



Counterparty Risk Methodology

Structured Finance / Covered Bonds / Project Finance

10 June 2022

Contacts

David Bergman

Managing Director

+39-02-30-315-838

d.bergman@scoperatings.com

Paula Lichtensztein

Senior Consultant

+49-30-27-891-224

p.lichtensztein@scoperatings.com

Sebastian Dietzsch

Director

+49-30-27-891-252

s.dietzsch@scoperatings.com

Call for comments

Scope welcomes market participants' comments on its proposed methodology. Please send your comments by 10 July 2022 to consultation@scoperatings.com.

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1. Introduction

This document is an update of Scope Ratings' Counterparty Risk Methodology. Besides editorial changes and clarifications to improve comprehension and readability, the updated methodology includes an extension of our counterparty replacement trigger framework and a clarification regarding the loss quantification procedure for non-servicer financial counterparty exposures.

The main updates are in:

- Section 3, an extension of our counterparty replacement trigger framework, which also includes our view on the benefit of contractual collateralisation as for most derivative counterparties and the highest supported instrument rating in case of no early replacement mechanism; and in
- Appendix IV: a clarification regarding the loss quantification procedure for non-servicer financial counterparty exposures.

Existing structured finance, covered bond or project finance ratings are not expected to be impacted negatively by this update.

2. Areas of application

We apply this methodology to assess counterparty risk in structured finance transactions, covered bonds, project finance transactions, and other debt ratings that rely on structured finance techniques. The methodology applies to European securitisations and covered bonds, but may be applied selectively to non-European transactions where appropriate.

Counterparties in the context of this methodology are bank and non-bank financial institutions.

The methodology should be read in conjunction with Scope's [General Structured Finance Rating Methodology](#) and asset-specific methodologies, which can be found on <http://www.scoperatings.com>. Covered bond ratings are strongly linked to the issuer's credit quality and reflect a rating uplift determined according to the Covered Bond Rating Methodology.

3. Summary

This methodology explains our approach to analysing counterparty risks and their mitigants from a credit perspective, and their impact on the assigned ratings. Counterparties introduce financial and/or operational risk to a transaction. Non-performance or mal-performance by a counterparty on its obligations may result in liquidity risk (e.g. payment interruption) or solvency risk that may result in losses for the transaction. Our key concepts for assessing counterparty risk are:

- **Materiality of exposure.** Counterparty exposures are classified as excessive, material or immaterial. This is based on the potential impact of the materialisation of the risk according to our analysis (see Figure 1).
- **Type of exposure.** Our analysis differentiates between financial and operational risks.
- **Effectiveness of remedies.** We assess the proposed remedies in terms of their ability to mitigate or reduce a counterparty exposure in the transaction.

We analyse the nature and size of the residual counterparty risk exposure after considering the effectiveness of proposed remedies. We will consider that all money handling agents pose a material risk exposure in line with Figure 3. However, we also expect no rating impact from these exposures in case proper risk mitigation as outlined in this methodology is in place. In the absence of adequate risk mitigation or ineffective measures, we will quantify the impact on the rating by analysing both the exposure at risk and the probability that a counterparty risk materialises.

Excessive exposures will generally only occur, if a large share of the funds available to service an instrument are exposed to a single counterparty, such as the collateral account bank in a synthetic transaction. Additionally, we consider exposures excessive, if the counterparty holds the entire credit enhancement available to an instrument, such as in the case of reserves that provide the only support for junior instruments. In the absence of adequate risk mitigation or ineffective measures, the counterparty credit quality will constrain the instrument rating. We will also test for excessive counterparty exposures associated with roles that we would normally (see Figure 3) only consider material pre-remedies, if these exposures are above certain thresholds (see section 4.2). In case this analysis would qualify an exposure as excessive, remedies otherwise associated with the respective role may not be efficient to turn the exposure to immaterial and may need a quantification or even result in a link, if not addressed.

Figure 1. Counterparty risk classification and rating impact

Materiality of risk (if not mitigated)	Excessive	Material		Immaterial
Available remedies	Collateral Replacement Other			Not needed
Effectiveness of remedies	Ineffective	Partially effective	Fully effective	N/A
Materiality of remaining risk after remedies	Excessive	Sizeable	Immaterial	
Rating impact (including mitigants)	Link to Counterparty	Quantify rating impact	None	

Source: Scope Ratings

We consider risk exposures excessive if the realisation of the risk results in an instrument rating decline of more than six notches. Exposures are classified as material if the potential instrument rating decline is between one and six notches. Credit risk substitution, such as collateralisation, a guarantee, or a counterparty's replacement are a common way to isolate the transaction's credit risk from the deteriorating credit quality of a counterparty.

Replacement trigger levels identified in our analysis mark the minimum credit quality for a counterparty that we deem sufficient to shield a transaction from counterparty credit risk. These trigger levels build on the current regulatory and supervisory framework for financial institutions (such as bail-in and stronger prudential metrics), which reduces the likelihood of banks to default within a short timeframe.

