



General Structured Finance Rating Methodology

Structured Finance

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Table of Contents

1. Executive summary	3
1.1. Introduction and updates	3
1.2. Methodology summary	3
1.3. Methodology highlights	3
1.4. Definitions and applicability	3
1.4.1. Rating definitions	3
1.4.2. Methodology application	4
1.4.3. Scope's financial contract (FC) ratings	4
2. Analytical framework	5
2.1. Collateral risk analysis	6
2.1.1. Collateral asset types and characteristics	6
2.1.2. Collateral default and loss-distribution analysis	9
2.1.3. Collateral pool characteristics: non-granular or variable composition	10
2.1.4. Obligor and risk presenter concentration risk	10
2.1.5. Collateral market value risk	12
2.2. Structure analysis	12
2.2.1. Structural and enhancement features and cash flow analysis	12
2.2.2. Liquidity risks	12
2.2.3. Exposure to interest rate risk	13
2.2.4. Country and industry risks	14
2.2.5. Representations and warranties	14
2.3. Counterparty risk analysis	14
2.3.1. Materiality of financial and operational risks	14
2.3.2. Asset management and servicer quality	14
2.3.3. Insurance-related credit enhancement	15
2.4. Legal risks and tax aspects review	15
3. Complementary analysis	16
3.1. Implementation of ESG factors in our analysis	16
3.1.1. Environmental risks	17
3.1.2. Social risks	17
3.1.3. Governance risks	17
3.1.4. ESG disclosures	17
3.2. Data adequacy, data guidelines and portfolio data template	17
3.3. Sensitivity analysis	18
3.4. Monitoring	18
Appendix I Technical note on the expected loss framework	19
Appendix II Technical note on Scope's cash flow model (Scope CFM) implementing the expected loss framework	21
Appendix III Technical note on Scope's portfolio model (Scope PM)	22
Appendix IV Technical note on timely payment	23
Appendix V Technical note on general asset recovery analysis	24
Appendix VI Legal considerations in structured finance	27

1. Executive summary

1.1. Introduction and updates

This document provides the latest update of Scope Ratings' (Scope) General Structured Finance Rating Methodology. Besides editorial changes it provides guidance on our analysis of insurance protection-enhanced transactions (see section 2.3.3) and clarifications regarding: i) the scope of this methodology (see section 1.4.2), ii) the incorporation of environmental, social and governance (ESG) factors into the rating analysis of structured finance instruments (see section 3) as well as iii) the acceptable level of default probability for a certain instrument rating level (see Appendix IV).

The updates are not expected to impact existing structured finance ratings.

1.2. Methodology summary

Scope's methodology relies on three analytical pillars that respectively address: i) the collateral risks, ii) the counterparty risks; and iii) the transaction's structure. Scope generally uses a fundamental bottom-up analysis to capture the credit risk of different asset, portfolio or structural characteristics expressed in a rating, considering the context of origination of the securitised assets, assets' risk exposure and relevant jurisdictions. Scope avoids one-size-fits-all assumptions and analyses structured finance transactions in a local context, applying its knowledge of the local markets. Local markets have laws, features and a history that may differ from one another. Specific controls and regulation in conjunction with individual safeguards or economic stabilisers provide differing levels of protection against certain shocks. This is reflected not only in the way Scope looks at key assumptions, but also in how it applies stresses to these assumptions. When applicable, Scope's rating approach incorporates the historical performance of a specific jurisdiction's structured finance transactions.

The rating analysis comprises both quantitative and qualitative components.

For the quantitative analysis, Scope calculates an instrument's expected loss and expected weighted-average life over the full contractual term of an instrument, with the result benchmarked against Scope's idealised expected loss table. The table is available on www.scoperatings.com. Scope also projects asset performance and where applicable cash flows, accounting for transaction idiosyncrasies by incorporating stressed combinations of risk variables.

Qualitative considerations include, among numerous factors, counterparty risk, origination quality, asset management or asset servicing quality, and incentives of various parties to the transaction. This analysis is particularly important for transactions whose assets require intensive care, dynamic management or an active workout. Qualitative factors may supersede quantitative results for both the initial rating and the monitoring of the rating. It is not unusual that a rating assigned is different from the one suggested by the pure quantitative analysis. Qualitative considerations can also limit a rating, link it to the counterparty's performance, or even lead Scope to not assign a rating.

1.3. Methodology highlights

Scope does not mechanically limit the maximum rating achievable by a securitisation based on the credit quality of the country of the issuer or of the securitised assets.

Scope complements the analysis of historical performance data with its forward-looking views on economic cycles and incorporates macroeconomic factors into base case assumptions. Scope's forward-looking approach assesses how structural factors may affect credit markets. Scope also pays attention to the interplay of national and supranational developments. For example, we may incorporate our view on the evolution of loan-underwriting standards; regional factors, such as demographics, wage structures and consumption patterns; or changes in local banking regulations or supervision.

The counterparty risk analysis builds on post-2007-2008 global financial crisis realities, including the regulatory and supervisory framework for banks, such as bail-in and stronger prudential metrics, and the resulting limited likelihood for banks to default in the short term. For further detail please see Scope's [Counterparty Risk Methodology](#).

1.4. Definitions and applicability

1.4.1. Rating definitions

Scope's structured finance credit ratings constitute a forward-looking opinion on relative credit risks of a debt instrument, or a synthetic credit instrument. A rating reflects the expected loss associated with payments contractually promised by an instrument

on a payment date or by its legal maturity. It factors in both the likelihood of default on such payments and the loss severity expected upon default. While the expected loss approach forms the cornerstone of Scope's analysis, the agency closely assesses the frequency of default and may limit the rating of an instrument, which has a low expected loss but a high default frequency (see Appendix IV).

Ratings assigned to unfunded instruments such as credit default swaps measure the expected loss for the credit protection seller, i.e. the risk of making a payment following a credit event under the transaction's terms. Ratings assigned to structured finance vehicles as contract counterparty measures the risk of such vehicle not fulfilling its credit obligations under the terms of its contracts. Ratings assigned to unfunded instruments and vehicles as counterparty do not address potential losses resulting from any market risk associated with the transaction's early termination, such as reinvestment risk.

For more detail, refer to the technical notes on the expected loss framework and timely payment under 3.2.

The default of a structured finance instrument entails among others one of the following events: i) a missed payment of interest or principal incurred under the instrument's terms and conditions; or ii) an event of default under the instrument's terms that leads to the security's enforcement. For additional details please also consult [Scope's Rating Definitions](#).

Scope applies the 'SF' suffix to structured finance instruments in line with Regulation No. 1060 of the European Parliament and the European Council. Such instruments include asset-backed securities (ABS), mortgage-backed securities (MBS) and collateralised debt obligations (CDO). The suffix is not applied to covered bonds and non-tranched asset securitisations. Scope may, however, apply the present methodology and relevant addendums to analyse the credit risk of instruments not subject to the 'SF' suffix.

1.4.2. Methodology application

This methodology applies to i) all types of structured finance instruments, particularly debt instruments issued by a special-purpose vehicle (SPV) and exposed to the performance of real or financial assets, and ii) unexecuted contracts¹. The securitised asset's economic risk can be transferred to the issuer² via either legal ownership (a true sale) or credit derivatives (synthetic transfer), where the latter may be funded or unfunded, but contractually agreed.

Structured finance instruments issued by an SPV are generally non-recourse or limited-recourse debts. Their repayment is driven primarily by the underlying collateral's performance and the transaction's priorities of payments or loss allocation mechanisms. Collateral can include a wide range of financial or real assets encompassing sectors such as real estate, consumer credit, SMEs, corporates, project finance and infrastructure. Should there be specific considerations, as outlined in the asset-class-specific methodologies – see section 2.1.1, those specific considerations supersede the general considerations outlined in this document.

Scope also applies this methodology to assign ratings that reflect the ability of a structured finance SPV to honour its obligations as counterparty under financial contracts, such as derivative products (see 1.4.3. Scope's financial contract (FC) ratings).

This methodology applies to structured finance transactions in Europe. This methodology can also be selectively applied to structured finance transactions outside Europe when terms and conditions, legal framework and institutional framework are similar.

This methodology applies to both, the assignment and monitoring of ratings.

1.4.3. Scope's financial contract (FC) ratings

Scope's financial contract ratings apply to a vehicle's conditional financial obligations³, such as providing liquidity facilities, or potentially various swap contracts, i.e. interest rate, currency, credit default, asset or index swaps. The special purpose vehicle's financial contract rating concerns only the vehicle's capacity to fulfil its contractual obligations and does not address the capacity of the respective contractor to pay the vehicle. We assume that the contractor is able to pay its obligations. Therefore, we do not factor any consequences of a contractual default by the contractor into our analysis as we would instead withdraw the FC rating in case there is a contractual default by the contractor. Thus, FC ratings would not address the ability of the SPV to pay swap termination payment if the SPV is not the defaulting party.

¹ Scope may assign a final rating to instruments defined under unexecuted contracts which are related and tied to an executed one.

² In this document, Scope refers to the issuer of the notes indistinctly as the 'issuer' or the 'SPV'.

³ We refer to obligations that are not predefined as conditional obligations.

Scope applies the 'FC' suffix to financial contracts a structured finance vehicle can be a counterparty to.

The suffix distinguishes financial contract ratings from structured finance instrument ratings. The analysis required to assign a FC rating incorporates generally all the steps also required to assign structured finance instrument ratings. The main rating drivers of a FC rating are the definitions in the respective contract defining the obligation of the rated vehicle, the credit quality of the assets of the SPV⁴ whose cash flows will be used to honour the SPV's obligation under the financial contracts, the legal setup of the special purpose vehicle, the position of the obligation in the vehicle's priority of payments, and the credit profile of the third-party counterparties, including counterparty risk mitigating features.

2. Analytical framework

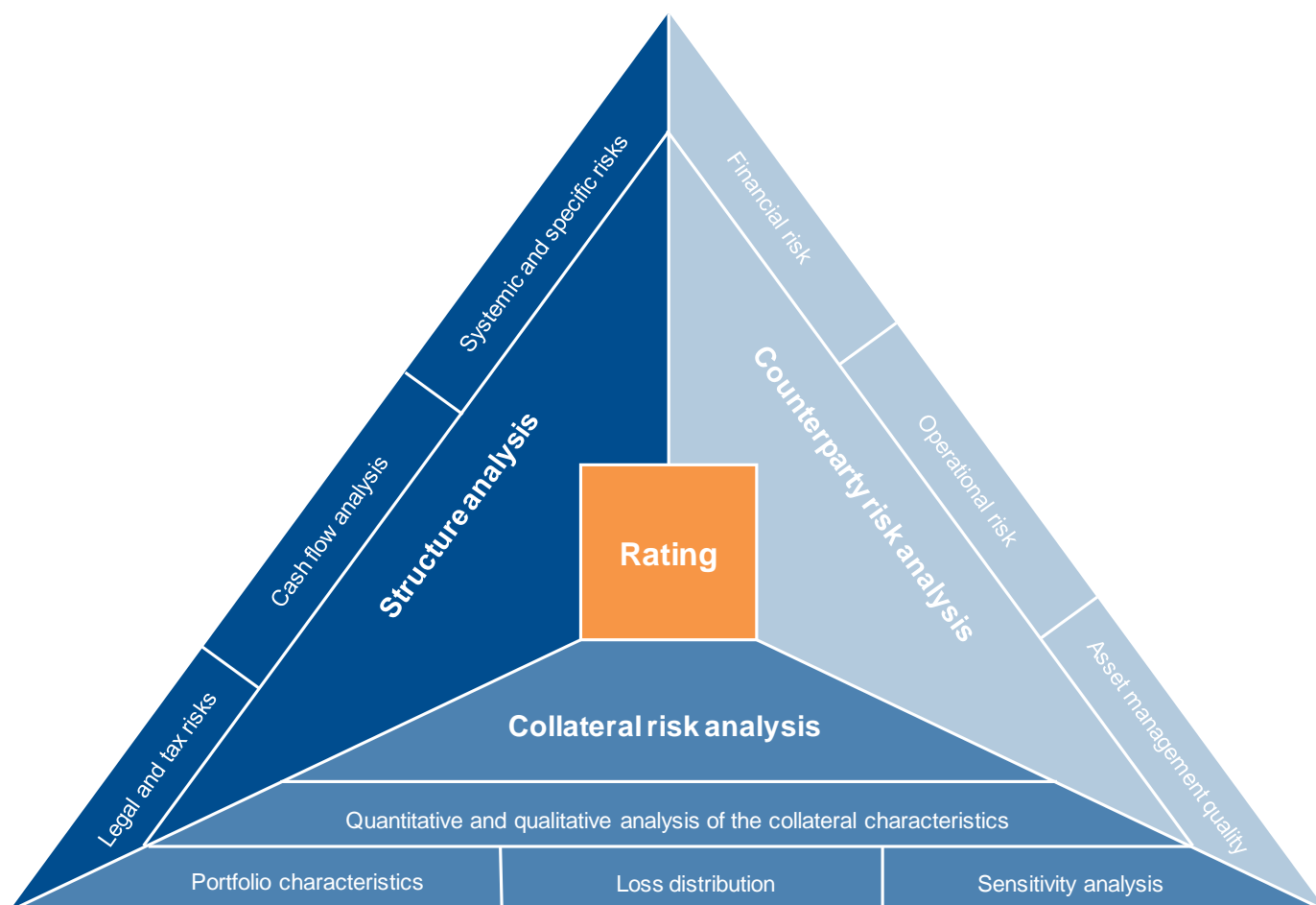
Scope's credit risk analysis of structured finance instruments consists of three pillars: i) **the collateral risk analysis**, which assesses, among others, the underlying collateral's main characteristics, default distribution, loss distribution as well as the timing and level of cash flows; ii) **the counterparty risk analysis**, which identifies and assesses parties that can affect the transaction's performance; and iii) **the structure analysis**, which looks at the transaction's structural features, such as the priority of payments and legal risks. Figure 1 below gives a visual representation of Scope's approach.

