

Analyzing Finance Companies

Best's Financial Strength Ratings (FSRs) and Issuer Credit Ratings (ICRs) are assigned to an operating insurance company based on the assessment of the entity's financial strength, operating characteristics and business profile. The assignment of an ICR to a holding company of an operating insurer or noninsurance entity reflects an analysis of the impact of the creditworthiness of the various insurance and noninsurance subsidiaries on the parent's credit profile. This includes consideration of the risks associated with the holding company being a discrete legal entity and the impact of the subordination of holding company creditors to the operating company's policyholders. The FSR/ICR of an operating entity reflects A.M. Best Co.'s analysis of the extent to which the operating company is supporting debt or other obligations of a holding company, and vice versa. For noninsurance finance entities, A.M. Best performs a detailed internal analysis of their risk profile and the resulting effect on rated entities within the group.

The analytical framework outlined for assessing finance companies highlights special issues particular to the finance industry. There are two main segments within this industry: commercial finance and consumer finance. Unique factors include:

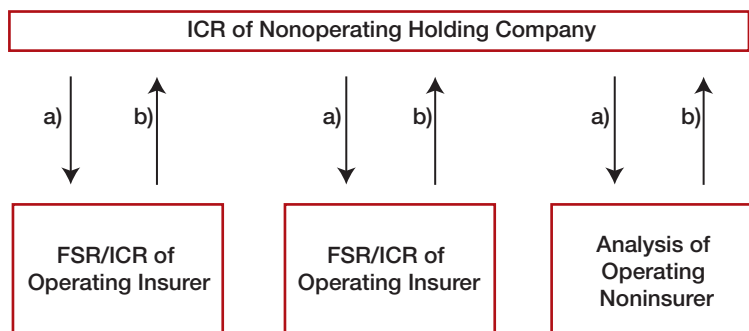
- The lack of regulatory oversight of the industry creates a wider variation in reporting standards by finance companies than by other regulated financial institutions. Among the critical areas of difference in reporting standards are delinquencies, earnings recognition and lease residual valuation. Information on some of these areas only can be obtained directly from the finance companies.

- Without access to low-interest funding sources, such as deposits or similar funds available to banks or insurance firms, finance com-

panies rely more on capital markets and institutional sources of financing. Since these are confidence-sensitive sources, finance companies generally exhibit relatively lower leverage and have more prudent liquidity-management policies. Accordingly, the capital structure and access to a variety of funding sources are likely to be the prominent factors affecting the credit-risk profile of a finance company.

- Commercial finance companies provide

Summary of the Relationship Between Different Ratings for Complex Organizations



a) The ICR of the holding company is derived from the ICRs of the operating companies via A.M. Best's analysis of the degree of impact each operating company has on the holding company's creditworthiness and any benefits it gains from diversified sources of funds from operations.

b) The FSR/ICRs of the operating companies reflect A.M. Best's analysis of the extent to which each is supporting debt, or other obligations, of the holding company or of affiliated companies.

This is the second in a series of special reports discussing A.M. Best Co.'s approach to analyzing noninsurance financial services affiliates of rated insurance companies. This series of methodology reports reflects the trend toward convergence of the financial services and insurance industries, whereby a number of insurers either are owned by banking or other financial services companies or have affiliated or established subsidiary companies operating in these areas. This report describes A.M. Best's methodology for evaluating the financial health of the finance operations of an enterprise. These evaluations generally are performed in the course of assigning a Best's Financial Strength Rating (FSR) to insurance entities within an organization. A.M. Best's earlier report on *Analyzing Commercial Banking Operations* was released March 28, 2005.

Questions regarding A.M. Best Co.'s methodology for evaluating commercial banking operations can be directed to Khanh Vuong, senior financial analyst, in the life/health division at A.M. Best Co.



alternative nonbank financing to commercial entities based on the value of the financed asset(s). This requires most commercial finance companies to specialize in specific types of asset classes to provide expertise in service. This also leads to a relatively lower degree of price sensitivity but greater cyclical effects for the commercial finance industry than for others such as banking.

- Unlike the commercial finance segment, the consumer finance industry is highly fragmented, with many companies offering essentially the same commoditized products to consumers. As a result, and unlike the commercial finance companies, price sensitivity is relatively higher. Furthermore, the competitive factors favoring the successful companies are size of operation/market position and technological advancement in new account sourcing, application processing and customer servicing. Acquisitions and investments in technology are recent strategic operating trends in the industry.