For material exposures, counterparties that are financial institutions with a minimum credit quality of BBB/S-2 can support the highest achievable rating of AAA on tranches or transactions, while counterparties with a minimum credit quality of B/S-4 can still support the lowest investment grade instrument rating BBB- (see Figure 2). Counterparties with a minimum credit quality of B-/S-4 can support all non-investment grade instrument ratings, if posing a material exposure. These achievable rating levels are contingent upon appropriate risk substitution triggers and provisions being in place.

When there is no replacement mechanism to mitigate a material counterparty exposure, our analysis will incorporate only the counterparty's credit quality, but still allow for an uplift. We consider counterparties with a minimum credit quality of BB/S-3 to be able to support instrument ratings up to six notches above the credit quality of the counterparty in the absence of a replacement mechanism. Counterparties with a credit quality below BB/S-3 may support instrument ratings up to four notches above the counterparty's credit quality.

Figure 2 also illustrates Scope's criteria to mitigate excessive exposures. In case of no replacement mechanism, the instrument rating will be constrained at the level of the counterparty's credit quality.

If a counterparty is subject to contractual frequent margining to collateralise its net exposure towards the issuer through payments in an issuer account, we account for the reduced exposure¹. We deem this counterparty capable to support maximum instrument ratings one notch higher than those displayed in Figure 2, if the counterparty has a minimum credit quality of BB/S-3 and is subject to replacement triggers at the same level. For example, a counterparty with a BBB credit quality subject to i) a replacement at loss

¹ We will review the derivative contracts to ensure that their terms result in an effective and timely reduction of the issuer's exposure to the derivative counterparty. In particular threshold amounts and frequency of the collateral transfer should be reasonable in the context of the transaction size and nature.

of BB and ii) contractual daily margining, would support instrument ratings up to AA- for material exposures and up to BBB+ for excessive exposures.

Figure 2. Replacement triggers for financial counterparties

Replacement trigger level (long-term or short-term)	Highest achievable rating	
	Material exposure with replacement	Excessive exposure with replacement
AA and above/S-1+	AAA	AAA
AA-/S-1+	AAA	AAA
A+/S-1+	AAA	AAA
A/S-1	AAA	AAA
A-/S-1	AAA	AA
BBB+/S-1	AAA	AA-
BBB/S-2	AAA	A+
BBB-/S-2	AA+	A
BB+/S-3	AA-	BBB+
BB/S-3	A+	BBB
BB-/S-3	BBB+	BB+
B+/S-4	BBB	BB
B/S-4	BBB-	BB-
B-/S-4	BB+	B+

Note: Full collateralisation of the exposure will continue to support outstanding ratings, if counterparty substitution is not finalised within 30 days.

Source: Scope Ratings

The levels outlined in Figure 2 relate to financial institutions that are important for the economic and financial system of the relevant country and therefore likely to be resolved if needed. For unregulated financial counterparties, or those not subject to the EU's Bank Resolution and Recovery Directive (BRRD), we determine whether the applicable regulatory body is likely to follow a resolution approach for the entity or whether the entity is likely to fail. If this analysis does not result in a support of similar level, Scope will apply a transaction-specific approach with the aim of assessing the minimum credit quality of a counterparty deemed sufficient to shield a transaction from counterparty credit risk.

4. Methodology

4.1 Materiality of counterparty risk as a guiding principle

Our analysis starts with an assessment of the counterparty exposure and its potential credit impact on the transaction, which we classify as excessive, material or immaterial, following the list in Figure 3. We will assess the counterparty risk exposures of a transaction to other counterparty roles not mentioned in Figure 3 on a case-by-case basis.

Excessive exposures generally relate to financial counterparties' obligations and usually result in the rated instrument's credit risk being strongly linked with the respective counterparty's credit quality. In addition to the mitigating replacement clauses of an excessive counterparty, further mitigating measures such as collateralisation support the transition from one counterparty to another, but are often uneconomical.

Material exposures arise from financial or operational risks, even though operational exposures seldom prove to be material. For material exposures, we assess whether proposed remedies can protect the rated instruments or reduce the exposure to non-performance or mal-performance by a counterparty, or make the likelihood of a performance failure sufficiently remote.

Immaterial exposures do not significantly affect the instrument's expected loss. We deem an exposure to be immaterial if the credit failure or non-performance by a counterparty is sufficiently remote or its consequences would be irrelevant, i.e. would not result in a downgrade of the instrument's rating. Such exposures are excluded from our assessment. Typical examples are financial exposures to payment systems (including central-bank accounts) or clearing houses, certain operational exposures, or some very short-term exposures to high-rated paying agents. However, if a counterparty provides multiple services (financial or operational) whose risks are immaterial individually but material in aggregate, or on which the security's ongoing performance relies too heavily, mitigating measures may have to be as strong as those used for financial counterparties.

Our counterparty risk analysis also considers concentrations of counterparty roles in a limited number of agents. Such concentrations may result in excessive exposures, even if the individual roles would only show material or even immaterial exposures after remedies.