Scope estimates an instrument's expected loss using a quantitative approach, supplemented by qualitative considerations, for each of the three analytical areas shown in Figure 1. Scope benchmarks the resulting instrument expected loss and the corresponding weighted average life of the instrument with the idealised expected loss tables. The qualitative analysis incorporates numerous factors including operational and credit counterparty risks, as well as legal and tax risks. It is not unusual that a rating assigned differs from the one suggested by a purely quantitative analysis, as qualitative considerations may override quantitative results for both the initial rating and the monitoring of a rating. Qualitative considerations generally relate to unquantifiable elements or are applied when Scope identifies constraints in the quantitative analysis, for example, if an excessive counterparty exposure limits the assigned rating, or if the quantitative output is volatile.

Regarding optional features in a transaction, Scope generally assumes an investor takes a passive role. For example, when an investor has the option to alter transaction features, e.g. advance additional funds to a transaction to raise the credit enhancement of the rated instrument, Scope generally does not consider its impact on the ratings but monitors the effects should this option be exercised. When relevant, Scope may however factor investors incentives to act.

⁴ Assets in this case combine all instruments that a SPV acquired, a portfolio of securities, loans or cash.

Figure 1. Scope's three analytical pillars for structured finance ratings



2.1. Collateral risk analysis

The first step of Scope's analysis is to examine the credit quality of the underlying asset or pool of assets (underlying collateral). Scope evaluates the characteristics of the assets to understand default patterns, loss severity upon default, associated timings, and dependency structures. The assessment of collateral risk involves both qualitative and quantitative components at various rating-conditional levels in order to estimate the collateral's default and loss distribution under different scenarios.

Scope's preferred approaches for assessing collateral risk are i) to analyse loan-by-loan data for non-granular portfolios, or ii) the historic performance of the originator's loan book in the case of granular portfolios. From a qualitative standpoint, Scope analyses the context of origination or asset sourcing. This approach therefore considers the assets' type, along with the originator's underwriting process, incentives, strategy and standards. Scope calibrates asset modelling parameters using historical collateral data when available and incorporates qualitative considerations on the collateral. The calibration may also be based on loss characteristics common to structured finance transactions with comparable collateral. Scope normally applies more conservative assumptions when only shorter historical data sets or poor-quality data on the collateral pool are available, to reflect the greater uncertainty associated with the parameter calibration. In some instances, insufficient quantitative or qualitative data may even make it impossible to assign a rating.

2.1.1. Collateral asset types and characteristics

The collateral behind structured finance instruments can include a large variety of assets like loans, credit lines, bonds or credit default swaps. Assets can reflect secured or unsecured risk exposures and can also be real assets. Asset obligors include consumers, corporates or even public entities and sovereigns. Figure 2 summarises the characteristics of common structured finance asset classes.

Figure 2. Summary of asset types and typical characteristics of core structured finance asset classes

Deal types	Underlying assets	Typical characteristics of the asset types			Asset analysis	
		Risk horizon	Collateral granularity	Homogeneity ⁵	Focus	Asset-individual rating assessment
ABCP	Commercial discount credits or credit advances	Generally short-term	Granular	Homogeneous	Originator loan book	No
Credit cards	Credit card balances	Short-term	Granular	Homogeneous	Originator loan book	No
Trade receivables	Commercial credit	Short-term	Typically, granular	Homogeneous	Originator loan book	No
Auto ABS	Auto loans or auto leases	Medium-term	Granular	Homogeneous	Securitized portfolio	No
Consumer ABS	Consumer loans	Medium-term	Granular	Homogeneous	Securitized portfolio	No
RMBS	Residential mortgages	Long-term	Granular	Homogeneous	Loan by loan or securitized portfolio	No
SME ABS	Loans to small and medium-sized enterprises	Typically, medium-term	Typically, granular	Mixed	Loan by loan or securitized portfolio	Possible
NPL ABS	Loans	Medium-term	Typically, granular	Mixed	Loan by loan	No
Corporate CLO/CDO	Corporate leveraged loans, Large corporate bonds, credit default swaps	Medium-term	Non-granular	Relatively homogeneous	Loan by loan	Yes
CMBS	Commercial mortgages	Medium- to long-term	Non-granular	Heterogeneous	Loan by loan	Yes
CRE loans	Commercial real estate loans	Medium- to long-term	Non-granular	Heterogeneous	Loan by loan	Yes
Reverse mortgage	Equity release	Long-term	Typically, granular	Mixed	Loan by Loan	No
Credit-linked notes/ repackaging	Any financial assets	Medium- to long-term	Typically, single asset	N/A	Pass-through rating/asset by asset	Yes
Insurance-linked securitisation	Pool of insurance contracts or reinsurance contracts referencing a portfolio of exposures	Medium-term	Granular	Homogeneous	Securitized portfolio of exposure	No
Other/esoteric	Real assets, funds shares, credit default swaps, other	Short- to long-term	Typically, non-granular	Heterogeneous	Bespoke	Possible
PF CLO	Project finance debt	Medium- to long-term	Non-granular	Heterogeneous	Loan by loan	Yes

⁵ Homogeneity indicates whether the portfolio assets share a lot of similar characteristics that allow to use similar assumptions to describe their credit profile.

Consumer ABS, and auto ABS – consumer credit

Consumer credit includes credit lines, consumer loans and credit card debt. Collateral pools backing consumer ABS or auto ABS transactions are often homogeneous and contain many loans. The portfolio assessment for such transactions considers pool characteristics, the quality of the pool's servicing, the originator's lending standards, and Scope's forward-looking performance expectations based on historical data and macroeconomic forecasts. Additional details can be found in Scope's [Consumer and Auto ABS Rating Methodology](#).

RMBS –residential mortgage loans

Residential mortgage-backed securities (RMBS) are securitisations of granular and homogenous portfolios of standard mortgage loans to purchase, refinance or refurbish a residential property. The portfolio assessment for such transactions considers the pool characteristics, the quality of the pool's servicing, the originator's lending standards, and Scope's forward-looking performance expectations incorporating historical data and macroeconomic forecasts. Some RMBS transactions might show limited granularity, thus Scope might complement the portfolio analysis with a loan-by-loan analysis, at least for the largest loans.

SME ABS

Depending on the granularity of the securitised pool, Scope either performs a loan-by-loan analysis or assumes an idealised portfolio. Scope may assess the pool's credit quality by examining individual credit ratings and internal assessments, calibrating historical data, and incorporating the internal rating systems of loan sellers. Scope also incorporates its macroeconomic view on the relevant SME market. Details on these procedures can be found in Scope's [SME ABS Rating Methodology](#).

Non-Performing Loans

Structured finance securitisations of non-performing-loan (NPL) portfolios, while similar to performing loan transactions, have the key difference that their income consists of an irregular flow of recovery amounts, as opposed to the regular cash flows paid by performing debtors. Scope's analysis focuses on the portfolio servicer's ability to extract the security value, the collateral appraisal quality (especially for security from real estate), the security liquidity, the recovery timing as well as the applicable legal framework and enforcement proceedings. Details on these procedures can be found in Scope's [Non-Performing Loan ABS Rating Methodology](#).

CDO/CLO – corporate credit

CDO/CLO transactions expose investors to portfolios comprising leveraged loans, large corporate's bonds and also credit default swaps on corporates. The characteristics of these instruments are relatively homogenous. However, portfolios composed of such instruments are often non-granular and require a credit-by-credit analysis to assess credit risk. Scope relies on its ratings, internal assessments on each underlying instrument or, when available, monitored ratings from other regulated credit rating agencies⁶. Details on these procedures can be found in Scope's [CLO Rating Methodology](#).

CMBS and commercial real estate loans

Underlying collateral of CMBS transactions and commercial real estate loan securitisations is often non-granular and highly heterogeneous. For these transactions Scope assesses each underlying commercial real estate loan. This is achieved by reviewing economic features, tenant credit quality, property quality, loan structure, rent roll, the economic environment, and the servicer's ability to service the loans. Details on these procedures can be found in Scope's [CRE Security and CMBS Rating Methodology](#).

Credit-linked notes and asset repackaging

Credit-linked notes (CLN) can be used to repackage a variety of assets under a different format, thus modifying the underlying assets characteristics. The instruments' cash-flows are linked to either the asset cash flows and/or derivatives contracts cash-flows. Such structure may either pose significant counterparty risks or modify the underlying asset's payment characteristics, e.g. payment maturity profile, currency, or coupon basis.

The analysis of such structure will typically rely on modelling the timing of default of both (i) the underlying entities and (ii) the derivative counterparty and applying the cash-flow mechanism, including any hedging arrangements, as per the legal

⁶ Scope may apply an adjustment on a case-by-case basis.

documentation. The analytical focus is therefore on the legal structure, including typically existing credit support annexes, and counterparty risks.

Insurance-linked securitisation

Insurance-linked securitisation instruments do cover any debts issuance whose repayments are linked to the realisation of claims on a portfolio of granular insurance exposures either from all risks type and from a single risk type, for example catastrophe bonds. The analysis of such exposures uses the same concept as for credit exposures, where claims frequency is akin to default frequency and claims severity is akin to loss severity. The assessment of such transactions considers the risk transfer characteristics, the underwriting standards, the quality of the claims management and Scope's forward-looking claims expectation based on historical data.

Project finance loans securitisations

Project finance (PF) assets are usually very heterogeneous since the asset class covers financing for infrastructure, transportation, energy and real estate. Project finance often addresses public needs. Scope's analysis of structured finance instruments backed by PF loans generally involve the preparation of a rating or credit assessment on each underlying loan in the collateral pool. The assessment incorporates a detailed view of the economics of each project, the project phase and the liability-servicing abilities, including seniority and credit enhancement. Scope also considers the off-takers and guarantee providers, which often play a significant role with respect to going-concern operations. More information regarding the analysis of individual project finance loans is available in Scope's [General Project Finance Rating Methodology](#).

2.1.2. Collateral default and loss-distribution analysis

Scope analyses collateral risk by projecting expected future losses and deriving cash flows associated with the securitised assets' performance. A technical description of Scope's expected loss framework and a definition of its cash flow model Scope CFM are found in section 3 and Appendix II. Central to the collateral risk analysis is the selection of a modelling approach that captures collateral characteristics, allowing the construction of a collateral loss distribution that best mimics how the assets behave over time. To adequately capture the risks of different collateral pools, Scope applies a framework that provides a consistent projection of defaults across asset classes and of collateral exhibiting various levels of granularities and homogeneities.

Scope's estimation of the probability for each possible default rate differs according to the granularity of the underlying asset portfolio.

Collateral pools with limited diversification call for a default distribution that reflects specific assumptions for each asset. For such pools, Scope produces a non-parametric distribution of losses using a Monte Carlo simulation method, typically with a Gaussian copula dependency framework. Appendix III provides a definition of Scope's portfolio model Scope PM that implements such a non-parametric distribution of portfolio losses. Simulating numerous scenarios allow results to converge with a level of volatility commensurate with the target rating's expected loss.

