk profile and to refine our cash flow analysis in accordance with the corporate criteria. (We define tangible equity as total equity less goodwill and nonservicing intangibles.)

65. We generally use debt to tangible equity for FSFC that have positive tangible equity and whose balance sheets contain a substantive portion of financial assets. We view the traditional measure of debt to tangible equity as reflective of how some FSFC fund their business and how much cushion they have to sustain unexpected losses. We determine the debt to tangible equity assessment using table 2.

Table 2

Assessing Debt-To-Tangible Equity Ratio

Assessment	Debt-to-tangible equity ratio (x)
Minimal	<1.0
Modest	1.0-2.0
Intermediate	2.0-3.0
Significant	3.0-4.0
Aggressive	4.0-5.0
Highly leveraged	>5.0

66. In certain circumstances, our calculation of debt allows for netting of funding with the assets associated with the funding ("asset-specific funding"). This netting is typically restricted to debt specifically used to finance high-quality and generally liquid assets. Importantly, this netting is applied to debt when a company uses it to fund assets that expose it to minimal credit risk, and generally for a short duration. As a result, we also treat interest expense associated with such funding sources as an operating expense and do not subtract it in our calculation of EBITDA.

67. One example of netting debt facilities with assets financed with the facilities is when a U.S. mortgage company originates loans that conform to government-sponsored enterprise (GSE) guidelines. The loans are guaranteed to be purchased from the finance company within a short period of time, typically 20 days. We net as long as we believe that the GSE has no incentive to reject the pool of assets (rejection of conforming assets would signal a shift in market practice). Individual nonconforming assets that are rejected are not netted against debt when and if they are placed back on the balance sheet of the mortgage originator.

68. We also net debt used to finance mortgage servicer advances when the advances have a first-priority lien against an entire pool of mortgage properties and we believe the residential mortgage-backed security will not decline below the value of the collateral against which the finance company has advanced money (these advances are typically supported by significant overcollateralization).

69. When we believe there is some possibility, such as in stressed market conditions, that a GSE will stop purchasing

assets (or abruptly change its criteria) or that a warehouse provider has the option of requiring significant additional margin with little notice to the finance company, we do not net the debt (asset-specific funding) with the assets funded by the debt.

70. We generally calculate core and supplementary ratios based on a three-year average: trailing one year's results, our current-year forecast (incorporating any reported year-to-date results and our estimates for the remainder of the fiscal year), and our forecast for the next fiscal year. It is often impractical to make projections for FSFC beyond the next fiscal period because of the lack of visibility of top-line revenues. We place greater emphasis on the forward-looking estimates, which incorporate upcoming debt maturities and expected debt issuance/refinancing, than on the historical ratios. We generally weight the previous year, the current year, and the next fiscal-year forecast as 20%, 40%, and 40%, respectively.

Part III: Modifiers

A. Diversification/Portfolio Effect

71. In assessing diversification/portfolio effect for FSFC, our analysis uses the same methodology we use for corporate entities (see "Corporate Methodology").

B. Capital Structure

72. We analyze capital structure for FSFC by using the same criteria that we do for corporate entities (see "Corporate Methodology"), except that we consider a company's dependence on revolving, and generally short-term, asset-specific funding as an additional tier 1 risk subfactor.

73. We assess asset-specific funding as either: (1) neutral, (2) negative, or (3) very negative. We then replace table 21 in the corporate criteria with table 3 here to determine the preliminary capital structure assessment.

74. When debt, such as warehouse facilities, or other asset-specific funding is used to finance assets and we net the debt with the assets, we assess the asset-specific tier one subfactor as negative.

75. Typically, asset-specific funding includes secured and unsecured warehouse lending facilities, repurchase agreements, asset-backed security (ABS) securitizations, and residential mortgage-backed security (RMBS) securitizations.

Table 3

Assessing Capital Structure

Preliminary capital structure assessment	Subfactor assessment
Neutral	No tier one subfactor is negative.
Negative	One tier one subfactor is negative, and the tier two subfactor is neutral.
Very negative	Two or more tier 1 subfactors are negative; or one tier 1 subfactor is negative and the tier two subfactor is negative; or asset-specific funding is very negative.

76. We consider asset-specific funding a key driver of creditworthiness when a company is dependent on this form of funding to facilitate origination volume, primarily because the company could be susceptible to disruptions in adverse economic environments. Specifically, how an FSFC funds its business and the confidence-sensitivity of its assets directly affect its ability to maintain business volumes and meet obligations in the event that asset-specific funding options become unavailable at different points in the business cycle. However, finance companies with large confidence-sensitive funding exposures are more susceptible to changes in asset credit quality and tangible capital, and we rate these entities under our NBFI criteria.

77. We assess asset-specific funding by considering stability during times of stress, the diversity of counterparties, the type of collateral being pledged, and the maturity of asset-specific funding sources.

78. An FSFC with a "neutral" asset-specific funding assessment generally has a limited amount of, or no reliance on, asset-specific funding sources for ongoing business operations.

79. An FSFC with a "negative" asset-specific funding assessment is typically characterized by one or more of the following:

- The company is reliant on asset-specific funding sources for ongoing business operations.
- A large proportion of maturities are less than one year, or there is a maturity concentration in the same quarter.
- The company is reliant on a concentrated group of financial counterparties.

80. An FSFC with a "very negative" asset-specific funding assessment is characterized by both of the following:

- A company exhibits all of the characteristics of a "negative" asset-specific funding assessment as per the previous paragraph.
- One or more facilities are subject to substantial margin call exposure.

C. Liquidity

81. In assessing liquidity for FSFC, our analysis uses the same methodology we apply to corporate entities (see "Corporate Methodology").

D. Financial Policy

82. To assess financial policy for FSFC, we use the same methodology as for corporate entities (see "Corporate Methodology").

E. Management And Governance

83. We analyze management and governance for FSFC according to the same criteria that we use for corporate entities (see "Corporate Methodology").

F. Comparable Ratings Analysis

84. In assessing the comparable ratings analysis for FSFC, our analysis uses the same methodology we apply to corporate entities (see "Corporate Methodology").

RELATED CRITERIA AND RESEARCH

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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