Figure 3. Standard materiality for certain counterparty roles (non-exhaustive)

Counterparty	Exposure	Standard pre-remedies materiality	Potential remedies ^{2,3}	Rating trigger to support highest instrument rating (see Figure 2)	Standard post-remedies materiality ⁴
Derivative counterparties	Financial	Material	Collateralisation or guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2; Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify (including notching)
Bank account providers	Financial	Material	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2; Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify (including notching)
Reserve bank account provider	Financial	Excessive, for lower tier rated instruments ⁵	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of A/S-1; (Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank)	Compliant: immaterial Else: link to the counterparty
Collateral holding entity in a synthetic securitisation	Financial	Excessive	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of A/S-1; (Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank)	Compliant: immaterial Else: link to the counterparty
Liquidity facility providers	Financial	Material	Replacement/draw to cash	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2; (Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank)	Compliant: immaterial Else: quantify (including notching)
Servicers	Financial/Operational	Material	Replacement/operational covenants	<ul style="list-style-type: none"> Operational covenants specific to the service provided (hot, warm or cold back-up/performance-based triggers); or Rating-based triggers to be considered on a case-by-case basis 	Compliant: immaterial Else: quantify (including notching)
Paying agent	Financial/Operational	Immaterial, unless there are significant cash-flow concentrations	Replacement/reduction of exposure	<ul style="list-style-type: none"> Mitigating covenants specific to the service provided; or Rating-based triggers 	Immaterial
Collection or calculation agents	Operational	Immaterial	Replacement/operational covenants	<ul style="list-style-type: none"> Operational covenants specific to the service provided; or Rating-based triggers to be considered on a case-by-case basis 	Immaterial
Trustee	Operational	Immaterial	N/A	N/A	N/A

Source: Scope Ratings

² This list includes only the most common remedies. Scope assesses any other remedies available.

³ We only consider guarantees, if they are payable on first demand, unconditional and irrevocable.

⁴ Quantification would determine the impact on the rating by analysing both the exposure at risk and the probability that an adverse event occurs. Notching would allow the committee to apply a qualitative adjustment on a case-by-case basis.

⁵ The credit enhancement for rated instruments with low levels of overcollateralisation may mainly consist of cash reserves, which we would consider an excessive exposure for such lower tier instruments.

4.2 Definition of material and excessive counterparty exposures

Central to the materiality assessment is the likelihood of a counterparty's failure to perform and whether this might significantly impact or even lead to a termination of the transaction. A counterparty exposure with a negative rating impact of seven notches or more – usually under the consideration of structural remedies other than risk substitution triggers – is excessive. A non-excessive counterparty exposure with a negative rating impact – usually under the consideration of structural remedies other than risk substitution triggers – is material.

We test counterparty exposures for excessiveness, if the loss potential associated with a counterparty default would be equivalent to more than 5% of the portfolio balance. For most transactions with market standard counterparty exposures and credit enhancement a rating committee may classify the exposure as material without performing any detailed calculation.

An excessive exposure after the consideration of remedies results in a direct link between the rated instrument and the counterparty in terms of credit quality. For material risk exposures we quantify the additional expected loss from a materialisation of the counterparty risk for the rated instrument, if the proposed remedies are ineffective. Also, some transactions may require the quantification of the additional expected loss from a counterparty failure to factor for example replacement or hedge settlement losses into the correct positioning of the instrument rating below the maximum achievable rating, irrespective of the materiality. The calculation would apply the principles as outlined in Appendix IV. A direct link of the rated instrument to the counterparty credit quality can also be applicable in case of material exposures as a fall-back option.

4.3 Transaction-specific assessment of remedies

Our assessment of materiality, counterparty types and proposed remedies begins with the following analytical framework. The transaction's proposed risk-mitigation features guide our analysis, reflecting:

- Contractual provisions in the documentation;
- The maximum net amount of a financial obligation at risk;
- The maximum duration of the exposure to the counterparty;
- The level of disruption caused in the transaction by an operational failure;
- The complexity of the relevant counterparty role;
- The availability of alternative service providers as well as the functioning and depth of relevant markets; and
- The current credit quality assessment, including its rationale and outlook on the counterparty.

The transaction-specific view reflects our opinion that such risks may still affect the transaction in times of stress, even if legally binding remedies are in place. Originators are not always able to find adequately rated or willing counterparties. Further, replacement tends to take longer than contractually agreed, especially in times of general stress.

We distinguish between financial and operational counterparties. Non-performance on a financial obligation can have an immediate credit impact, demonstrating that constant performance by a financial counterparty is essential to ensure timely and full payment to noteholders.

Typical financial counterparty exposures include bank accounts, liquidity facilities, derivative counterparty exposures, and guarantors. Derivative obligations are especially likely to pose considerable counterparty risk and are harder to replace than other types of financial obligations. Additional mitigants such as collateralisation are often required to facilitate replacement and thereby prevent the transaction's credit quality being affected.

Collateral can mitigate financial counterparty risk in full as long as new credit risks are not introduced. In some cases, the high cost of collateralisation or the standardisation of financial obligations with limited replacement costs usually results in the counterparty's removal from the transaction.

Replacement triggers mark the minimum credit quality of a counterparty that we deem sufficient to shield a transaction from counterparty risk. The trigger levels we identify build on the current regulatory and supervisory framework for banks and the resulting limited likelihood for banks to default over the short term (see also Appendix II). For example, financial institutions with a minimum

credit quality of BBB, combined with appropriate risk substitution triggers, can support the highest rating of AAA on a structured finance transaction (see Figure 2).