- The consumer finance companies deal with a large volume of small receivables, with more standardized product features (repayment schedules, interest rate indexing standards, and other features pursuant to consumer protection guidelines as may exist in many countries). Thus, the asset receivables and corresponding liabilities funding these assets primarily are processed, managed, funded and sold in bulk, typically through the securitization market. Accordingly, the liability structure of consumer finance companies may reflect more securitization activity than that of commercial finance companies.

- Commercial finance companies are subject to the cyclical forces specific to their respective product niches, from new competitive factors drawn into a niche by high margins, to the larger economic conditions affecting borrowers' capital spending or receivable turnover. Consumer finance companies, on the other hand, are subject to consumer credit cycles, which in turn are tied to economic conditions. It is, therefore, essential to understand the specific product line(s) that a finance company specializes in, and to conduct an analysis over at least a full cycle of credit expansion through contraction.

Key firm-specific issues are assessed for finance entities, including the competitive environment, management and strategy, fund-

ing and liquidity, financial and operating leverage, capital adequacy, earnings sources and stability, and risk management. Each element considered fits comfortably within the traditional A.M. Best insurer rating analysis framework of **balance sheet strength, operating performance and business profile.**

Taken together, these factors result in a determination as to whether the given finance activities add to or potentially detract from the financial strength and flexibility of the respective A.M. Best-rated companies.

Balance Sheet Strength

Balance sheet strength indicates the absolute and relative degree of capital maintained by a company with respect to its operating and financing needs, on both a current and an expected basis. When this is applied to finance companies, A.M. Best evaluates four general areas of balance sheet risk in determining balance sheet strength and flexibility:

- Asset Quality
- Market Risk and Interest Rate Risk
- Funding/Liquidity

A.M. Best Co.

Methodology

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quantitative and qualitative evaluation of a company's balance sheet

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<http://www.ambest.com/ratings/methodology.html>.



The Insurance Information Source

- Capital and Leverage

- Asset Quality**

A.M. Best assesses both qualitative factors of management's strategy and operating constraints, and quantitative measures in terms of the relation of credit costs (loss provision, reserve and charge offs) to total receivables, level of income derived from these assets, portfolio growth and capital base. A finance company generates receivables from its lending activity, which need to be converted into cash in a timely manner and at a loss and delinquency rate commensurate with pricing expectations or assumptions. Higher losses and delinquencies than expected in a portfolio not only reflect mispricing of assumed risks, with direct adverse impact on earnings, but also have implications for the adequacy of loss reserves and capital levels.

A review of a finance company's asset quality examines the nature of the asset class and the portfolio composition and diversification of both its on-balance sheet and off-balance sheet assets. Examples of off-balance sheet items primarily include unfunded extensions of credit, derivative products, securitized assets and certain leases. The first step in analyzing the receivables (both on- and off-balance sheet) involves understanding the underlying risk of the end borrowers. For commercial finance companies, the end borrowers' respective industry(ies) determines the nature of the receivables, while for consumer finance companies the demographics and the product type become the determining factors. Lending to a final producer, as compared with a middleman or a supplier, affects the turnover of the receivables. Providing equipment financing is a different risk than lending against the inventory of a customer, for commercial finance companies. Financing cyclical industries will lead to some cyclicalities in the financing company as well. Additionally, receivables can be created on a secured or unsecured basis. For secured receivables, commercial finance companies' advancing rates vary for different asset classes (inventory, equipment or property) and for the different industries of the borrowers. These factors determine the repayment potential as well as the liquidity of the finance receivables.

Another area of asset quality relates to management's accounting policies of nonperforming assets. In contrast to banks, finance companies have greater latitude in their methods

of reporting problem credits, and adjustments may be necessary to convert the reported levels of nonperforming assets into a common standard for comparability. The most conservative form of delinquency reporting is "original contractual," where the delinquent status remains until all late payments are received. On the other hand, the more popular method of "present contract" allows for renewals and extensions as a way for receivables to become current again. Finally, the least conservative method of "recency of payment" allows for the receivables to become current as the most recent payments are received without prior delinquencies remedied.