For homogenous and granular pools, Scope typically applies standard, parametric probability distribution laws such as the inverse Gaussian to approximate the portfolio default rate distribution. This limits the number of required inputs to define default distribution as: i) a measure of mean default rate; and ii) a variance (or correlation parameter). The inputs can be calibrated using historical data and adjusted via a qualitative assessment of securitised assets. If possible, Scope also considers performance data on other structured finance transactions exposed to similar collateral.

The determination of each input's characteristics is generally subject to sensitivity analysis, based on information provided by the assets' originator. Scope also uses public historical data, proprietary data, market studies by reputable providers, and academic research. This approach notably applies to retail mortgage loan pools, consumer credit or granular pools of SME loans.

For asset classes with sufficient data, Scope looks at long-term market performance data and takes a forward-looking view on the economic cycle. Scope incorporates market information into base case assumptions. This includes macroeconomic factors correlated to defaults in the relevant asset class, for example, GDP and unemployment rates can be used for default assumptions on consumer credit transactions. Scope's forward-looking approach may incorporate structural factors of local markets that could impact credit performance.

When relevant, Scope may use a long-term distribution of portfolio defaults to calculate the expected loss, using an average through-the-cycle performance reference for a AAA_{SF} stress and a point-in-time distribution⁷ of portfolio defaults for a B_{SF} stress. Under all other rating stress scenarios, i.e. from BB_{SF} to AA_{SF}, Scope blends the results obtained from both point-in-time and long-term defaults. As the rating target becomes higher, this blending process assigns more weight to the long-term distribution and less to the point-in-time. This approach can prevent undue volatility on high investment grade ratings over the economic cycle. The stabilisation effect on non-investment grade ratings gradually becomes less noticeable, and B_{SF} ratings are driven only by the point-in-time distribution.

Once the collateral pool's default pattern is determined, Scope analyses the collateral's cash flow by deriving assumptions on default timing, recovery amount and timing, prepayment patterns, amortisation, asset yield, and any other cash flow drivers. These assumptions depend significantly on the characteristics of assets in the pool. Scope may also analyse the sensitivity of cash flows to these assumptions.

2.1.3. Collateral pool characteristics: non-granular or variable composition

Transactions with collateral that has low granularity or high concentrations require additional attention. Collateral can vary widely in composition, ranging from a few heterogeneous assets in CMBS or CDO transactions to several thousand relatively homogeneous assets in ABS, RMBS or SME ABS transactions. For SME ABS, collateral may comprise numerous assets, but with only a few representing a large portion of the total balance. Collateral concentration exposes the transaction to idiosyncratic risk, and it is not possible to perform the analysis based only on averages.

Scope measures the equivalent effective number of exposures – the inverse of the Herfindahl Index – to assess portfolio concentration under different criteria, depending on the asset class. This diversity metric may measure concentration by obligor, industry or region. Scope uses the measure to determine the application of certain modelling applications, as outlined in the respective asset class methodologies.

Expression (1) shows the diversity index that measures obligor concentration:

$$(1) D_{obligors} = \frac{1}{\sum_{i=1}^{obligors} p_i^2}; \text{ where } p_i = \frac{Balance_{obligor i}}{Total Balance}$$

Certain asset classes require a detailed asset-by-asset analysis to assess collateral pool risk. For this purpose, Scope may produce a credit rating or assessment on some or all assets in the pool to infer the assets' default risk and, when relevant, the associated loss severity (loss given default). Scope's analysis may also incorporate external ratings from a regulated bank or other rating agencies if available but reserves the right to adjust these as appropriate.

Scope focuses on the actual collateral's characteristics when the portfolio of assets is static, i.e. when assets cannot be removed from or replaced in the portfolio. By contrast, when collateral can be replenished, sold or actively traded, the analysis incorporates a hypothetical portfolio that follows asset-eligibility covenants. The agency does not consider a worst-case portfolio, but a likely portfolio, taking into account among others the initial portfolio, the expected composition over time, the originator strategy and the transaction covenants.

Scope also evaluates the manager's ability, incentives, and potential to add value in the context of the transaction. This is particularly important for managed transactions with covenants that limit, or allow a significant margin for, credit deterioration from the actual characteristics of the invested collateral. This is also important for transactions whose performance is driven by value generation from active asset management such as capital expenditure plans and business plans connected with transactions exposed to real estate.

2.1.4. Obligor and risk presenter concentration risk

Large obligor analysis

Transactions may have large single-asset exposures with different concentration levels that pose significant idiosyncratic risks. Therefore, Scope assesses the credit risk of large exposures individually, with a different approach depending on the level of asset concentration.

⁷ A point-in-time distribution of defaults reflects our assumptions under current market conditions, not a long-term through-the-cycle view.

Figure 3 describes Scope's approach to assessing and monitoring different concentration levels of direct single-asset risks securitised in a portfolio.

Figure 3. Standard approach for assessing and monitoring direct single-asset risk by level of concentration

Obligor concentration (% of portfolio balance)	Credit quality derived from:
Less than 2%	Mapping of external credit risk measures available to Scope*
Less than 5%	Mapping of external credit risk measures available to Scope* and consistency checked** by Scope's analysts
Less than 10%	Credit estimate or similar assessments by Scope or its affiliates ⁸ OR an external rating mapped to Scope's rating scale.
10% to 25%	Public or private rating by Scope OR the second-best external rating mapped to Scope's rating scale, if there is more than one external rating available***, OR an external rating if there is only one available, adjusted, if necessary, by sensitivity analysis
Exposure >= 25%	Public or private rating by Scope

* Such external risk measures may be internal rating models of the originator, portfolio assumptions from vintage data or public ratings from a regulated and supervised CRA. Scope may use those measures and adjust them as necessary.

** A consistency check reviews whether the exposures' considered credit quality level is consistent with credit quality benchmarks available for the obligor type.

*** If there are three or more external ratings that can be considered, we may adjust the mapped rating further, if we find that the worst mapped rating diverts more than one notches from the second-best mapped rating.

Indirect risk presenters

Mainly in the context of transactions that concern non-granular asset portfolios some assets may also be exposed indirectly to the default of a third party (a risk presenter), such as a lessee of the securitised asset. To assess a risk presenters' creditworthiness, Scope uses its own ratings when a risk presenter's contribution to the cashflow available to service payments to the rated instrument is larger than 25%. Otherwise, Scope relies on periodically updated credit estimates⁹, available public ratings from other regulated and supervised CRAs or credit quality assumptions derived from other types of risk measures, such as originator's internal ratings or market benchmarks, as outlined in Figure 4. Scope may consider a different creditworthiness than the public rating if Scope's credit estimate deviates significantly from the external regulated and supervised CRA's public rating.

Figure 4. Standard approach for assessing the creditworthiness of indirect exposures to risk presenters

Exposure to risk presenters ¹⁰	Credit quality assessment derived from Scope Rating, or:
Less than 5%	Generic default risk assumption or mapping of external credit risk measures available to Scope ¹¹
5% <= exposure < 10%	Credit estimate or similar assessments by Scope or its affiliates OR public rating(s) from a regulated and supervised CRA
10% <= exposure < 25%	Credit estimate or similar assessments by Scope or its affiliates and public rating(s) from a regulated and supervised CRA, if any OR the second-best external rating mapped to Scope's rating scale, if there is more than one external rating available, OR an external rating if there is only one available, adjusted, if necessary, by sensitivity analysis
Exposure >= 25%	Credit rating by Scope (public or private)

Source: Scope

Risk presenters contributing more than 5% of total debt-service cash-flow may be subject to a fallback credit quality assumption of 'B-' if the approaches outlined in Figure 4 are not possible due to limited information available. This may apply to all corporates or

⁸ See 5.1.6 Sensitivity analysis; credit estimates or similar assessments will be periodically updated.

⁹ Scope will update such credit estimate at least annually in the context of the periodic analysis update of the rated instrument.

¹⁰ Measured as % of cash flow available for debt service on the rated instrument.

¹¹ See examples for large-obligor credit assessment information sources below Figure 3.

financial institutions that have not publicly filed for bankruptcy or any other debt protection scheme. Risk presenters to which the fallback credit quality assumption applies will be subject to the sensitivity analysis outlined under section 3.2.

2.1.5. Collateral market value risk

Securitisation instruments may be exposed to collateral market value risk, for example, when cash flows used to repay the instrument are generated from the sale of all or part of the securitised assets. This exposes the instrument to the price volatility of the sold assets, which typically depends on the asset's market liquidity, duration and currency. In Europe, high market value risk is uncommon for securitisation transactions. Therefore, Scope will assess this risk using a transaction-specific approach to reflect the different characteristics of the assets and their respective markets.

2.2. Structure analysis

Scope evaluates the structural characteristics of the rated transaction by examining transaction-specific risk drivers not captured in previous analytical steps, such as the issuer's characteristics and the instrument's structure. Key structural elements include: i) legal risks and tax aspects; ii) structural enhancements and liquidity; iii) systemic risks; and iv) other transaction- or sector-specific risks.

2.2.1. Structural and enhancement features and cash flow analysis

Structural features can improve or weaken the transaction performance from the perspective of a rated debt. Key structural features generally include: i) the order of priority of the rated notes' interest and principal payments; ii) the instrument's payment frequency; iii) enhancement features such as excess spread, cash reserves or liquidity buffers; iv) mismatches of cash flows between the underlying collateral and the issuer's financial obligations; v) the coverage of the issuer's ordinary and extraordinary expenses; vi) guarantees or hedging mechanisms; vii) covenants, performance triggers or other protective mechanisms; and viii) call, early-redemption, asset-substitution or new-issuance features. Scope analyses the efficiency and impact of these features, incorporating the most important in its quantitative analysis.

Scope combines quantitative methods, based on simulations or standard distribution laws, see '2.1 Collateral risk analysis', with an analysis that reflects the transaction's key cash flow characteristics. Such characteristics include interest and principal priority of payments, sources of credit enhancements, liquidity lines, reserve accounts, and costs borne by the structure over the instrument's term. For each scenario, Scope calculates a loss for the rated instrument to produce an expected loss associated with the rated instrument¹². This cash flow analysis aims to replicate as closely as possible the transaction's structure and reflect structural and enhancement features. As a result, the analysis can measure how, when and to what extent cash flows generated from collateral cover costs and liabilities borne by the structure.

Many of Scope's assumptions for the cash flow analysis are based on legal documents related to the rated issuance. Most constant parameters relevant to income and expense assumptions are derived from contractual terms governing the structure. Parameters that are not contractually specified or include provisions for variable components will be incorporated into Scope's qualitative assessment.

For simple structured finance transactions for which cash flow allocation does not drive the rating, Scope may derive the notes' expected loss directly by deriving the collateral pool's loss distribution and allocating losses to the rated instrument in each scenario, instead of computing expected loss through a full cash flow allocation.

For instruments exposed to non-tranched portfolios and not subject to material cash flow enhancements, the expected loss of the instrument may equal a simple weighted average of the expected loss of each asset securing the instrument's repayment.

2.2.2. Liquidity risks

While Scope's structured finance ratings are anchored in the measure of expected loss, Scope also pays careful attention to the credit risks related to liquidity. We only assign high ratings in the AAA_{SF} or AA_{SF} categories if timely interest payment is highly likely, even upon portfolio servicing disruptions.

¹² The expected loss for the structured finance instrument is therefore the sum-product of i) the probability of occurrence of a given scenario associated with a given asset performance; and ii) the loss derived from the cash flow model and specific to the transaction in each scenario.

A liquidity shortfall in a transaction, i.e. the issuer's available funds being insufficient to cover senior costs and interest payments on the notes, may derive from different factors, among which i) insufficient cash flows received from the securitised portfolio; ii) a servicer disruption causing a temporary cash interruption; iii) the servicer's default resulting in issuer and servicer funds being commingled; and iv) the default of a key counterparty such as the swap counterparty, account bank, or paying agent. We analyse whether liquidity support in a structure can reduce the risk of missed interest payments over certain (potentially long) periods, such as the time needed to replace a disrupted servicer.