We consider intraday or overnight exposures to financial counterparties such as the paying agent as immaterial, even in the absence of a mechanism to replace the counterparty. Longer-term exposures, however, can only be considered immaterial if the replacement language in relation to a counterparty accords with the principles featured in Figure 2 and Figure 3. If that is not the case, we may quantify the additional expected loss by applying the principles as outlined in Appendix IV.

Counterparty obligations that introduce mainly operational risks can still pose financial risks (i.e. liquidity and solvency) in the event of non-performance. These risks are generally mitigated through pre-arranged operational remedies, such as back-up agents, procedures to redirect payments, regular cash sweeps, or the availability of a 'hot' back-up service provider (see Appendix I).

Our rating communication generally provide a list of the relevant financial and operational counterparties, detailing their roles as well as the usual remedies to mitigate identified risks and our opinion on the adequacy of these remedies. We disclose any alternative considerations or assumptions made on a specific transaction.

4.4 Financial counterparties

4.4.1 Definition of financial counterparties

Financial counterparties provide financial services related to securitisation. They include credit enhancement providers, liquidity providers, account banks (where collections or reserve funds are held) and derivative counterparties.

We determine the materiality of the exposures and assess remedies implemented by the transaction. Adequate remedies include pre-funding or draw-to-cash provisions in the case of liquidity facilities or other easy-to-collateralise exposures. In our view, remedies are effective only if executed within 30 calendar days and the bank accounts to which cash is transferred are in line with eligibility expectations. This also assumes the draw-to-cash provision is legally sound, determined as part of our bankruptcy remoteness analysis.

4.4.2 Effective remedies for material or excessive exposures to financial counterparties

In cases where the exposure is not immaterial, the following remedies (see Figure 2) may be appropriate:

- Financial institutions rated above the replacement levels in Figure 2 can support instrument ratings up to eight notches higher than their own credit quality, if their role is subject to a corresponding replacement provision. The respective uplift granted depends on i) the rating level at which the replacement is triggered and ii) the pre-remedies materiality of the exposure. For example, if a counterparty role foresees a counterparty replacement at loss of BBB/S-2, a financial institution, rated at least BBB/S-2, to which the issuer has a material exposure can support a maximum instrument rating of up to AAA.
- Contractual provisions detail the actions following a downgrade of the counterparty below the replacement level. Scope considers such provisions effective mitigants to counterparty risk, if institutions agree to replace themselves with an eligible counterparty or obtain unconditional, irrevocable and first demand guarantees from another eligible entity within 30 days. If such remedies are not implemented within that timeframe, the institution should post collateral from that day until replacement is completed, at a level that covers the next payment obligation, the current mark to market of the exposure, and a buffer capturing the volatility of the exposure up to its next valuation.
- Contractual replacement provisions also may nominate an independent third party, in addition to the counterparty, that has both the responsibility and ability to find and effect a replacement.
- For the most critical roles, outgoing counterparties agree upfront to cover counterparty replacement costs.
- The incoming counterparty assumes similar obligations and commits to the same remedies as the outgoing counterparty.
- Counterparties have the same operational capabilities to fulfil contractual obligations.

Counterparties whose ratings are close to a rating trigger will not lead the instrument's rating to be placed 'under review for downgrade'. If a trigger has been breached and no replacement is found within the applicable timeframe, we consider efforts undertaken by the transaction's agents and the rating implications of the remaining counterparty exposure on a case-by-case basis.

Collateralised derivative counterparty obligations are considered secured liabilities in the context of the resolution regime (see Appendix II for a typical bail-in waterfall). The ranking of secured liabilities in the bail-in waterfall, combined with the remote likelihood

of a bank failing to provide services during a resolution at the proposed trigger levels, can support the corresponding rating levels of the instrument without introducing undue risk. Other financial obligations owed to or provided by financial institutions that are subject to a resolution regime are ranked differently in a bail-in scenario but retain a very remote risk of being bailed in, similar to derivative obligations. We therefore envisage the same rating trigger for all financial obligations.

We may take a transaction-specific approach and, under certain situations, may not directly apply the principles highlighted in Figure 2. For financial counterparties that are not regulated as banks or not subject to BRRD, we assess whether the applicable regulatory body is likely to apply resolution to the entity or whether the entity is likely to fail.

4.5 Servicer risk

A servicer that fails to perform can expose a transaction to additional losses, create liquidity risks for the transaction, or both.

4.5.1 Servicer transferability

Upon a servicer disruption event, the continuity of cash flows and payment to noteholders depend on the effectiveness and speed with which servicing activities are transferred to a new servicer. We assess servicer transferability risk by examining: i) the presence of either a back-up servicer or back-up servicer facilitator appointed at closing; ii) the complexity of the servicing activities; iii) the availability of suitable potential replacements; and iv) the legal framework's potential to inhibit or delay the transfer process.