Additionally, when possible, it is important to obtain delinquency and loss rates on static portfolios rather than on portfolio statistics inclusive of new receivables. If a portfolio consists of distinct asset classes or subportfolios, then statistics on the subportfolios need to be examined individually and compared against like portfolios of peers. This is true also for companies that purchase or manage receivables of other finance companies, where performance of owned receivables, as opposed to managed receivables, is analyzed separately. Finally, if available, internal information from companies should be obtained on management's risk-management and underwriting policies (concentration limits, lending criteria, asset monitoring and audit, and other credit administration procedures). The composition of the portfolio is reviewed for any actual concentrations of risk.

Primary asset quality ratios considered include the following:

Receivables Growth Rate and Portfolio Characteristics. Any rapid change in the portfolio over the past five years, and especially within the recent year, is reviewed for potentially adverse factors other than business cycles. Aggressive growth may be achieved by a company at the expense of prudent underwriting principles, or to mask underlying problems in existing portfolios. Management should have an identified market opportunity or strategy to support any significant growth in the portfolio. A business expansion strategy beyond its current or core markets also may be viewed as higher risk for the company. The fundamental characteristics (such as composition and diversification) and performance statistics of the portfolio (as measured by the ratios below) would likely change along with

the rapid growth, and are thus assessed against peers' portfolio statistics as well as in the context of earnings and capital levels.

Net Charge-Offs to Average Net Receivables. Because some portion of nonperforming assets eventually becomes actual charge-offs, this ratio can be a good indicator of trends in credit quality. The recovery rate of charge-offs also is considered in conjunction with the impact of any cyclical factors to gain a better perspective on these ratios. To the extent that a company has nonfinance subsidiaries, only statistics related to the finance operations are to be used in the ratios.

Provision to Net Charge-Offs. These ratios measure the amount of capital set aside by management for actual charge-offs. As such, the annual loss provision and cumulative loss reserve should closely track the actual charge-offs of assets. Any significant deviation in historical trends of the provision and reserve levels to charge-offs is reviewed with further details on management strategy for receivable growth and reserve policies. Peer group comparison also is important since there is wide latitude by management in setting the levels of loss provisions and reserves in an effort to show higher earnings in a particular year by under-reserving.

Tangible Common Equity plus Reserve to Net Charge-Offs. This ratio provides an indication of the adequacy of capital in a company as a multiple of net charge-offs. The multiple should be in line with peers of similar portfolio characteristics or competing in the same niches. Furthermore, there should be sufficient capital cushion for a company to sustain the down cycles of its business, when margins are lower combined with higher credit cost.

Nonperforming Receivables to Total Receivables. Nonperforming receivables consist of delinquent and nonaccrual receivables in accordance with either industry standard measurements or the most conservative reporting methods. This ratio is a forward-looking indication as it measures the performance of a portfolio prior to charge offs.

Pretax, Preprovision Income to Nonperforming Receivables. Also referred to as the earn-out ratio, this ratio illustrates the relation of nonperforming assets to preprovision earnings, measuring the payout ratio of future asset losses from internally generated cash flow. Pretax, preprovision income represents core earnings and is the first line of protection

against credit losses before capital is affected.

Market Risk/Interest-Rate Risk

Market risk exposure in the operation of finance companies is predominantly interest-rate risk. These exposures are created by mismatches between duration or maturity of assets and liabilities and are part of a company's asset-liability management. Mismatches may be structural, caused by the difficulty in completely matching the asset maturities with the liabilities or by unexpected prepayments or early terminations of some assets. Hedging techniques and interest-rate risk-management strategies of a company need to be reviewed and assessed with regard to the interest-rate assumptions and in comparison with historical performance against interest-rate volatility. Some mismatches also may be part of a deliberate strategy to take a risk position on interest-rate movements. The company's maturity gap report to be provided by management or published in its annual report is reviewed for the extent of interest-rate gaps by maturity, and in terms of capital level.

To the extent that trading activity may be part of companies' operations, market risk exists in positions taken in their trading books as well. Analysts review management's market risk control systems and policies for various internal limits of market risk, as disclosed in annual reports. Additionally, the following quantitative indicators are considered:

Noninterest Income as a Percentage of Gross Operating Income. This indicator includes the component ratios of trading income to gross operating income, investment income to gross operating income, etc. To the extent that a company's earning sources include income from trading activities, the market price volatility risk present in these earning streams makes them less stable than credit related earnings. Trend analysis of a company's trading earnings over a period of five years or more should indicate not only the reliability of this earnings stream but also management's view and strategy for trading activities as a source of earnings.