The minimum liquidity needed to achieve a certain rating depends mainly on: i) the type of asset being securitised, ii) the counterparties' operational capacity and financial strength; iii) the contemplated liability structure; and iv) structural mechanisms to replace key counterparties if needed.¹³

In securitisations of plain-vanilla performing assets, the first layer of liquidity protection is generally provided by regular cash inflows, excess spread, and 'principal to pay interest' mechanisms. Replacing a servicer in such securitisations is usually simpler, both in terms of timing and the availability of suitable replacements. As a result, the minimum required liquidity support (contractually agreed) for ratings in the AAA_{SF} or AA_{SF} categories ranges between two and six months of the expected senior fees and interest on the notes. For investment grade ratings on senior notes from BBB_{-SF} up to A_{SF}, a servicer disruption scenario is likely to have a lesser negative impact. At this level, our analysis can also incorporate the incentives in place and capabilities of a transaction party to provide additional liquidity to a transaction.

For transactions whose assets produce irregular cash flows and/or require active or complex servicing, Scope may only assign high investment grade ratings (AAA_{SF} or AA_{SF} categories), if the minimum liquidity coverage ranges from 24 to 36 months. Among others, this should address the risk of a long servicer replacement process, which could impair the transaction cash flows, driven by long on-boarding periods to gain the knowledge required to actively manage the assets. For investment grade ratings on senior notes from BBB_{-SF} up to A_{SF} the irregularity of the cash flows and the importance of active servicing may still require a certain level of readily available liquidity, e.g. in the form of a liquidity reserve, even if other strong additional mitigants are present in the structure.

Junior and mezzanine notes typically have coupons that are deferrable making them less sensitive to liquidity risks as a non-payment of interest would typically not trigger a default on these notes.

Scope's analysis may account for optional liquidity injections, back-up servicing agreements and the effectiveness of servicer replacement mechanisms, as well as derivative contracts that ensure a certain level of liquidity.

Coupon deferral

Some structured finance instruments contractually allow interest to be deferred and then potentially accrued. Prolonged interest deferral is generally due to the underlying collateral performing worse than expected. Scope will consider this risk through a downward adjustment of the instrument's rating. Scope is unlikely to assign investment grade ratings to instruments that allow discretionary interest deferral over long periods, i.e. greater than the shorter of one year and two interest payment dates. In addition, Scope is unlikely to assign high investment grade ratings to instruments allowing interest deferral for credit performance reasons, unless the likelihood of deferral remains in line with the timely payment standards highlighted in Appendix IV.

2.2.3. Exposure to interest rate risk

Interest rate risk is the risk that the interest rate payable on the rated instruments differs from the interest rate on the securitised assets. Such risk may stem from: (i) basis risk, where both the portfolio and the notes have a floating rate, but they are linked to different reference rates, (ii) fixed-floating risk where the portfolio pays a fixed rate, whereas the rated instruments pay a floating rate (or vice versa), and (iii) reset date mismatch, where both the portfolio and the rated instruments have floating rates linked to the same reference rate, but the reset dates are different.

We expect the rated instruments not to be materially exposed to interest rate risk. To mitigate interest rate risks, the issuer may enter into a contractual hedging agreement. We assess the main terms of the hedging agreement to determine how effectively the risk is mitigated¹⁵. If not contractually hedged, we also consider the protection that an asset-liability-hedge provides, i.e. assets and

¹³ For more details on the analysis of counterparty risks, consult Scope's Counterparty Risk Methodology.

liabilities pay interest based on highly correlated benchmarks, supported by the priority of payment structure that would shield highly rated instruments from potential mismatch losses.

Unless fully covered structurally or hedged, we would analyse the sensitivity of the transaction to material changes (upward or downward) in interest rates throughout the transaction life.

2.2.4. Country and industry risks

In addition to the analysis of collateral and counterparty risks, Scope carries out a qualitative, forward-looking evaluation of systemic trends affecting the countries and industries to which the transaction is exposed. Scope considers macroeconomic, environmental, sovereign and industry risk factors that may impact instrument performance.

Scope sees no valid analytical reason to systematically cap the maximum rating achievable by a securitisation based on the sovereign credit quality of the country of the issuer or of the securitised assets.

However, Scope's analysis still considers country risk. Credit ratings allow investors to consistently compare credit risks between different instruments and securitisation types across different locations. As a result, the ratings must adequately and consistently reflect the credit risks of an instrument, including those arising from an exposure to a country with weak economic fundamentals.

Scope's sovereign risk analysis for structured finance transactions looks at convertibility risk, e.g. risk of eurozone exit, the risk of institutional meltdown within the transaction's tenor, and macroeconomic factors. A material exposure to a financially weak domestic sovereign is viewed as a material credit risk that may negatively impact the rating.

2.2.5. Representations and warranties

Scope considers the strength and expected impact of representations and warranties made by transaction parties, including those made by the originator of the assets in the collateral pool. In some instances, Scope may complement representations and warranties with any external audits performed on the pool.

For the portfolio audits, Scope generally relies on the standard agreed upon procedures that internationally recognised accounting firms apply for the respective asset class and a given level of portfolio granularity.

2.3. Counterparty risk analysis

2.3.1. Materiality of financial and operational risks

Scope evaluates the credit risk impact on the rated instrument stemming from the transaction's exposure to the various transaction counterparties in terms of both financial risk and operational risk. The materiality of an exposure is assessed as excessive, material or immaterial depending on the impact the counterparty default would have on the rated instruments. Scope also assesses the extent to which available measures mitigate or reduce counterparty risk in the specific context of the transaction. More detail on the approach can be found in Scope's [Counterparty Risk Methodology](#).

2.3.2. Asset management and servicer quality

Qualitative factors are crucial to the analysis of structured finance transactions whose assets require intensive care, dynamic management or active workout.

The performance of NPL transaction is mainly driven by the servicer's capabilities. Recent CMBS transactions in Europe have shown the key role played by special servicers in maximising recoveries for investors. Similarly, the active role of CLO managers helped to not only preserve the portfolio par value of several transactions during economically distressed periods, but also to accelerate the transaction's recovery by seizing investment opportunities to reconstruct notional par.

Scope's rating methodology emphasises qualitative credit judgment based on objective components.

For transactions involving active management of the collateral pool, i.e. to source, develop, work out, add, exchange or remove assets, Scope examines the potential risks related to the asset manager's performance. The impact and importance of this risk on Scope's analysis greatly depends on the level of discretion left to the manager or servicer and how this can maximise, preserve or destroy the collateral pool's value. When Scope holds a positive opinion on the asset manager, additional management flexibility or a longer reinvestment period may be seen as credit-positive.

Scope analyses the asset manager or servicing agent by reviewing its structure, skills, expertise, processes, performance and track record, considering:

- the agent's economic incentives within the structure, e.g. remuneration, interest in the transaction's performance, and how or to what extent its interests are aligned with those of debt investors;
- the importance of the securitised asset segment within the agent's overall development strategy;
- the standard of care and general liability; and
- reputational risk.

When available, the analysis may incorporate relevant elements part of Scope's Asset Management Rating analysis. The Asset Management Rating does not measure credit risk, but rather the quality of management companies acting as service providers for the issuer.

2.3.3. Insurance-related credit enhancement

Credit enhancement available in a transaction sometimes includes insurance protection. The instruments' ratings then need to reflect the credit quality and conditionality of such credit enhancement. Therefore, Scope's analysis focuses on the contractual provisions and the credit quality of the insurers.

The analysis of the insurance contracts' provisions focuses on the conditionality of the protection, timing delays of the payment from the insurance company, and potential scenarios under which a payment claim for loss coverage could be filed, while at the same time the insurance company can put a defence to not pay. This analysis would be based on our understanding of the insurance contracts, supported by legal opinions.

Regarding the credit quality of the insurer(s), we consider public rating(s) from regulated and supervised CRAs in our analysis, which we may adjust in case we deem necessary. Scope distinguishes two cases of insurance-related credit enhancement:

- 1) Insurance(s) provide(s) for enhanced recoveries on the underlying assets, i.e. an insurance contract covers a certain portion of portfolio loss in the context of an individual asset's default.

Transaction exposure to a single insurer	Credit quality assessment derived from:
Up to 100%	Public rating(s) from a regulated and supervised CRA mapped to Scope's rating scale*

- 2) The protection provided by the insurance(s) would result in credit substitution, i.e. the rating of the rated instrument reflects to a large extent Scope's assessment of the credit quality of the insurer(s).

Transaction exposure to a single insurer	Credit quality assessment derived from:
Less than or equal to 25%	Public rating(s) from a regulated and supervised CRA mapped to Scope's rating scale*
More than 25%	The second-best external rating mapped to Scope's rating scale, if there is more than one external rating available**

*Should there not be a public rating available, Scope will assess the exposure, supported by sensitivity analysis, or may choose not to rate the transaction.

**Scope may choose not to rate the transaction or constrain the instrument rating if there is only one public rating for an involved insurance company available.

In the context of this second case, Scope will provide in its rating communication sensitivity analysis to indicate the benefit that an instrument receives from the insurance protection.

2.4. Legal risks and tax aspects review

Scope examines the structure's legal integrity to identify any legal issues or weaknesses that could affect transaction performance, for example, taxes on collateral affecting cash flows. A key element affecting structural integrity is how likely the issuer could default for reasons not related to collateral or counterparty risks. Even if the collateral and counterparties are performing well, an issuer's default may lead to collateral liquidation and expose the instrument to market value losses.

The analysis of how legal aspects affect credit risk considers the transaction structure and incentive mechanisms, among others. Scope's credit view depends on the associated credit risk and the applicability of legal principles as described below and in Appendix VI. The latter results in adjustments to Scope's analytical assumptions. For instance, legal aspects determine the mechanisms and features that Scope can give credit to when analysing available sources of credit enhancement in a transaction.

Scope generally assesses risks related to unclear or imprecise definitions in the legal documents, for example, on key transaction mechanisms defining transaction default and termination events.

Scope considers third-party expert opinions on tax and legal analysis. Typically, Scope examines whether these opinions confirm:

- the SPV capacity and authorisation;
- that all transaction documents constitute valid, legally binding and enforceable obligations of the parties;
- the effectiveness of the true-sale (unless there is a synthetic credit risk transfer);
- the effectiveness of SPV bankruptcy-remoteness elements; and
- the taxation of underlying assets, transaction documents and the SPV.

Legal opinions may merely contain assumptions and qualifications. If any of these cast doubt on the opinion, Scope will discuss the implications with the transaction's counsel and arrange to better gauge the impact on the structure's robustness.

For cash transactions, Scope assesses the legal robustness of the true sale to evaluate the risk of collateral claw-back and consolidation on the seller's balance sheet, should the seller default shortly after the collateral's sale. Scope may also examine whether, upon default of the originator, securitised assets could become subject to set-off claims from the obligors (set-off risk). For example, if the obligor holds a cash deposit account with the originator, the obligor may be able to set off a part or the whole outstanding debt against the deposit amount, generating a loss for the transaction.

The risk of an issuer's bankruptcy cannot be fully eliminated. However, the issuer can be protected through standard securitisation features specific to the issuer's nature, activities, and relationships with transaction parties. Scope evaluates the strength of protective elements, which include the issuer's legal nature, restrictions on its activity, its ownership structure and its limited liabilities. Scope also reviews the limited-recourse and non-petition provisions in transaction contracts aimed at preventing other contractual parties from causing the issuer's default.

3. Complementary analysis

3.1. Implementation of ESG factors in our analysis

Scope adheres to the principles for responsible investment (UNPRI), which considers the impact of environmental, social and governance factors on credit risk and our credit analysis. We incorporate significant aspects that can influence the expected financial loss over an instrument's expected life regardless of whether they can be classified as ESG risks or not. If ESG considerations are relevant to certain areas affecting credit risk, those are reflected in our structured finance ratings.

Given that structured finance issuers generally hold a pool of financial assets like, loans, bonds, leases or other receivables, which generate cash flows over time we assess how ESG factors may affect those cash flows, over the term of the rated instrument.

With respect to ESG factors, we consider both how regulation and self-imposed ESG targeted actions can impact the future cash flows. We also analyse how the cash flow of the assets, including the assets long term sustainable value securing claims, can be affected by ESG considerations, when supported by historical data¹⁴, which for the time being is often not the case. For a pool of diversified assets, the direct impact is more muted than for concentrated pools, due to off-setting and diluting effects.

Where we believe that ESG related risks materially increase the uncertainty about future cash flows but where we do not have enough information to project the impact on the cash flows, we may incorporate the ESG risks through a qualitative adjustment.

¹⁴ There is only limited historical data available from which the ESG impact on cash-flows and collateral values can be inferred.