We evaluate whether servicer replacement would be practical and analyse the strength and clarity of replacement provisions. An effective back-up servicer arrangement typically involves regular access to the securitised portfolio database and a clear contractual commitment to adequately replace the servicer following a termination event. A back-up servicer facilitator also mitigates, although to a lesser extent, the risk of servicer disruption by assisting the issuer in finding a replacement. The effectiveness of this provision depends on the back-up servicer facilitator's expertise and market knowledge, as well as the availability of suitable providers. It is more challenging to replace servicers specialised in asset classes like non-performing loans or operational leasing with ancillary services, as these areas tend to have fewer market participants and require more time for new servicers to become fully operational. Finally, we consider the jurisdiction's legal environment to assess potential impediments for the transfer of servicing activities, such as data protection laws.

4.5.2 Liquidity risk when a servicer is replaced

A servicer disruption event poses liquidity risk for the transaction as the portfolio may remain unserved for a prolonged period. Servicer replacement can be time-consuming for reasons such as a lack of alternatives in the market, operational problems in accessing payment information on credits and obligors, and the operational complexity of migrating certain processes to a new platform. In certain cases, a servicer's failure may create more loan delinquencies if collections cannot be undertaken.

Liquidity risk is usually mitigated by structural features such as cash reserves, liquidity lines, portfolio principal collections available to pay senior fees and interest on notes, or the frequent transfer of collections into the issuer's account from the servicer's account. We also assess the risk that senior fees and expenses deplete available liquidity and thus leave the rated instrument unprotected. For more details refer to Appendix I and Appendix III.

4.5.3 Resolvable financial institutions as servicers

Resolvable financial institutions are more likely to continue as a going concern and honour operational obligations in the event of financial impairment, at least for the duration of a resolution. Bank resolution frameworks comparable to that in Europe can provide comfort that structural features in a securitisation can be implemented before counterparty risk materialises. This view particularly applies when the servicer causing the disruption is a resolvable bank.

Nevertheless, securitisation transactions may feature unrated servicers that are also less regulated than banks are. A jump to default of such servicers would result in extra losses for investors or temporary payment interruption. We evaluate such servicers in terms of their initial viability, alignment of interests with the transaction, and performance incentives.

4.5.4 Servicer commingling risk

Commingling risk arises when the issuer's cash is mixed (commingled) with the servicer's and deposited in an account under the servicer's name. The materiality of this risk depends on several factors including: i) the credit quality of the servicer; ii) the legal framework under which the servicer performs its function; iii) whether the servicer operates with pledged accounts, such as escrow accounts, and the funds on these accounts benefit from a segregation right in case of a servicer default under the jurisdiction-specific insolvency law; iv) the ease with which collections can be redirected into the issuer's account upon a servicer event (e.g.

direct debits); v) the duration of servicer holding periods based on cash sweep frequency; and, generally, vi) the receivables' characteristics, which determine the amount and potential clustering of collections around certain dates.

We consider whether structural protection features, such as a dedicated commingling reserve or third-party guarantee, are effective at delinking the transaction from servicer commingling risks. An example is a reserve account in the issuer's name that covers collections over a stressed servicer holding period. Servicer exposures that cannot be delinked from the transaction will be considered in our analysis. For more details, see Appendix III.

4.6 Other counterparties

The operational failure of counterparty agents that result in their non-performance or mal-performance may also be disruptive for the transaction, even if the issuer has no financial exposure to such parties. A swift replacement of such counterparties can shield the transaction from additional risk. Such counterparties include collection agents, paying agents, calculation agents, trustees, asset managers and special servicers/agents.

We analyse the risk of operational disruption in the context of the transaction, focusing on the agents' track records, economic incentives and operational standards, including standard of care and general liability standards. We also evaluate whether replacing the agent would be practical and analyse the strength and clarity of replacement mechanisms in the transaction. The analysis also considers the existence of fees covering not only an agent's replacement at a potentially higher cost but also the party tasked with finding it.

When such counterparties are rated, rating-based replacement triggers can simplify the monitoring of credit impacts for the rated notes, but may affect other remedies (see following section: Credit quality assessment of counterparties).

5. Credit quality assessment of counterparties

To measure the counterparty risk we rely on our ratings (public or not) which are monitored over the life of the transaction.

If we have not rated the counterparty, our counterparty risk analysis can also incorporate public ratings from a regulated and supervised credit rating agency. We may adjust these ratings as needed.

If a counterparty that poses material counterparty risk has no rating from a regulated and supervised credit rating agency (including Scope) or other credit quality-relevant information, we will either be unable to rate the transaction or limit achievable ratings to the range below BBB-.

Rating-based counterparty replacement triggers can simplify the monitoring of credit impacts for the rated notes. Clear, transparent, independently monitored and enforceable covenants referencing financial or operational triggers may also shield other counterparty exposures from impacting the credit quality of the notes.

Similarly, risks arising from unrated counterparties may be structurally mitigated without having to refer to ratings. For example, provisions for daily cash sweeps (immaterial when considered individually) into an account under the issuer's name can mitigate commingling risks, but are only effective if the account is shielded in line with expectations for general financial counterparties. Other remedies include additional credit enhancements, liquidity facilities, and payments made into a lockbox account that limits servicer access and ensures money is transferred to an eligible deposit account.