Variable Rate Receivables to Variable Rate Debt. This ratio measures the extent to which a company's assets and debt are on the same interest-rate basis. The higher the ratio, the more coverage a company has in assets of its obligations. However, it also implies that the company is asset sensitive, with its receivables being repriced at a greater volume than its

debt. In a rising rate environment, this would be beneficial to the company, as it would improve its net interest margin, but more disadvantageous in a declining rate environment.

Value-at-Risk (VaR) Index. This measurement provides a more robust indication of a trading portfolio's market risk and potential impact on earnings. As disclosed in most major annual reports, the VaR index is a statistical probability of potential losses to a company's trading portfolio, within a certain defined confidence interval. A useful related ratio is the multiple of trading income to VaR, which indicates the level of earnings generated by trading activity as compared with the risk level assumed by a company.

Funding and Liquidity

A finance company's ability to obtain funding as needed to generate receivables is an essential part of its operating model. An analysis of a finance company's funding and liquidity risk addresses three sets of interdependent factors: the company's cash flow from operations in relation to its essential cash needs; its asset liquidity in terms of quality and turnover; and the mix of its funding sources for short-term and long-term needs. It is critical to assess a finance company's core liquidity sources for its current operation, as well as its contingent liquidity sources and operating flexibility in the event of disrupted or reduced access to the capital markets.

To sustain or protect its niche or core business lines, a finance company would need to fund two core areas of cash needs: new originations to replenish the run-offs of a portfolio of receivables, and roll over of maturing debt. These needs normally would be satisfied by a company's turnover of the maturing assets and continued access to the securitization market, commercial paper and the short-term debt market. Bank lines typically provide back-up liquidity support to capital-market instruments, or directly provide temporary funding to the company in the event of any disruption in normal channels of funding.

Fast turning and high-quality receivables or finance assets lead to improved liquidity coming from the normal operating cycle of a finance company. The level of these assets relative to slower turning assets in a company's portfolio is a measure of this source of more immediate liquidity. Cash on hand and other liquid assets besides finance assets are additional measures of a finance company's

degree of liquidity.

In cases of unforeseen liquidity calls, a company should have sufficient excess internal cash flow in conjunction with back-up lines to withstand a temporary crisis. Alternatively, it should have the ability to scale back its cash demands for a short period while still preserving its core niche market position.

The composition of the funding structure of a finance company is assessed in terms of the diversity, quality and stability of its funding sources. The depth of the particular market of investors or demand for funding instruments issued by a company is assessed by looking at past track records. The company's access to the debt market is determined by the history and frequency of issuances, the terms of issuances and the rate carried on the debt. In the bank lines, it is essential to understand the quality of these arrangements in terms of the presence of standard or stringent conditions attached to the bank line facilities; whether they are advised lines as compared to evergreen (self-renewed) lines; secured or unsecured; and other, similar clauses. The quantity and diversity of bank relationships of a finance company are both important factors to review.

Primary liquidity ratios considered include:

Receivables Due Within One Year to Total Receivables. This indicates the scheduled run-offs within a year as a percentage of total receivables. This ratio should be reviewed in conjunction with the historical trends of run-offs and replenishments through new originations; the industry cycle and company-specific operating cycle as they affect these run-offs; and the collection rate within each maturing category of receivables.

Receivables Due Within One Year to Short-Term Debt. If a company's cash conversion cycle (the length of time for receivables to be converted into cash) is proportional to its short-term debt financing, then these short-term debt outstandings are fully self-liquidating. Typically, companies use some short-term leverage to finance a portion of the new originations, in addition to the cash collections. The extent of short-term leverage utilized by a company beyond its cash collections in funding new receivables depends on the bank line availability, industry cycle and management strategy.

Average Cash Collections to Average Receivables. This is an aggregate measure of a portfolio's cash conversion rate. A parallel ratio

can be calculated by dividing 365 days by this ratio to arrive at the number of days for receivables to be converted into cash. To the extent of available information, these ratios are assessed within each subportfolio, with any slower collection statistics to be reviewed for further explanation (nature of the asset, signal of potential delinquency, or slow credit administration system of the company).