Also, ESG factors may impact the credit risk profile of structured finance transactions indirectly. They feed into our analysis through ESG aspects already incorporated in corporate or bank ratings on specific issuers, either included in a securitisation; or counterparties of the transactions such as account banks or portfolio servicers.

3.1.1. Environmental risks

Scope integrates acute environmental risk when the transaction is directly exposed to natural disasters or other environmental aspects and there is no hedge in the form of an appropriate insurance or cost coverage in place.

To also integrate the long-term emergence of chronic environmental risks, we may conduct sensitivity analysis, for example investigating the impact of certain climate change scenarios.

3.1.2. Social risks

Structured-finance transactions are exposed to very specific social risks, which may deviate from our usual definition of social risks for corporates or sovereigns, due to their nature. Existing frameworks from the sovereign or corporate world are not directly adaptable to structured-finance transactions, due either to the long-term nature of the factor, i.e. demography, or the nature of the issuer, a special purpose vehicle with no customers or employees. Nonetheless, we have seen occurrences of social risk in structured-finance transactions via laws and regulation risks, like property squats in Spain, the introduction of new debt-like products in securitised pools, or the introduction of debt moratoria across Europe. Additionally, social risks stemming from the key transaction parties, i.e. the originator, servicer, or asset manager are factored in our counterparty risk analysis. Finally household resilience is captured either explicitly or implicitly in our rating methodologies.

3.1.3. Governance risks

Governance is core to our analysis of structured-finance transactions. Although not described as an explicit rating factor in our methodology, our ratings systematically reflect those risks through: i) our assessment of the legal structure, using concepts linked to the notion of simple, transparent and standardised (STS) transactions or just reflected by the structural governance, the legal construct used to implement the securitisation; ii) the counterparty governance, i.e. the quality of the transaction parties, including their own operational due diligence; and iii) the qualitative governance aspects, which consider the alignment of interest of the involved parties. Incorporating weak governance into our analysis can be quantitatively and qualitatively through key rating drivers or corresponding adjustments to supplementary rating drivers, or may lead to a rating process conclusion without assigning a rating.

Structural governance is our assessment of the legal structure of the transaction as per Appendix VI Legal considerations in structured finance. We review the transaction documentation and raise any concerns regarding the structure, execution, and enforcement of the security as well as any anomalies in the waterfall. Concerns are included in our publications and comparisons are made with established standards.

Counterparty governance is our assessment of the quality of the transaction involved parties. It is described in the relevant methodologies with our different areas of focus and examples of the elements used in our analysis. This includes, inter alia, the quality of origination, strength of lending standards and due-diligence processes.

Qualitative governance aspects relate to the purpose of the transaction and the existing (or absence thereof) alignment of interest between investors and different parties to the transaction. This is discussed during the rating process and embedded into our opinion.

3.1.4. ESG disclosures

Scope will disclose relevant ESG factors in its publications to the extent they are drivers of rated instrument risks and outline how those were taken into account in the analysis. The absence of such disclosure should therefore be read as ESG considerations were not a relevant driver of transaction risks.

3.2. Data adequacy, data guidelines and portfolio data template

Scope can work with data in any proprietary template because originators and asset managers already produce many valuable metrics for the analysis of credit risk for the respective assets. Besides this, we will review the available material with the aim of identifying information gaps and highlight these elements.

For further information regarding data requirements, please consult the asset-class-specific methodologies.

3.3. Sensitivity analysis

Scope supplements the quantitative analysis and model input calibration by testing the sensitivity of the results. This includes selecting the main variables that drive an instrument's credit profile and assessing which assumptions on these variables would change the instrument's rating. The rating committee decides whether such potentially stressed assumptions correspond to a scenario whose likelihood is consistent with the rating. Scope may also test whether different stress levels in the collateral pool might shift the rated instrument from investment grade to non-investment grade, or vice versa.

Scope tests the sensitivity of the rated instrument to credit estimates, fallback credit quality assumptions or similar assessments by Scope or its affiliates (collectively credit estimates) that apply to portfolio exposures, see Figure 3, and unrated risk presenters, see Figure 4. Credit estimates are typically i) point-in-time and in some instance periodically updated but not on an ongoing basis, ii) are not derived from a rating methodology and iii) rely of less information than ratings. Scope checks the sensitivity of the quantitative results for the rated instruments to:

- 1) A joint default scenario of the two largest direct or indirect exposures¹⁵ to which credit estimates, standard assumptions or similar assessments apply; and
- 2) A joint default scenario for all indirect exposures¹⁶ above 10% to which a credit quality assumption above BB-, derived from a credit estimate or similar assessment, applies.

Scope will disclose these two sensitivities in the respective rating report.

3.4. Monitoring

The monitoring process of the rated instrument starts immediately after the rating is assigned. Scope continuously monitors the credit risk and performance of collateral, as well as of key transaction counterparties. Scope may adjust the rating if the instrument's performance materially differs from initial expectations.

Scope typically monitors structured finance transactions based on performance reports produced by the servicer, the management company, the collateral agent, or trustee in the transaction, as well as on information from the originator or other transaction key agents. If the information provided by issuer or its agent is of insufficient quality, or inappropriately delayed, Scope may have to consider the impact on the ratings and may even withdraw the rating.

The ratings are monitored continuously through high-level checks and reviewed in detail at least once a year, or earlier if warranted by events.

Since Scope's ratings aim to provide a long-term view based on the rated instrument's maturity, a temporary dip in performance is not necessarily a reason to downgrade the rating. Similarly, Scope may only adjust the rating if underperformance or outperformance occurs over a sufficiently long period. Scope aims to avoid rating pro-cyclically and, where possible, seeks to anticipate the effect of cyclical trends on structured finance asset classes. This translates into ratings that are forward-looking rather than reactive. Therefore, any change in outlook for the collateral's credit cycle may be considered when re-assessing its credit quality.

¹⁵ If exposures are of equal size, the one with the better credit quality will be considered for the sensitivity analysis, i.e. the increase in expected loss would be higher.

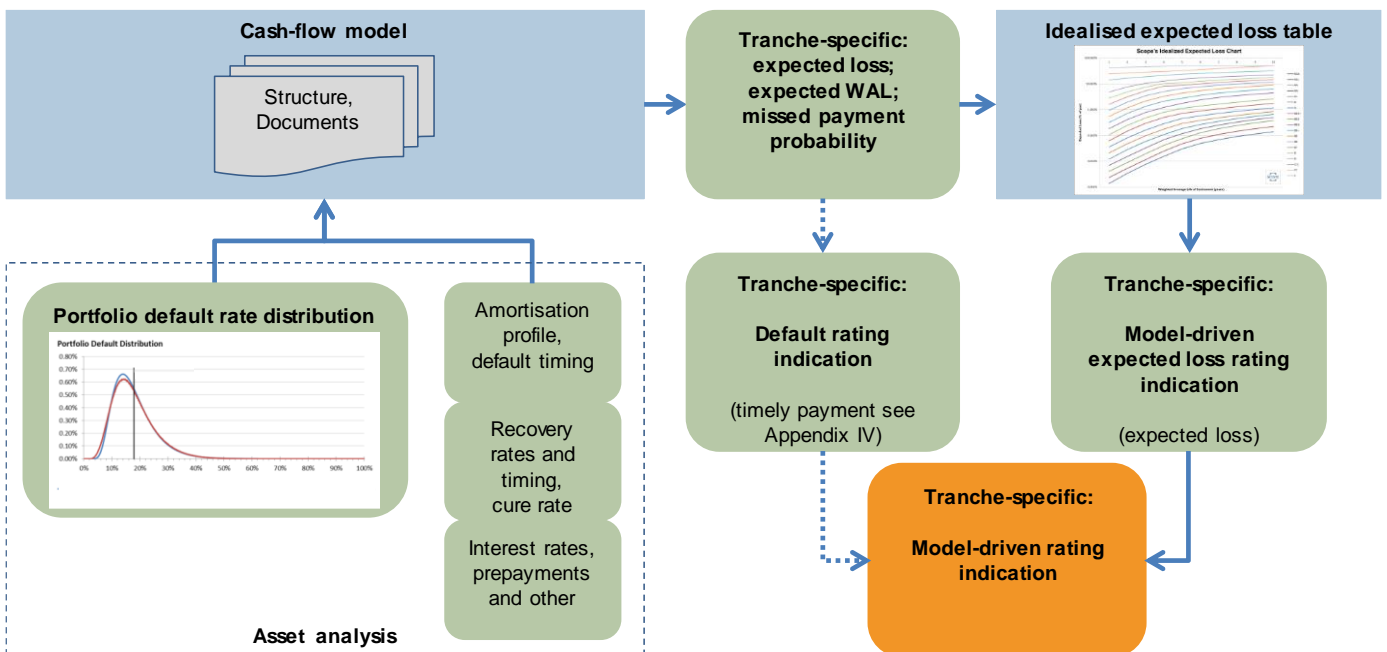
¹⁶ See section 2.1.4.

Appendix I Technical note on the expected loss framework

Scope estimates the probability-weighted average loss, e.g. the expected loss, and the probability-weighted average life (WAL), i.e. the *expected* WAL, for each rated tranche. The rated structure is tested for every possible portfolio default rate from 0% (no defaults) to 100% (the entire portfolio defaults), incorporating rating-conditional recovery rate assumptions and multiple prepayment assumptions. Scope associates the rating-conditional expected loss and expected WAL calculated for a given tranche to Scope's idealised expected loss table to indicate the rating for a given instrument.

The probability of each possible default rate is taken either from an idealised distribution such as the inverse Gaussian distribution, or from the probability distribution produced by a Monte Carlo simulation. Losses in the structure result from portfolio losses following the application of rating-specific recovery assumptions and from costs of carry. The portfolio default probabilities are used to weight the losses obtained for each rated tranche under every default rate scenario. This is shown in expression (1).

Figure 5. Diagram of the structure analysis and cash flow model implementing the expected loss framework



The loss of a tranche under a given default rate scenario i , LR_i , is the difference between the par value of the tranche and the present value of all principal and interest cash flows for the investor, discounted at the promised rate of the tranche, as shown in expressions (2) and (3).

Similarly, the portfolio default probabilities are used to weight the different WALs, resulting in a cash flow model for each rated tranche under every default rate scenario from 0% to 100%. This is shown in expression (4). For consistency, the WAL of a given default rate scenario i is derived by considering all principal and interest cash flows for the investor, see expression (5).

$$(1) EL = \sum_{i=1}^N \text{prob}\{\text{scenario}_i\} \times LR_i$$

$$(2) LR_i = \frac{\text{par} - \sum_{t=1}^N PV_{\text{@promised rate}}^i}{\text{par}}$$

$$(3) CF_t^i = \text{Principal } CF_t^i + \text{Interest } CF_t^i$$

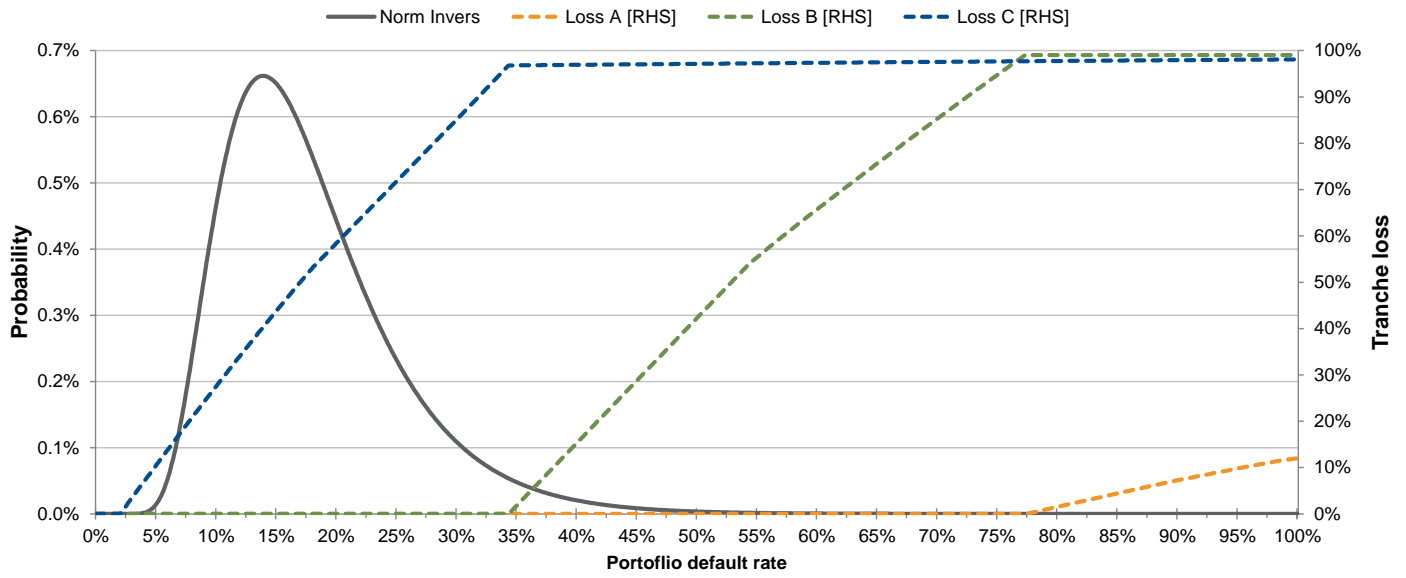
$$(4) \text{Expected}\{WAL\} = \sum_{i=1}^N \text{prob}\{\text{scenario}_i\} \times WAL_i$$

$$(5) WAL_i = \frac{\sum_{t=1}^T t \times CF_t^i}{\sum_{t=1}^T CF_t^i} \quad (17)$$

¹⁷ Our calculations consider $WAL_i = 0$, if there is no cash-flow in scenario i .