The above illustrates that we do not expect one-size-fits-all remedies but consider financial and operational covenants tailored to a specific transaction. Appendix I and Figure 3 provide some examples and rationales for this.

Other breaches of proposed financial or operational covenants by a counterparty should, within 30 days, result in a contractual requirement for that counterparty to:

- be replaced with another eligible counterparty⁶; and
- provide additional mitigants such as eligible guarantees or a liquidity facility or redirect collections directly to the issuer's bank account.

⁶ The provisions for the replacement period in Appendix I apply, should the replacement not conclude within 30 days.

Appendix I. Definitions and applicable conventions

General convention

We compare the issuer's or arranger's remedies with this methodology to establish a rating opinion. Transaction parties may provide the same mitigants as presented in this document but are not obliged to follow this methodology.

Replacement commitment

A pre-commitment by the service provider to transfer its tasks to another eligible party can protect the securitisation against a deterioration in the service provider's credit quality. Upon a breach of obligations, the service provider would need to transfer its exposure to another eligible party, on the same terms, to ensure there is no credit impact on the rated debt. A service provider can agree to either find a replacement within a predetermined period or obtain a guarantee from an entity with adequate credit quality.

External accounts are provided by banks. The costs to maintain issuer bank accounts are similar between countries and banks. The replacement provision does not need to rest with the original bank account provider to enable a transaction to achieve the highest rating, as long as the issuer or trustee ensures bank accounts are held with eligible financial institutions.

Replacement period

Trigger levels to replace a counterparty are set to ensure the counterparty can provide services without exposing investors in rated debt to the potential for a resolution or moratorium of a regulated bank or insolvency of the service provider. A replacement period of 30 calendar days for uncollateralised exposures can, in our view, ensure an orderly transfer and prevent operational risks. A credit impact can even be prevented if the exposure is sufficiently collateralised after 30 days, as long as the counterparty is replaced within 60 calendar days. In the meantime, the provision of sufficiently detailed information would ensure there is no credit impact.

Other replacement triggers based on financial and operational covenants

Not all parties providing services to a transaction are rated financial institutions. In the case of such unrated and primarily operational service providers, remedies can take the form of financial or operational covenants. We assess whether the proposed financial-ratio-based or operational triggers, typically independently verified, can substitute for credit-risk-based triggers aimed at reducing service or payment disruption risk.

We assess proposed covenants in the context of the transaction as replacement may create new sources of risk. Replacing smooth processes at an incrementally higher risk may even be preferable to switching service providers, as the latter is likely to cause disruption.

Financial and operational covenants

Covenants addressing liquidity risk

Daily cash sweeps to eligible bank accounts in the issuer's name enhances the available liquidity and can largely isolate a transaction from commingling risk arising from collection agents or other service providers receiving cash on behalf of the issuer.

Our minimum requirement for liquidity coverage in a transaction is outlined in our General Structured Finance Rating Methodology.

Covenants addressing solvency risk

For unrated entities, we believe replacement triggers based on operational performance are better at limiting risks than those based on default events. This reflects insolvency administrators' preference to preserve functions that generate recurring income. Disruptions to operational performance are more easily mitigated for standardised assets as long as back-up servicers are identified in the initial stage. 'Cold' or 'hot' back-up servicers are one solution, depending on the complexity of the assets or the servicing process. Regular confirmation of positive net cash flow, along with regular audits by reputable firms, can provide additional comfort on the servicer's solvency.

We generally distinguish between 'cold', 'warm' and 'hot' back-up servicers. The categorisation indicates the readiness and speed with which they take over servicing a portfolio. Whereas a cold back-up servicer only receives a back-up of the data file, hot back-

up servicers already incorporate the relevant obligor data in their systems, perform parallel processing, and have established procedures to ensure a replacement can be deployed within days rather than weeks.

Other operational covenants

We evaluate proposed operational provisions in the context of the relevant third-party servicing market, successful past transfers, and the amount of servicing fees. We also assess whether regulatory or consumer-protection requirements could hinder timely replacement.

Other operational covenants include:

- Pre-approved forms for debtor notification to ensure timely perfection of interest as well as contractual obligations to redirect payments upon a breach of pre-defined triggers.
- A contractual provision for regular updates on pool and debtor data including specified data back-up provisions (to trustee).
- Public ownership with a strong governance and operational track-record, as well as restrictions on changes to ownership structure or business strategy.

Issuer/transaction bank accounts

Typically, sums used to repay the notes transit through bank accounts held with one or more banks. The repayment of notes may therefore be affected by the insolvency of these banks. Banks, while highly regulated, are not bankruptcy-remote like typical special-purpose entities. Account balances can be temporarily blocked or even lost if a bank is placed under moratorium, restructured or declared bankrupt by regulators. We are more likely to assign a high rating if the transaction adequately protects investors from the risk of their money being trapped or lost.

Our assessment on the effectiveness of replacement triggers accounts for the importance of the bank account to the transaction.

In certain jurisdictions, structural mitigants (e.g. investments in highly rated liquid securities with no additional risks) or legal mitigants (trust or custodian accounts) can isolate funds against an insolvency of the institution providing accounts for the transaction. A detailed legal review of such structures can reveal potential issues regarding full and timely access to such funds.