Unsubordinated Liabilities Less Cash and Near Cash/Monthly Cash Collections. Senior ranked liabilities net of cash equivalents as a multiple of cash inflow from collections gauges the number of monthly collections to cover the claims on the cash.

Senior Debt/Gross Receivables. This ratio reflects the proportion of gross receivables that would have to be liquidated to pay senior debt. Senior debt is the primary source of financing utilized by finance companies for working capital such as financing for the purchasing of receivables. Therefore, it is important to determine the coverage of senior debt by total receivables.

Bank Lines and Revolver to Bank Borrowings and Commercial Paper. This ratio indicates the extent of coverage of back-up lines of outstanding commercial paper of a company. The ratio is calculated on the basis of peak, average and period-end Commercial Paper outstandings. Other short-term calls on cash additionally may be considered in relation to bank lines.

Capital and Leverage

The capital level of a finance company needs to be analyzed in terms of absolute level, as well as relative to an appropriate capital structure (i.e., in relation to debt financings) and to other risks (i.e., capital adequacy). The absolute size of a company's capital essentially determines its niche market and growth opportunities. Given a certain capital level, the extent of use of financial and operating leverage will affect the financial strength of the company and its ability to raise funds through the capital markets and private institutions. The quality of the capital composition also adds to or detracts from financial strength. An analysis of capital quality addresses the equity or debt-like nature of various components of capital, as well as the consistency of earnings contribution. Capital adequacy addresses whether a company has enough equity to support the risk on its balance sheet; whether asset growth can be supported by proportionate

equity growth; whether a company has the capacity to market commercial paper, medium-term debt and securitized receivables; and whether capital is being eroded by excessive dividends. A key determinant of capital adequacy is asset risk, because the size and type of the portfolio ultimately require capital support directly and indirectly. Off-balance sheet items also can impact credit risk, growth, and funding.

Besides the impact of intangible assets and equity, a review of the accounting policies of a finance company also is of paramount importance, since the industry is not subject to the same regulatory oversight as banking or insurance. Particular attention is put on the assumptions underlying the reporting of earnings, asset values and liabilities, relative to the rest of the industry, that could impact capital adequacy.

The following primary capital adequacy ratios are considered:

Components of Capitalization as a Percentage of Total Capitalization. This includes all the various components of equity and hybrids to total equity. These are metrics used to gauge the level, quality and trends of capital across different finance companies within a peer group. These ratios also are reviewed in relation to a company's financing requirements for both ongoing operations and growth. Strong capitalization combined with historically consistent equity formation is a strong indicator of financial flexibility to the capital markets, allowing a company to raise the funds necessary to build its asset base and defend or bolster its earnings stream.

Components of Debt as a Percentage of Total Debt. All the various components of debt by tenor, rate basis (floating as compared to fixed), source (private vs. public), are analyzed for any vulnerability in the debt structure relative to the asset base and other financing needs of a company.

Total Debt to Tangible Equity. Total debt to tangible equity, long-term debt to tangible equity, and short-term debt to tangible equity are reviewed over a cycle and against peers. Various measurements of tangible equity also are used in arriving at several types of multiples for gauging individual finance companies. Tangible equity net of investments in nonfinance subsidiaries is used to assess the leverage on just the finance company operation. Deferred income taxes, which can be accumulated to

become a significant quasi-equity item, can be added to tangible equity to measure the extent of tax advantages utilized within some niches of finance companies (although these companies do have to consistently grow in order to prevent a reversal of the deferred taxes).

Interest Coverage and Fixed-Charge Coverage Ratios. Various ratios of the coverage of EBITDA and other cash flow equivalent measures of interest and fixed charges provide indicators of a company's debt-service ability. Furthermore, any excess debt capacity based on a company's cash flow relative to debt service requirements would lend more flexibility to its financial condition.

Tangible Net Worth to Total Assets Plus Securitized Assets. This is a measure of a firm's leveraging of its capital to generate assets on its balance sheet. Finance receivables, investments and other earning assets should have, as a matter of prudence, certain capital to be reserved against the respective asset risks. This operating leverage ratio is another commonly used ratio by the capital markets to compare a finance company's leverage against its peers. Total assets include both on-balance sheet and off-balance sheet assets. Securitized assets are added back to total assets, since most firms retain the first loss exposure on securitization transactions. Tangible net worth to total managed assets also is reviewed.