Figure 6 illustrates the losses on each level of a three-tranche structure for each portfolio default rate. The loss rates are expressed as a percentage of the tranche notional at closing. In this example, it is notable how class C benefits from excess spread that is not trapped by the transaction until the first assets are classified as defaulted. This together with a different discount factor allows class C's maximum losses to be lower than the maximum possible for class B. The probability-weighted loss for class B would, however, be smaller than that of class C.

Figure 6. Sample portfolio distribution and corresponding losses in a three-tranche structure



Appendix II Technical note on Scope's cash flow model (Scope CFM) implementing the expected loss framework

Scope CFM implements the calculation of expected loss as described in Figure 5. The expected loss is determined via a numerical integration of the losses under different default rate scenarios, weighted with their respective probability. The algorithm naturally separates into a cash-generating and a cash-consuming part – each will be described below. Losses on the tranches manifest when the projected discounted cash flows are less than the initially invested amount.

Asset treatment (cash generation)

The model assumes perfect granularity and homogeneity of the asset pool. The assets generate future cash flows according to assumptions for interest and amortisation payments as well as for prepayments, defaults, recoveries, asset cures and other market parameters, such as foreign exchange and interest rates. Asset assumptions are specific to the analysed transaction and recorded as vectors.

In the simulation, assets are considered either performing, delinquent or defaulted. Performing assets pay interest and amortise according to a specified schedule. Defaulted assets are excluded from the asset balance and the assumed recovery will be distributed over time according to a defined recovery schedule. Assets normally do not change directly from performing status to default but rather undergo a period of delinquency. Delinquent assets can fully or partially cure before defaulting. Scope generally assumes a level of liquidity stress by considering that a certain percentage of assets may become delinquent and cure, i.e. becomes performing again and pays missed payments after a moratorium period, before default.

The performing asset balance in each period undergoes the following sequence

1. Add back cures to the opening performing asset balance
2. Subtract new delinquent loans to the opening performing asset balance
3. Calculate interest over the period based on the resulting performing asset balance (steps 1 and 2)
4. Subtract prepayments over the period
5. Subtract amortisation over the period

The generated cash is passed to the securities according to the main interest and principal priority-of-payment features defined in the transaction structure.

By default, each period corresponds to a calendar month except if the transaction's time-related characteristics need adjustment.

Liability treatment (cash consumption)

Scope's cash flow model has a very flexible description of the priorities of payment for the different transaction structures. The model features a set of accounts that keeps track of outstanding liabilities and received or paid cash amounts.

Appendix III Technical note on Scope's portfolio model (Scope PM)

Scope PM implements a numerical procedure to estimate the default and expected loss metrics of an amortising pool of assets. The approach is based on a Monte Carlo simulation, which randomly determines whether the assets of the pool have defaulted and the time of its occurrence. Multiple iterations of the simulation generate statistics which are used to estimate the pool's default characteristics. Asset default is determined by applying a Merton model, which compares a random asset value against a defined threshold value. If a default happens, the corresponding default time is determined along with the outstanding balance at that time, as defined by the asset's amortisation profile. This information is used to ascertain the aggregate default rate at the end of each iteration, calculated as the total balance of defaulted assets divided by the total initial balance. The default frequency is determined as the number of defaulted assets divided by the total number of assets. The statistics of such values over all iterations constitutes the final portfolio default rate and frequency curves.

The asset's threshold value is implied by the asset's default risk and its risk horizon. The random asset value is driven by the combination of a set of market risk factors and an idiosyncratic component for each asset. The common market risk factors create a default dependency framework. Typically, the different factors reflect the key dependency factors of the respective asset, for instance, their geographic location, industry or other relevant elements. In most cases, asset values will also depend on a global factor that reflects macroeconomic influences. The weights assigned to these factors are voted on by a rating committee, which considers the transaction characteristics and the public benchmark's sensitivity to weights of those factors.

In mathematical terms, Scope constructs the Gaussian random variable Z_j , as a linear combination of standard independent Gaussian random variables $z_1, \dots, z_n; z_j z_1, \dots, z_n; z_j^{id}$:

$$Z_j = \sum_{i=1}^n \beta_i \cdot z_i + \beta_j^{id} z_j^{id},$$

where the sum of weights $\sum \beta_i$ is less than one and the idiosyncratic factor weight is calculated as $\beta_j^{id} = \sqrt{1 - \sum \beta_i^2}$

$\beta_j = \sqrt{1 - \sum \beta_i^2}$ to make the Z_j standard Gaussian.

The model can also generate loss statistics when used with asset-per-asset recovery rate assumptions. Additionally, the model reports default timing profiles, which can be constructed for the entire pool and in dependency of default quantiles. This allows a detailed look into the conditional default term structure.

Appendix IV Technical note on timely payment

The rating assigned to a structured finance tranche may be lower than the rating derived from its expected loss and expected WAL if the probability of missing at least one payment, which is due and payable, is high relative to the expected loss. Consequently, Scope complements the analysis by assessing the instrument's probability of default.

The expected loss framework does not always sufficiently differentiate between the credit qualities of timely-payment and ultimate-payment instruments as the time value of coupon deferral is generally negligible, depending on the size of a tranche. As further explained below, Scope can analyse both timely-payment and ultimate-payment structures in the quantitative analysis. Most structured finance ratings consider a timely-payment structure for the most senior outstanding note, but Scope can also assign ultimate-payment ratings in case both the terms and conditions of the notes allow for that and it is not uncommon in the relevant market or asset class. Scope's rating communication will detail if a rating reflects ultimate payment.

Additionally, Scope believes the probability of missed payments should be remote for instruments rated AAA_{sf} and AA_{sf}, irrespective of their terms and conditions, given that investors in highly rated securities expect strong certainty on timely payment, regardless of how small a time-value loss is.

As part of the general analysis, Scope computes the probability of missing at least one payment under all possible default scenarios for the underlying exposures (0% to 100%), which is then compared to the cumulative default probabilities implicit in Scope's idealised expected loss table. When assigning a final rating, Scope applies a degree of tolerance in line with the relationship between the long- and short-term rating scales as published in its [Rating Definitions](#). For example, a tiny number of missed payments in the tail of a tranche's life may be acceptable, particularly if they result from technical defaults captured in the quantitative analysis. We apply analytical metrics to investigate i) the time period for which a due amount remained unpaid and ii) whether a due amount was ultimately paid and what is the difference between the probability of default under timely-payment considerations versus the probability of ultimate payment failure.

Depending on the respective instrument target rating level, we deem the following levels acceptable:

Instrument target rating level	Acceptable notch difference probability of default and expected loss model result
AAA	4 notches
AA- to AA+	5 notches*
BBB- to A+	6 notches*

*(particularly when it is a tiny number of missed payments, as evidenced by additional analytical metrics)

When the model results indicate a probability of default which is important, i.e. commensurate with the default probabilities implicit in ratings below the B category according to our idealised expected loss table, then we generally restrict the notch difference to maximum five notches. The high end only applies when the model results for the probability of default are close to, albeit below, the B category in the idealised default probability table.

In addition, Scope is particularly observant when there is an important risk that there could be a default or default like event, as further defined in the Rating Definitions, within the next year to year and a half. The quantification of the degree of risk can either be the function of i) a quantitative output which shows a high probability of default for a significant amount in relation to the total transaction amount or ii) through a qualitative assessment of such a probability, for example reflecting our view on current refinancing conditions. In such cases the notch difference is normally not higher than 4 notches and the level depends on the quantity and certainty of the recoveries as further described in the Rating Definitions.

Appendix V Technical note on general asset recovery analysis

Scope determines portfolio recovery rates using two different approaches, which can effectively coexist: i) a statistical analysis of recovery performance, for example vintage analysis, when available data is adequate and the securitised pool is highly granular – applicable to secured and unsecured exposures; or ii) fundamental analysis – generally only applicable to secured exposures.

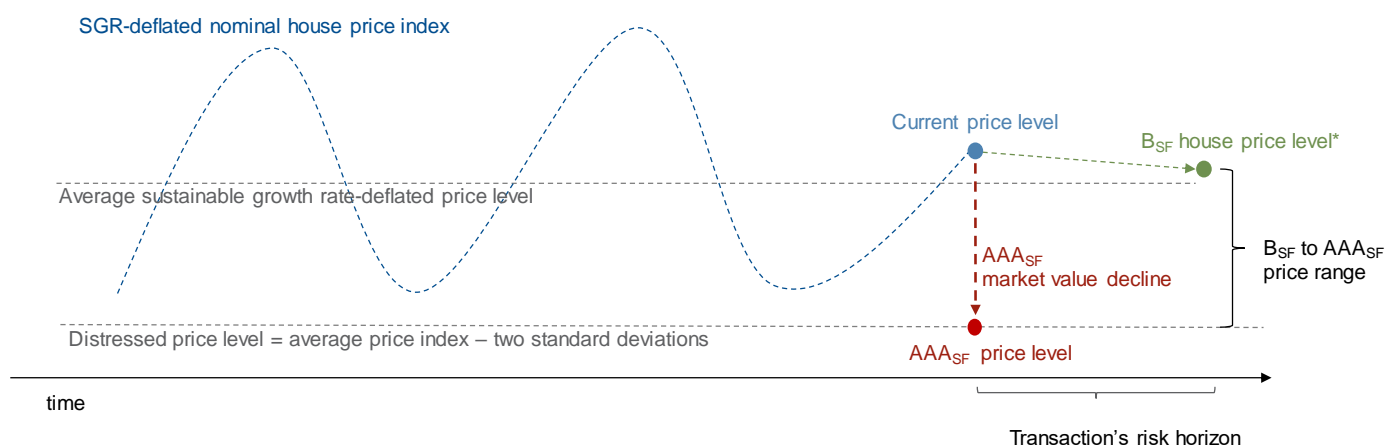
Scope applies a fundamental analysis for secured exposures in non-granular portfolios and complements the statistical analysis with the fundamental approach for highly granular portfolios of secured exposures. The fundamental approach relies on analysing asset price movements and asset liquidity. This approach is most appropriate when data limitations prevent a statistical analysis. The security value is the stressed value of the underlying asset.

Scope relies on fundamental recovery analysis when the security provides first-lien claims on the underlying asset, for instance, a security on real estate that the agency believes cannot be challenged as it is supported by a legal opinion. This also applies to non-first-lien claims if Scope has clear evidence about prior ranking claims.

While real estate security represents most of the analysed cases, Scope may also give credit to other forms such as pledges on cash accounts and real or financial assets so long as enforceability cannot be legally contested, and market value and liquidity risks can be estimated.

The fundamental recovery analysis considers the distance to a long-run or sustainable price for the underlying asset as well as fire-sale discounts, for instance, during a property foreclosure. Consequently, the market-value-decline assumptions that Scope considers may depend on market conditions or other factors relevant to the asset value.

Figure 7. Market-value-decline analysis



* In this example, Scope assumes that property prices will not fully revert to average prices, as market conditions over the transaction's risk horizon are expected to be supportive of nominal real estate prices (for instance, due to expansive credit conditions or positive market sentiment).