Collection accounts for servicers

The transaction usually ensures that funds are transferred to the bank account of the originator, seller or servicer before they are remitted to the issuer account. Noteholders can be exposed to payment interruption and/or commingling risk if an originator/seller or servicer has liquidity problems or becomes insolvent. We assess this risk by examining general legal provisions (including the required consent from or notifications to obligors), operational covenants, additional transaction-specific structural mitigants, or the counterparty's credit risk.

Liquidity facilities

Liquidity facilities typically ensure the timeliness of payments to noteholders. They do not provide credit support, but mitigate timing mismatches or payment disruptions arising from the default of other counterparties or borrowers.

Terms and conditions can indicate the ability to renew a facility and how much this would cost. Unless fully collateralised, accounts are opened at the transaction's inception. A facility not renewed as expected would become fully drawn by its expiry.

We regard as excessive any exposure to liquidity facilities that provide very substantial amounts or very material credit support to a transaction, typical for asset-backed commercial paper conduits. If the liquidity facility is essential to the transaction, we typically link the transaction to the credit risk of the liquidity provider.

Paying agents

Paying agents distribute funds to noteholders. Their non-performance could delay payment, but the risk is typically limited as funds are held for only short periods, usually one or two days. Choosing counterparties with a proven record and experience can mitigate this form of operational risk. We determine whether counterparties have a solid credit profile and whether transaction documents outline likely remedial actions if a counterparty can no longer perform its functions.

Calculation agents

Structured finance issuers, due to their typical set-up as special-purpose vehicles, typically rely on calculation agents to value derivative exposures. These valuations establish potential collateralisation needs under contracts and can be provided by a large number of counterparties. The risk of non-performance is generally tolerable as derivative counterparties can generally be replaced.

Cash administrators or cash managers

Cash administrators typically manage short-term investments during payment periods and only act as an agent for the transaction based on procedures outlined in the transaction documents.

Usually, this counterparty introduces operational risk only (i.e. not credit or liquidity risk). Choosing counterparties with a proven record and experience in the functions they are commissioned for can prevent this risk from materialising.

Servicers

Securitisation issuers are typically set up as special-purpose vehicles that rely on banks or corporations to manage relationships with obligors, monitor their performance, and enforce the obligation when necessary. We evaluate the proposed covenants for servicers in the context of the level of standardisation in processes, systems and their scalability. Other important considerations are the portfolio composition by product or asset type, the remittance form used (direct debit or transfers) and payment characteristics (amortising or bullet). We also account for soft factors when determining the effectiveness of proposed remedies, through our qualitative assessment that examines governance, service practices or franchise size, among other factors (see previous section: Other replacement triggers based on financial and operational covenants).

Commingling risk

Commingling risk mainly occurs when the servicer commingles collections from one entity with its own funds. See Appendix III.

Originator set-off

Set-off may be invoked by a debtor that holds a monetary cross-claim against the seller or originator. In this case, the debtor could be released from honouring the creditor's claim up to the amount of the cross-claim. Set-off might vary significantly by jurisdiction, asset class and transaction structure.

Set-off exercised by a debtor on an asset may either substantially reduce or cancel out the enforceable claim, i.e. the proceeds payable to the issuer. Where such cross-claims exist or are likely to come into existence, we examine whether potential offsetable amounts are crystallised or only will be crystallised upon future actions like a future notification of the sale. Also we review documents relating to the assets whether there are waivers of set-off and whether these are valid under the relevant jurisdiction. In case such waivers are not agreed or recognised by the applicable jurisdiction, we assess whether the structure has features that could mitigate the negative impact of set-off.

Otherwise, we evaluate whether the originator's credit risk must be factored into the rating. If mitigation does not take the form of an appropriately sized reserve or similar measures, but rather of indemnities or substitution rights granted by the originator, we evaluate whether those indemnities or substitution rights affect the true sale of the securitised asset.

Set-off may also create challenges for the structure if invoked by transaction parties other than the debtors of claims generated by the asset, for example, the account bank. In this case, we examine how set-off is treated in the transaction documents, as mentioned below, and how it affects the structure.

Appendix II. Bail-in waterfall for bank obligations (subject to resolution)

Regulatory and supervisory oversight, as well as additional regulations, enable a more differentiated view on bank counterparties that provide services for structured finance transactions. One such cornerstone is the EU's Bank Resolution and Recovery Directive (BRRD), which ensures banks can be resolved using available funds (bail-in) rather than through external support (bail-out).

Proactive regulation and supervision help to contain the speed of a negative migration timing, effectively avoiding a jump to default of such banks. Even if a resolution were to occur, counterparty obligations covered under these criteria would constitute either secured liabilities (such as derivatives subject to margining) or senior unsecured debt as defined by the BRRD. Given the ranking of counterparty obligations in the bail-in waterfall, we believe these to be either initially excluded (derivative obligations) or to have a remote ranking in the order of bail-in – although not the most remote (covered bonds are excluded from bail-in).