Retained Net Income to Average Equity. The relation of retained net income to average equity is a good indication of the rate of capital growth from internally generated earnings, as opposed to equity issuance. Firms that plow back more of their earnings to their capital base and ultimately their operations are more positively viewed from a balance sheet strength perspective than those adhering to a policy of distributing more of their earnings in the form of dividends to shareholders.

Double Leverage at the Holding Company. This ratio is calculated as equity investments in subsidiaries as a percentage of common equity at the holding company. This ratio not only shows the degree of debt burden across operating and parent levels, but also can reveal the extent to which a holding company is dependent on the operating company for dividends in servicing its debt. To obtain a more direct indication of the holding company's self-sufficiency in funding, another holding company ratio is considered: liquid

assets to short-term debt.

Operating Performance

As with strong capitalization and liquidity/funding access, a finance company's earnings provide one of the most important aspects of a creditor's long-term protection measures. The absolute size of a company's capital base, while important, can be eroded if a company lacks solid operating performance. Operating performance is assessed on an absolute and relative basis to peers, with an emphasis on the profitability of operations and structure and composition of revenues vs. expenses.

As with other areas of analysis, a finance company's accounting policies on the recognition of earnings are the first step to analyzing its profitability. Ideally, the method used to recognize earnings should reflect the true economic earnings stream of a company. Reviewing other, similar companies within the peer group will point out an industry-preferred method that should allow for better comparability of performance.

There are three main areas of analysis:

- Core Earnings Trends and Quality
- Individual Business Line Profitability
- Overall Return and Profitability

Core Earnings Trends and Quality

Core, sustainable earnings form capital to support growth; help maintain an adequate source of liquidity generation; and protect against a reasonable level of asset losses. Due to the increasingly fierce competition from banks entering financial services, margins have become narrower and a greater emphasis is placed on cross-selling more fee-based services to the same client base.

Sources of core earnings consist primarily (but not exclusively) of interest income and fee income from a company's main lines of business operation. Noncore earnings consist primarily (but not exclusively) of other trading income, investment income and nonrecurring income such as that generated by asset sales. Gains from securitization, while they may be an ongoing and essential part of every finance company's operation, are not viewed as part of core earnings. Furthermore, careful analysis of these sources of earnings generated from the sale of assets through securitization is done before considering them as part of a company's noncore earnings.

The following ratios are considered:

Net Interest Margin. The annual growth of net interest margin over a 10-year period should reveal the trends of a finance company's profitability over a credit cycle and include any changes in its operating environment. Peer comparisons also reveal a company's competitive performance. The components contributing to net interest margin (interest income and interest expenses) are analyzed to determine future stability and sustainability. Management's discussion of results in its financial statements helps relate the company's profitability to its business strategy and core business lines.

Noninterest Income to Total Revenues in Aggregate and by Source. The fee-generating sources of income for a finance company are important ways to compete and preserve its own niche position. The ability to execute these ancillary services to bolster income while enhancing client loyalty is essential to a finance company's competitiveness. The size and historical stability of these fee-income sources are important factors to assess.

Credit Costs and Noninterest Expenses of Different Asset Classes. These are discussed further in the Asset Quality section and sections below.

Dividend Payout Ratio (declared common stock dividends to net income). Taken over a period of several years, this ratio provides information on the rate of dividends paid by a company to its owners (and may be committed to in a moral sense). Naturally, the lower the ratio, the more positively the company is viewed.

Effective Tax Rate. The tax burden of a company can depend on whether it invests mainly in tax-free assets; whether it makes use of tax-advantageous vehicles such as certain deferral of taxes allowed under the U.S. code; and other tax-management opportunities. A.M. Best attempts to quantify the sustainability of any tax advantages to determine whether to factor this into the bank's profitability analysis, or to apply a discount on the historical profitability of the company.

Individual Business Line Profitability

To diversify from the effects of business cycles in various niches, finance companies may engage in many types of products. The larger companies also expand into other lines of financing as well as related services (insurance, asset management, etc.) to become full service providers. It then

becomes critical to analyze the various sector business dynamics affecting a company, in terms of competitive factors, operating challenges, and opportunities vs. risks.