Scope's framework for the fundamental recovery analysis involves: i) estimating the asset's current value, typically by indexation; ii) estimating the distance from the estimated asset price to the long-term sustainable values; iii) applying a haircut to the asset's current value via a rating-conditional market value decline; iv) considering a fire-sale discount; and v) deducting costs from the estimated gross recovery proceeds. Steps ii) and iii) are embedded in the total market-value-decline assumptions as highlighted in Figure 7. Alternatively, a stochastic analysis may address specific risks, e.g. concentration, or low liquidity. When permitted by data, Scope may also consider a distribution of security value to capture market value and liquidity risks.

The AAA_{SF} market-value decline captures the distance between current and historical average prices deflated for the sustainable growth rate of nominal prices plus an additional stress to capture historical price volatility. This stress is typically sized at two standard deviations from the average historical price. Scope may apply higher stresses to capture negative collateral selection, which is typically performed for very seasoned NPL portfolios. Scope may also apply a market-value-decline floor or a recovery rate cap to address data limitations like non-stationary or too short historical time series.

The B_{SF} market-value decline captures the distance between current and historical average sustainable-growth-rate (SGR)-adjusted prices and factors in current market conditions, e.g. credit expansion or credit contraction. It allows for the possibility of

reversion to mean prices over the transaction's risk horizon, including upward adjustments, in case current prices are below our assumption for the mean price. As a result, a B_{SF} market-value decline may not necessarily reflect the distance between the current price and historical average.

Scope derives market-value-decline assumptions for intermediate rating categories by interpolating B_{SF} and AAA_{SF} market-value-decline assumptions.

Real estate property appraisal analysis

Scope assesses the quality of property appraisals considering i) the transparency of the appraisal process; ii) the quality of the valuation techniques applied; iii) the age of the appraisals; and iv) the appraiser's incentive to conduct unbiased valuations.

Scope generally relies on the latest appraisals from independent third parties to estimate current property values. However, property appraisals connected with secured NPL securitisations may require extra attention due to i) outdated valuations; ii) simplified valuation procedures, e.g. desktop or statistical valuations; or iii) valuation biases arising from an appraiser's lack of independence from transaction parties.

Scope captures limitations on appraisal quality through transaction-specific haircuts. In addition, seasoned valuations are updated through indexation techniques based on public or private real estate indices.

Asset liquidity

Asset liquidity is a key driver of expected recoveries and implies transaction-specific fire-sale discount assumptions.

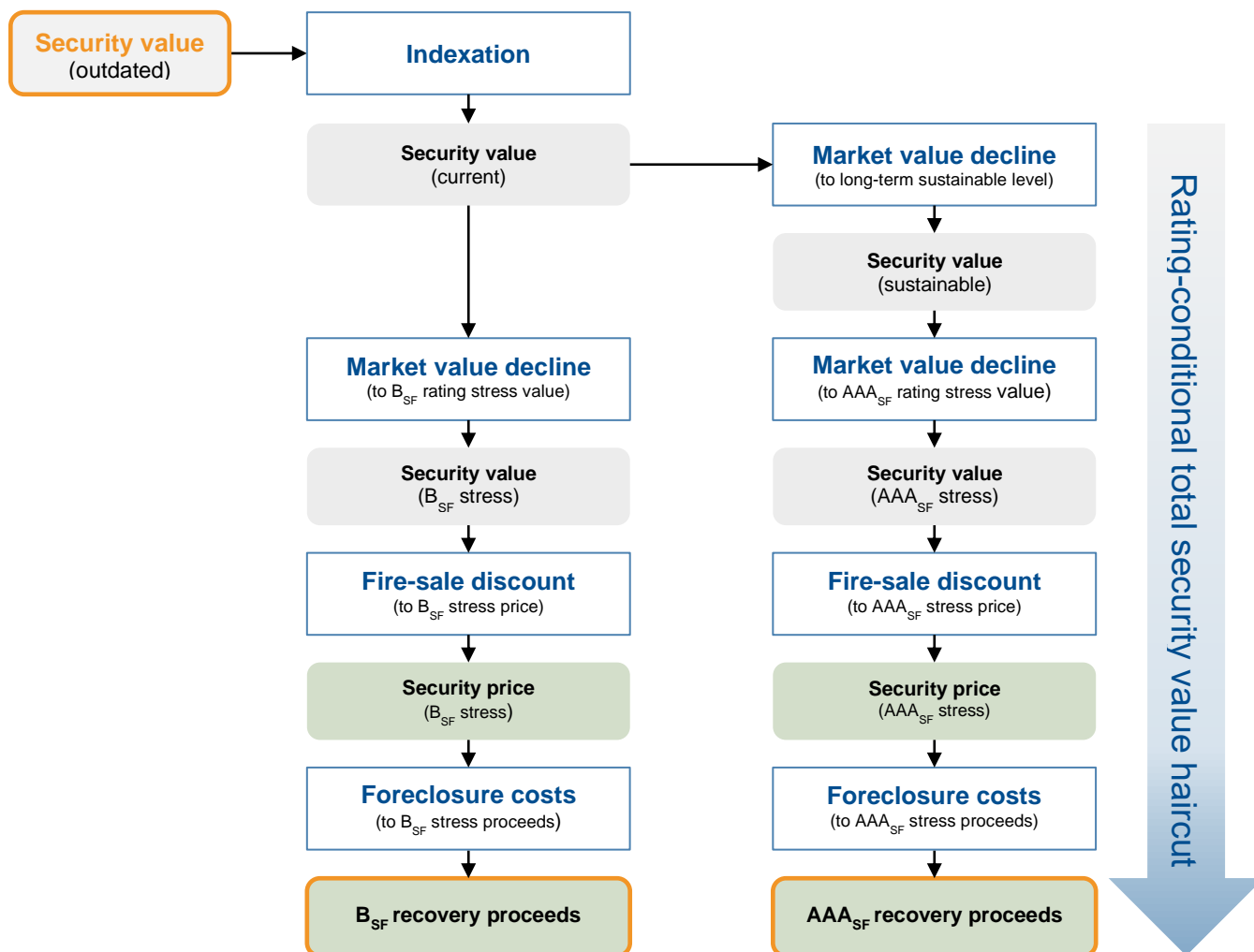
Scope's fire-sale discount assumptions are benchmarked against jurisdiction-specific historical evidence of market liquidity and may capture qualitative adjustments reflecting the nature of the collateral. e.g. residential versus non-residential. Such assumptions are typically derived on a deal-by-deal basis to account for i) servicer-specific historical evidence of appraisal values relative to the sale price; or ii) transaction-specific risks, driven by the ageing of the collateral, the workout options available to the servicer, asset marketability and quality, information asymmetries, obsolescence, among others.

Figure 8 shows the analytical framework applied to the estimation of proceeds recovered from the security's enforcement. This involves adjusting the security value to a long-term sustainable value in order to estimate proceeds under the highest rating stress.

Servicer adjustment

The servicer's methods can impact the recovery significantly both in terms of timing and the actual recovery rate. Scope's recovery analysis therefore also considers the servicer's ability by adjusting the expected recovery rates upwards or downwards and by reducing or prolonging the expected time for recoveries.

Figure 8. Diagram of fundamental recovery analysis for BSF- and AAASF-conditional stress levels



Appendix VI Legal considerations in structured finance

Asset analysis

The quality of underlying assets and the SPV's legal recourse to asset proceeds are essential to all structured finance and asset-based finance transactions.

Enforceable assets

To determine if the assets produce cash flows that can cover the SPV's liabilities, Scope assesses whether payments owed to the SPV are valid and enforceable at the amount required.

Applicable laws can challenge the existence and enforceability of claims and obligations stemming from assets. These laws may prohibit certain transactions, e.g. usury, fraudulent dealings, or collusion; may grant counterparties extraordinary termination rights (consumer protection), or may stipulate formal prerequisites, e.g. filings, or notarisation. Scope assumes the validity and enforceability of obligations and typically confirms this via a third-party legal opinion. When the transaction allows the purchase or substitution of assets at a later stage, the originator or collateral manager will generally explicitly represent any factual elements necessary for obligations to be existing and enforceable. Especially when the SPV's asset base consists of a pool of assets, the analysis may focus on whether a transaction party, i.e. the originator or the collateral manager, is contractually obliged and capable of validating the assets' existence and enforceability.

Even if payment obligations were originated in a valid and enforceable fashion, a creditor may be unable to fully benefit from them. Scope always considers any right of the obligor to refuse full payment due to statutory defences, or any contractual changes to payment obligations. In this context, set-off, dilution and encumbrances may negatively impact the ratings.

i) Set-off

Set-off may be invoked by a debtor that holds a monetary cross-claim against a creditor. In this case, the debtor could be released from honouring the creditor's claim up to the amount of the cross-claim. Depending on the jurisdiction, set-off rights may be a statutory defence, contractually agreed and in some instances may be contractually waived. Set-off risk can arise in consumer credit or SME loan securitisations if the securitised loans' originator holds debtor's' deposits or equivalent.

If set-off is successfully exercised by a debtor, the value of the securitised assets may be substantially reduced or cancelled, impacting the SPV's income. Where such cross-claims exist or are likely, Scope examines whether documents on the assets contain waivers of set-off rights and whether these are valid under the relevant jurisdiction¹⁸. If such waivers were not agreed on or are not recognised by the applicable jurisdiction, Scope assesses whether any structural features can mitigate the negative impact of set-off, such as a dedicated reserve. If the originator undertakes to indemnify the SPV to cover the risk, Scope considers whether this could affect the true sale of the assets (see below). Scope also evaluates whether the borrower has been notified of the transfer, as this can limit the potential set-off.

Set-off may also create challenges for the structure if exercised by transaction parties such as the servicer, cash manager or account bank. In most structures, transaction parties contractually waive their right to set off any amounts against their obligations with the SPV.

ii) Dilution

Dilution may affect a transaction's cash flow. For example, in a trade receivables securitisation, dilution gives debtors the opportunity to pay less for an underlying contract than the face value at which it was sold. Dilution may occur for several reasons based on different legal concepts such as contractual arrangements (fast pay or volume rebates), discounts, credit notes, and statutory withholding rights like price reductions due to defects in the deliverable goods or the services rendered.

Dilution reduces cash flow from an asset. Scope assesses this risk by considering documents governing the asset, the obligor's representations, contractual safeguards, and legal opinions. Where the risk of dilution cannot be excluded but is adequately quantified, Scope's assessment may rely on appropriate mitigants like dilution reserves.

¹⁸ In some jurisdictions, the amount that the debtor is entitled to set off against the issuer crystallises at the date of the receivable assignment's notification. As a result, if such a notification is performed at closing, the amount at risk can be quantified and decreases over time as the portfolio amortises.

iii) Encumbrances

Other impediments include encumbrances of rights to the assets, i.e. if any rights have been pledged, charged or are subject to a security interest for the benefit of a third party. This third party may be entitled to enforce its rights on the asset if the requirements have been fulfilled. Where such encumbrances must be made public to be valid, e.g. German mortgages must be recorded in a register, Scope assesses whether the public records have been checked by the transaction counsel. If there are no requirements for publication, Scope may rely on appropriate representations.

Legal benefit of the assets

Following the acquisition of the receivables for the securitised portfolio, the issuer should be legally entitled to receive cash flows generated by these assets.