Figure 4. Bail-in waterfall for banks subject to a resolution regime

Order of bail-in in resolution (for EU banks)
1. Equity
2. Additional Tier 1
3. Tier 2
4. Other subordinated debt
5. Senior unsecured debt included in MREL and/or TLAC
6. Other senior unsecured debt and non-preferred deposits (wholesale and institutional)
7. Preferred non-insured deposits (individuals and SMEs)
8. Deposit guarantee scheme (for insured deposits)

Source: Scope Ratings

Further supporting regulations are yet to be finalised and we recognise that various supervisory authorities in EU member states may deviate in their regulations⁷. We will adapt the criteria to reflect these variations depending on the individual circumstances.

⁷ For example, new regulations in EU member countries might have implications on the effective ranking of eligible liabilities, which might have implications on our view of the appropriate level of replacement thresholds.

Appendix III. Quantifying expected loss from servicer commingling

Commingling risk arises when the transaction's cash is mixed (commingled) with the servicer's or deposited in an account under the servicer's name. Servicer commingling can occur when the servicer is insolvent, there is a credit loss (collections are irretrievable) and/or payment is delayed (collections are blocked temporarily). We take into account several factors when assessing the potential impact of commingling risk:

A servicer's credit quality and nature and the risk of credit deterioration when operations are disrupted. For example, financial impairment may affect unregulated servicers differently than regulated financial institutions. We determine the servicer credit quality through a credit assessment from Scope. Such assessment may be a rating or a credit estimate produced by Scope's financial institutions or corporate analysts. If information on the counterparty is insufficient, our commingling analysis can also incorporate credit ratings from other regulated and supervised credit rating agencies.

Jurisdiction and legal framework: account segregation. Servicer commingling risk is low, for example, when the servicer uses accounts that are either in the issuer's name or are pledged to the issuer in a legal, valid, binding and enforceable way, and the jurisdiction-specific insolvency law allows for the segregation of the funds on such accounts in the event of the servicer's default.

Jurisdiction and legal framework: perfection of true sale. Servicer commingling risk increases, for example, when the servicer continues to collect obligors' payments (even if passively) until obligors are notified of the assignment of the receivables, which perfects the true sale.

Jurisdiction and legal framework: insolvency laws. For example, insolvency laws may affect the size of the exposure at risk of commingling losses. This could be relevant if the servicer is also the originator and seller.

Operational risk. For example, pre-defined processes for fulfilling the notification to obligors, with readily available contact data, clear responsibilities and powers, deadlines, among others, help reduce the risk of increased commingling exposures by shortening the obligor-notification period.

Characteristics of the receivables. The collection method (e.g. direct debit, manual transfers, cheques, on-site payments), the clustering of collection dates in the month, or the speed of scheduled and unscheduled amortisation, among others, may result in an increased exposure to servicer commingling losses.

We add the probability-weighted loss from servicer commingling to the credit losses from the portfolio to factor in the expected economic consequences of a servicing disruption. The loss from servicer commingling considers the stressed likelihood and severity of a jump to default of the servicer, resulting in the loss of issuer moneys held by the servicer. We consider a stress of three notches when calculating the probability of a jump to default of the servicer.

We consider a stressed exposure at risk, which reflect a holding period that includes the obligor notification time. The obligor notification time is the time needed to inform obligors that payments should no longer be directed to the defaulted servicer. The exposure is calculated considering collections under a scenario of zero portfolio defaults and with an expected prepayment rate. However, if the stressed servicer probability of default is commensurate with a BBB- probability or less likely and the exposure is around one month of collections, we regard the risk as immaterial and do not add any incremental commingling loss.

Figure 5. Typical stresses applied to the analysis of servicer commingling risk

Element	Assumptions
Servicer credit quality	Servicer credit quality minus three notches
Stressed exposure period	A maximum of i) one month; and ii) two times the cash sweep period
Obligor notification period	The actual assumption will consider the specific characteristics of the transaction
Stressed holding period	The sum of the stressed exposure period and the obligor notification period

Appendix IV. Quantifying expected loss from financial exposure to counterparties

Financial counterparty exposure arises for the transaction when a third party exposes issuer money to the risk of being lost in a default scenario of such third-party. Losses for the transaction may occur, if issuer funds form part of the insolvency estate of a third party. Counterparty exposures are often immaterial, if sufficiently strong counterparties and proper risk mitigation are in place (see Figure 2). If this is not the case, we estimate the additional expected loss from the counterparty exposure, considering the counterparty credit quality, the amount at risk and the tenor of the exposure. We add the loss expected in case of a counterparty default to the transaction's expected loss, accounting for all structural mitigants such as subordination and excess spread.

We determine the counterparty's credit quality with the use of a rating or a credit estimate produced by Scope, or a credit rating from other regulated and supervised credit rating agencies.

Figure 6. Typical stresses applied to the analysis of financial counterparty risk

Element	Assumptions
Counterparty credit quality	The counterparty credit quality minus three notches.
Amount at risk	To determine the amount at risk we consider the actual cash sweep period into the issuer's account.
Tenor of the exposure	The actual holding period, floored at one month.



Counterparty Risk Methodology

Structured Finance / Covered Bonds / Project Finance

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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