A similar analysis of the composition of a company's interest expense and credit costs by individual business lines provides an indication of its overall cost structure. A significant expense item is the provision for asset losses. Finance companies have wider latitude than banks or other regulated financial institutions in setting the annual provision for asset losses. Closer examination of management's policies and classification of problem assets is warranted. Noninterest expenses, such as operating expenses, overhead costs and other expenses related to personnel compensation, and the cost of administration are among other categories to be reviewed by individual business lines.

The following ratios examine the profitability of the various lines of business of a finance company:

Noninterest Expense (or Overhead Expense) as a Percentage of Receivables. This overhead expense ratio provides an indication of a company's operating efficiency. Low-cost operators can enjoy greater margins and flexibility in dealing with any decline in revenues, relative to their peers. Conversely, an unfavorable efficiency ratio can force a company into a defensive position of cost cutting and internal realignments to become more competitive. Another related ratio of efficiency is the number of employees as a percentage of gross receivables.

Yields on Average Assets by Niche Segments. The relative performance of certain assets within a company depends on cyclical factors; market position of the company in each line of business; and respective business strategies for those lines of business. Management's emphasis on some lines of business or strength in market position usually will translate into a certain yield performance for specific asset categories. The differences in asset yields determine the optimal asset mix for a company, which in turn, drives many aspects of the rest of its operations such as capital allocation, strategies for growth, etc.

Fee income can be another significant source of earnings for many finance companies through financial advisory services or insurance. The ratios of fee income to total

operating earnings as compared with percentages of various other earnings components provide information about a company's sources of earnings.

Various Cost of Funds. Cost of funds, commercial paper issuance, short-term borrowings and other short-term liabilities are the expense side of asset yields. At a minimum, these costs of funds indicate the funding sources and relative cost of access to them for a particular institution. At times, because these funding sources are based on market confidence, they also can indicate the credit strength of a company as perceived in the marketplace. This is especially true during certain crisis events or disruptions in financial markets when credit spreads can widen dramatically for weak institutions, which can limit funding options very quickly.

Overall Return and Profitability

Broader gauges of profitability include ratios for measuring performance returns on utilized assets and capital:

Return on Average Assets, Return on Average Managed Assets. Net income to average assets indicates the earnings performance of a finance company in its utilization of assets relative to its peers. This ratio can be adjusted for pretax income or pretax recurring income. It also is useful to determine the ratio in terms of total assets, including managed assets and securitized assets, to arrive at a risk-adjusted ratio. All of these ratios are reviewed and highlighted as appropriate, depending on the type and level of different activities undertaken by a company.

Return on Average Equity. Net income to average shareholder's equity indicates the earnings performance of a finance company from the perspective of shareholders and the equity market.

Both the return on assets and return on equity ratios are assessed over a sufficient period of time to establish historical contexts as well as to cover the entire cycle of credit risk and competitive forces.

Business Profile

A company's business profile is equated with its ability to maintain a distinct competitive advantage. Business profile drives current and future operating performance, which determines long-term balance sheet strength and ultimately financial security.

Business profile encompasses issues that are not obvious from the balance sheet strength or operating performance analyses and includes:

- Country and Sovereign Risk
- Economic and Business Market Risk
- Regulation and Regulatory Risk
- Corporate Structure
- Management and Strategy

Country and Sovereign Risk

The key point of analysis of any issuer institution, especially a finance institution, is the local environment in which it operates. For companies outside the United States, these factors are assessed and analyzed as part of A.M. Best's Country Risk Methodology available at www.ambest.com.

Factors studied include the organization and make-up of the local financial system, legal infrastructure and accounting system in a particular country. The local economic and financial-market conditions and cross-border risks directly impact the operating performance of not only the locally operating institution but potentially its parent holding company that may be based outside of that country in terms foreign-exchange and transfer risks. Additionally, the special legal infrastructure governing the financing of companies based on asset values is reviewed carefully. An analyst reviews the local legal framework and enforcement, critical to understanding the country risk of a finance company.

Transparency of local accounting and reporting standards is a significant factor for consideration. Among the developed countries, the different accounting standards have to be addressed to arrive at some comparability standards and a meaningful analysis of an operation in a particular country. The analysis of a company within the emergent countries of the world is rendered more challenging and may have to rely more on anecdotal and unofficial sources.