In any cash securitisation, Scope takes a two-step approach to analyse the asset transfer, examining the actual transfer and the true-sale requirement. The transfer of asset property does not apply to synthetic transactions. For this type of transaction, Scope's legal analysis focuses on the valid, legally binding and enforceable nature of payment obligations on the party transferring the risks to the SPV. This aims to determine whether the issuer will benefit from cash flows arising from the synthetic exposure to the asset.

i) Transfer

The actual transfer of the asset must be legally valid, binding and enforceable for the issuer to benefit from cash flows generated by the asset.

a) Transferability

The asset's transferability may be restricted by law or by contract. For instance, a bank loan's terms can limit transferability in terms of minimum amounts, number of transfers and qualifying transferees. The latter can pose a challenge for a valid transfer to the SPV if only financial institutions qualify as transferees under the loan contract. In this regard, Scope typically relies on the originator's representations and on legal opinions. In managed or revolving structures, Scope examines the undertakings of agents selecting the assets to be purchased during the life of the transaction. For instance, the collateral manager of an actively managed transaction may only purchase assets after verifying transfer restrictions, and Scope would typically assess whether the manager has the skills to comply with his obligation.

b) Perfection of transfer

Formal requirements must be met to perfect a transfer of securitised assets. If the legal opinion does not address this issue, Scope assesses whether relevant documentary proof is adequate, e.g. registry excerpts, or capital account statements. Transactions such as trade receivables securitisations may be structured so that the originator is not required to notify debtors of the asset transfer. This is typically the case when the seller, due to commercial reasons, does not want debtors to be informed about the sale of the receivables. Depending on the jurisdiction and transfer type, notification may be unnecessary for a transfer to be valid.

ii) True sale

In structured finance the term 'true sale' stems from the early days of US securitisation transactions, describing one characteristic of the transfer: its indefeasibility in an insolvency of the seller (normally the originator) of the assets. If the transfer of the assets to the issuer is a true sale, the ownership of the assets cannot be challenged by any creditor of the seller or by its insolvency administrator (or equivalent). The effectiveness of a true sale can be called into question depending on the jurisdiction governing the transfer and the applicable insolvency regime. The two major challenges to a true sale, which have been the subject of numerous court cases and academic discussions, are claw-back and re-characterisation.

a) Claw-back

Most jurisdictions provide for claw-back mechanisms to protect the creditors of an insolvent entity that has transferred assets or has otherwise diminished the value of its asset base, not only during but also prior to insolvency. In such cases, the transfer may be rescinded so that the transferred asset is 'clawed back' for the benefit of creditors by the insolvency administrator into the insolvency estate of the insolvent transferor. Such claw-backs can occur in the event of fraud but also when a transfer detrimental to the obligor's creditors falls within a certain observation period prior to insolvency. Scope's analysis considers the transaction's nature and the transferor's financial situation. Since Scope is generally not in a position to assess whether the transaction was effected at arm's length, Scope typically relies on corresponding representations from the parties. The transferor's financial situation

and credit risk will also be considered. A strong true-sale opinion will typically cover, amongst other insolvency searches, a check of applicable registers for filings of insolvency proceedings with respect to the transferor. Since not all stages of a company staggering towards insolvency are subject to a public filing, Scope looks for standard representations on the seller's solvency.

b) Re-characterisation

The second major challenge to a true sale is the re-characterisation of the asset transfer into a security over the asset. Should the seller become insolvent, the SPV would cease to be the asset's legal owner but would have a monetary claim secured by the asset against the seller. This jeopardises the timely payment of cash flows due to the delay caused by enforcing the security interest. When assessing the legal nature of the asset transfer and determining whether it might be re-characterised as a secured claim, the courts may consider the conduct of the transferor and transferee, how the assets are controlled and serviced, the ownership of the economic benefit, or the distribution of loss associated with the asset. The validity of a true sale could be challenged when the originator covers certain risks related to the assets.

A legal opinion confirming the perfection of the true sale (true-sale opinion) is necessary due to the diversity of aspects which can call a true sale into doubt, along with the differences in how jurisdictions recognise a true sale. The scope of the legal opinion may be reduced when the relevant jurisdiction has securitisation laws or insolvency regimes that facilitate or establish a true sale by law.

The issuer and the SPV

The issuing SPV constitutes one of the defining features of any structured finance transaction. This vehicle de-links the underlying assets from the originator's credit risk, enabling the structure to rely solely on the credit risks stemming from the assets. The issuer must fulfil several restrictive criteria to ensure payments from the assets are neither interrupted nor negatively affected during the life of the transaction. These criteria can be grouped into the SPV's two main goals: bankruptcy remoteness and non-consolidation. The first should prevent the SPV from entering insolvency proceedings, while the second should prevent the assets of the SPV from being affected by the insolvency of its parent or other related company.

Bankruptcy remoteness and non-consolidation are targeted through different types of corporate entities like SPVs, depending on the jurisdiction under which they are set up. To facilitate structured finance transactions, some jurisdictions have issued specific securitisation laws providing for the incorporation of bankruptcy- and consolidation-remote SPVs. A corporate entity not benefiting from this kind of statutory backup could still be structured to meet requirements. Structured finance transactions often rely on orphan SPVs and/or on jurisdictions that provide appropriate securitisation laws to ensure bankruptcy remoteness and non-consolidation.

Bankruptcy remoteness

SPVs are set up as bankruptcy-remote vehicles to reduce the risk of insolvency proceedings being initiated against the SPV. This feature is particularly important given the detrimental effect an insolvency can have on a transaction. First, the payment of interest and principal to investors may be halted in an insolvency scenario to protect other creditors. Second, a default resulting from such a shortfall may enable investors to enforce the security interest over the assets, which could result in fire sales. Finally, an insolvency is likely to trigger the termination of services and contracts entered into by the SPV that are vital for the transaction.

The different structural elements resulting in bankruptcy remoteness can be separated into restrictions that have been contractually agreed by transaction parties or that limit the number of potential claimants against the SPV. These elements apply cumulatively to the structure.

i) Issuer events of default

Even though SPV's are set up as bankruptcy remote entities, there are certain defined events that trigger a default and start the contractually outlined enforcement process. These events usually relate to: i) non-payment, in particular non-payment of due claims under the most senior outstanding debt instrument; ii) issuer insolvency and liquidation proceedings; iii) unlawfulness and invalidity; iv) repudiation; v) breach of material obligations; and vi) misrepresentation. We review such legal clauses and our analysis incorporates any nonmarket-standard events of default while modelling non-payment as the only event of default.

ii) Contractual restrictions

The essential contractual arrangements include limited-recourse and non-petition clauses, which generally form part of any transaction document creating potential obligations for the SPV. Their purpose is to prevent transaction parties from initiating bankruptcy proceedings against the SPV. The SPV typically grants pledges over all assets to a trustee, which reduces other creditors' incentives to file for bankruptcy, thus benefiting investors. Legal opinions will typically confirm that such contractual arrangements are valid, legally binding and enforceable.

a) Limited recourse

All creditors of the SPV (including the investors) agree to limit their recourse against the assets of the SPV. The limited recourse will typically be subject to the cash available under the waterfall of payments, complemented by a corresponding limit on termination rights. Therefore, it will not constitute an event of default if cash flows cannot cover the SPV's obligations towards creditors after the waterfall is applied.

b) Non-petition

All creditors of an SPV (including the investors) typically agree not to file, initiate or take part in insolvency proceedings against the SPV. As such, clauses can be invalid in certain jurisdictions, or the non-petition clause may sometimes be limited to a certain timeframe.

c) Asset pledges

Pledging the SPV's assets to a security trustee for the benefit of the investors provides the latter with recourse to the assets should this prove necessary to protect their investment. More importantly, it is crucial in the context of bankruptcy remoteness to dissuade other creditors from filing for bankruptcy. Ultimately, the investors will have priority over the assets' enforcement proceeds, with no significant assets to be liquidated for the benefit of other creditors to remain in the insolvent SPV's estate.

d) Debt limitation

The SPV must comply with the conditions listed below to not incur obligations other than those under the transaction's provisions. This limits the risk of a cash flow mismatch leading to an SPV's insolvency; ensures the waterfall is shielded from debt not initially anticipated in the structure; and ensures no third parties can file for the SPV's bankruptcy. These conditions are commonly made subject to representations of the SPV, which typically include, among others:

- No existing debt: the SPV has no past obligations towards third parties not set up explicitly for the rated transaction.
- Limits on debt: the SPV is prohibited from incurring debt other than that created in the transaction documents and under applicable laws, including taxes. Plans for further debt may be capped to be quantifiable for the credit risk analysis.
- Limited business purpose and powers: the SPV's constitutional documents set out a business objective and powers that are strictly limited to the issuance of the debt and the dealings necessary to set up and maintain the transaction structure.
- No employees: the SPV cannot enter into commitments regarding employment contracts, including pension liabilities.
- No subsidiaries: the SPV cannot create subsidiaries that could incur obligations for which the SPV might be liable.

Non-consolidation

Consolidation risk is the threat that the SPV and/or its assets are consolidated with (the estate of) another legal entity. This consolidation could ensue from corporate reorganisations or insolvency proceedings relating to the parent company.

i) No corporate reorganisation

To prevent a corporate reorganisation from affecting the SPV or its assets, negative covenants may prevent the SPV from entering mergers, consolidations or other forms of corporate reorganisations. These covenants normally extend to prohibiting dissolution, liquidation or asset sales, although do not strictly address consolidation risk per se.

ii) No statutory consolidation

In certain jurisdictions, insolvency proceedings may allow assets of the SPV to be consolidated with the insolvency estate of the parent company. This risk is sometimes addressed through orphan SPVs or by choosing a jurisdiction that prohibits such consolidations. If consolidation is a threat in the applicable jurisdiction, it may still be mitigated through structural elements. In this

case the transaction may typically include elaborate separateness covenants and independent management provisions, ensuring the SPV will be treated by the applicable insolvency regime as a separate entity, i.e. will not be consolidated with an insolvent parent company.

Other SPV safeguards

While Scope's legal analysis focuses on bankruptcy remoteness and non-consolidation, other contractual safeguards can be either essential or at least beneficial to the overall robustness of any structured finance transaction. These include, among others, representations regarding the fulfilment of appropriate regulatory requirements, the existence of independent management, and a restriction on changes to the constitutional documents of the SPV.

i) Necessary licenses and authorisations

The SPV must possess all the necessary licences and authorisations to ensure its business can comply with all legal obligations and regulations. Any lack thereof could result in additional liabilities through the asset transfer's validity being under threat, transaction documents being voided, or fines from supervisory authorities. The SPV documents may contain adequate representations. As a result, legal opinions may not include such qualifications.

ii) Independent management

SPVs are generally managed by a board that is independent from the SPV's parent or other transaction parties. This prevents the board from being wrongly incentivised in its management of the SPV and limits the risk of a dependent manager filing for voluntary insolvency to benefit certain transaction parties or the SPV's parent company. One independent director may suffice if, according to the SPV's constitution, that director can ensure board decisions are not influenced by transaction parties with interests contrary to the investors'.

iii) No change to constitutional documents

Scope is aware that the above-mentioned, and necessary, restrictions to the SPV could be changed by its owners, who are generally entitled by law to amend constitutional documents at their discretion. This risk can be mitigated by covenants prohibiting changes before transaction parties are notified and appropriate consents obtained, including, in certain cases, investor approval.

Taxation

Scope considers any liabilities originating from taxes that could affect cash flows and hence the instrument's rating. Potential tax liabilities are a major concern, not only because they are senior obligations by law in most jurisdictions, but also because non-payment could result in regulatory actions affecting the SPV or the structure. Tax liabilities usually rank senior to all other payment obligations in the cash flow priority of payments.

Sources of tax liabilities

Tax liabilities arise for diverse reasons and Scope groups them according to the transaction item they affect.

i) Taxes on assets

These can take the form of:

- withholding taxes on payments to be made from the assets to the SPV;
- VAT on the transfer of an underlying asset; or
- stamp duties for the perfection of the asset transfer.

ii) Taxes on the SPV

Earnings of the SPV can be taxed unless it is tax-neutral or tax-transparent. In any case, tax solely on profit would not affect the structure, i.e. earnings after deducting cash needed to service the rated debt plus senior-ranking obligations.

iii) Taxes on transaction parties' payments and withholding taxes on derivatives

Payments by third parties, credit enhancement providers or derivative counterparties could also be taxed.



General Structured Finance Rating Methodology

Structured Finance

Tax analysis

Scope generally assesses tax liabilities by relying on tax opinions. Cross-border transactions may add complexity via tax re-characterisation or secondary tax liabilities. Tax re-characterisation is relevant when a jurisdiction in which the SPV is not resident applies its tax regime to the SPV, for instance, a jurisdiction in which a company providing all essential services to the SPV is domiciled. Secondary tax liabilities can have an effect when an SPV's parent has unpaid taxes and the relevant jurisdiction requests payment from the SPV. Double-taxation treaties governing cross-border taxation, among other mitigants, can help to reduce tax risks.

Scope may not need to rely on external tax assessments to demonstrate that no tax obligations exist if the relevant transaction documents contain valid, legally binding and enforceable gross-up clauses in favour of the SPV; or if the generated cash flow is enough to settle all potential tax claims. Additionally, Scope considers whether withholding taxes could be due on derivatives and, if that is the case, whether the counterparty will gross up the payments or not.

Scope's ratings do not address the potential taxes borne by investors on their investment in the rated instrument.



General Structured Finance Rating Methodology

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