Economic and Business Market Risk

In understanding local economic conditions, which drive operating performance and the financial health of a company, a study of the local economic indicators is conducted with the following as a beginning: gross domestic product activity, inflation, employment rate, interest rates, the yield curve, the equity markets, trends in corporate and personal bankruptcies, and trends in commercial and residential real estate values, occupancy rates and rental rates.

Additionally, local business and market conditions are assessed in terms of competitive forces and structural dynamics of a local business environment. Of special importance is the stage of development of various supporting structures and submarkets for the finance industry, namely the securitization market(s) for specific asset types and the resale and liquidation markets, which are critical for asset valuations. The corresponding support-service providers in these submarkets also are important to the viability and feasibility of the functions of the submarkets. Local asset-valuation services, for example, are an integral part of a well-functioning resale market. For consumer-finance companies, there is less dependence on local services in the secondary resale market for their receivables.

Regulation and Regulatory Risk

While the finance industry typically is unregulated in most countries, there is still the general issue of corporate governance for any publicly held companies. Government regulatory policies vary by country and financial systems. Not only does the regulatory framework vary from country to country among developed countries, but, more importantly, it presents critical structural and systemic issues in emergent countries. Analysts consider the nature of the applicable local regulatory system (however corporate governance is conducted locally), as well as peer analysis produced by the various regulatory bodies.

Corporate Structure

The analyst studies the entire organization of a company, including the parent company's balance sheet strength, diversity of operations (earnings and cash flow, sources and uses of

capital), and geographic spread of various lines of business. Other nonfinance members of the organization are examined with regard to the level of risk or support they contribute to the overall entity, as are any legal/tax/regulatory-driven structures. The willingness and legal ability of the parent company to provide financial support for the company is considered. In addition, the existence of less profitable members of the organization that could divert earnings away from the group, or of obligations by the finance operating company to provide loans at less-than-market rates to such group members, are examined.

Management and Strategy

Assessing a company's management is probably the most subjective aspect of analyzing a finance company. Notwithstanding the subjectivity, it is still a useful step to consider the make-up of the senior management and board members of an institution. The strategic direction and internal control systems of a company also can be assessed from its historical activities and operations, which should be considered as the broader context and underlying influences for the financial performance of the company. Among critical internal controls to be assessed by an analyst are a company's risk-management organization, underwriting criteria and risk appetite. Finally, the history of a company's moral and litigation standing is reviewed for any outstanding cases and the frequency of penalties levied against it, litigation suits, and investigations by any authorities. These aspects would be especially significant if an institution is subject to a greater burden of these issues as compared with its peers.

GUIDE TO BEST'S RATINGS

A Best's Rating is an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile. Best's Ratings are not a warranty of a company's financial strength and ability to meet its financial obligations.

Financial Strength Ratings

A **Best's Financial Strength Rating (FSR)** is an opinion of an insurer's financial strength and ability to meet ongoing obligations to policyholders.

	Rating	Descriptor
Secure	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Very Good
Vulnerable	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the rated entity to meet its senior obligations. In certain markets or product lines, particularly where the credit market scale is widely recognized, A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Very Good; (bb) - Fair; (b) - Marginal; (ccc-cc) - Weak; (c) - Poor. A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

Rating Modifiers		Affiliation Codes	
"u"	Under Review	"g"	Group
"pd"	Public Data	"p"	Pooled
"s"	Syndicate	"r"	Reinsured

Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

Long-Term Credit Ratings

A.M. Best uses its long-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior obligations).

	Rating	Descriptor
Investment Grade	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
Non-Investment Grade	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a "u" modifier for Under Review.

Ratings prefixed with an ("i") denote indicative ratings. Issuer Credit Ratings may also be assigned a "pd" modifier, which indicates that a company does not subscribe to A. M. Best's interactive rating process. These Issuer Credit Rating descriptors apply to entities which do not issue insurance obligations.

Short-Term Credit Ratings

A.M. Best uses its short-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior financial commitments on obligations maturing in generally less than one year).

	Rating	Descriptor
Investment Grade	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
Non-Investment Grade	AMB-4	Speculative
	d	In Default

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

Rating Outlook

Best's Ratings (A++ to D, aaa to c) are assigned a Rating Outlook that indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Public Data Ratings are not assigned an Outlook. Rating Outlooks are as follows:

Positive	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.

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