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How We Rate And Monitor EMEA Structured Finance Transactions

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How We Rate And Monitor EMEA Structured Finance Transactions

Standard & Poor's Ratings Services uses a principles-based approach for assigning and monitoring ratings globally (see "Principles Of Credit Ratings," published on Feb. 6, 2011). These broad principles apply generally to all types of corporate, governments, securitization structures, and asset classes.

We have complemented these principles with specific methodologies and assumptions for the various structured finance asset classes. Our rating analysis applies all relevant and applicable criteria for the transactions in a given sector or country within Europe, the Middle East, and Africa (EMEA), as updated from time to time (see "Related Criteria And Research"). We use the same methodologies and assumptions to assign and monitor our EMEA structured finance ratings.

The analytical framework for structured finance securitization ratings includes five key rating factors:

- Credit quality of the securitized assets;
- Legal and regulatory risks;
- Operational and administrative risks;
- Counterparty risks; and
- Payment structure and cash flow mechanisms.

This article provides more details on these rating factors, how we assess them, and the data we use when assigning and monitoring our EMEA structured finance ratings (including covered bonds).

How We Assign EMEA Structured Finance Ratings

Evaluation of the five rating factors

Credit quality of the securitized assets

The first key step in analyzing the credit quality of the securitized assets is estimating the amount of total losses that we could expect at each liability rating level.

For some asset classes, the estimation may proceed in stages—we may separately estimate asset default frequencies and loss severities under stress conditions and then combine those components to form the overall loss estimate.

For some asset classes, we define an archetypical asset pool and use it as a comparison benchmark for gauging the estimated losses under various stress scenarios for pools of securitized assets. Similarly, some of our criteria call for a comparison of rating scenario asset default rates at each liability rating level with expected tranche break-even default rates (see "Payment structure and cash flow mechanisms" below).

Likewise, for other asset classes, the estimation may use generalizations based on historical studies, such as the notion that we can estimate losses under stress conditions as a multiple of expected losses, with the multiple potentially varying for different asset classes.

Legal and regulatory risks

We assess, under the applicable legal regime, the extent to which a securitization structure isolates securitized assets from bankruptcy or insolvency risk of the entities participating in the transaction. Our analysis typically focuses on the entity or entities that originated and owned the assets before the securitization.

A true sale of the assets from the originator/seller to an insolvency remote issuer is one method commonly used to achieve asset isolation in a securitization. In other cases the applicable legal framework allows the asset isolation within the issuer's balance sheet. The term true sale is commonly used to refer to a transfer of ownership of the securitized assets from an originator to a special-purpose entity (SPE), assets that will back the payment obligations resulting from the securities issued by the SPE. From a legal perspective, a true sale generally results in the assets ceasing to be part of the seller's bankruptcy or insolvency estate. A legal opinion often provides comfort as to whether a structure achieves a true sale or the equivalent asset isolation.

In our analysis, we also consider an SPE's insolvency remoteness. Among other things, we consider whether bankruptcy courts would respect the SPE's separate legal entity. In addition, we assess the presence of features intended to minimize the likelihood that the SPE itself becomes the subject of the bankruptcy.

Operational and administrative risks

This part of our analysis focuses on key transaction parties to determine whether they are capable of managing a securitization over its life.

The framework distinguishes between performance key transaction parties (performance KTPs), which, in substance, affect the transaction's collateral performance by their practices and loss mitigation strategies (for example, servicers and asset managers), and administrative KTPs that fulfil a role that is, while essential, generally administrative in nature (for example, trustees, paying agents, and calculation agents).

The framework generally considers the possibility that a performance KTP may become unable or unwilling to perform its duties during the transaction's life. For each performance KTP, our analysis considers the potential impact of a disruption in the KTP's services on the issuer's cash flows and the ease with which the issuer could replace the KTP, if needed.

Counterparty risks

The analysis focuses on third-party obligations to either hold assets (including cash) or make financial payments that may affect the creditworthiness of structured finance instruments.

Counterparty risk is an important consideration in assessing the overall credit risk of structured finance securities. Cash received and collected from the underlying assets is typically deposited or held by counterparties pending interest payment dates, and interruption to accessing that cash may impede the issuer's ability to meet its payment obligations.

Moreover, a variety of agreements may be entered into between the issuer and counterparty to enhance or otherwise transform the nature or timing of cash flows received from the underlying assets, for example, interest rate and

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cross-currency derivatives. A counterparty's failure to perform its obligation may lead to a downgrade of, or even payment default on, supported securities, notwithstanding the performance of the underlying assets.

Payment structure and cash flow mechanisms

The objective is to assess whether the cash flows from the securitized assets would be sufficient, at the applicable rating levels, to make timely payment of interest and ultimate payment of principal.

Where applicable, we derive stress assumptions based on risk factors that can arise from the four previous rating factors and perform cash flow analysis of the assets, capital structure, and payment structure to determine the bond's likelihood of payment under economic scenarios consistent with our rating definitions (see "Understanding Standard & Poor's Rating Definitions," published on June 3, 2009).

Our stress assumptions are primarily asset-specific and generally include our analysis of historical performance, our forward-looking view, and various economic scenarios. For traditional assets, such as consumer loans and mortgages, the variables that we generally stress include default or loss rates, interest rates, loss timings, voluntary prepayment speeds, market value declines, recovery rates, and recovery timings, whenever applicable. For assets that call for a comparison of rating scenario default rates with tranche break-even default rates to determine our rating (for example, leveraged loan collateralized loan obligations), our cash flow analysis will determine the tranche's break-even default rate based on these factors.

Overall, this analysis will also combine to determine the level of credit support provided in the form of excess spread (also known as "soft credit enhancement").

Wherever relevant, we may apply cash flow stresses to account for legal, operational, and counterparty risks that the transaction structure does not mitigate. Examples include setoff losses, commingling losses, and interest rate or basis risk due to an unhedged structure.

The combination of this structural and cash flow analysis and our credit analysis (see "Credit quality of the securitized assets") will typically determine the minimum level of credit enhancement required at each liability rating level.

Information And Models Used To Assign Ratings

To assess the credit quality of the assets, we typically receive two main types of data: portfolio or loan-level data, and historical performance (static/dynamic default and recovery information).

To evaluate the other rating factors, we review the transaction documentation provided by the originator/arranger and the other relevant transaction parties. In addition, for the analysis of operational and administrative risks, we would typically visit the originator and/or servicer.

While securitizations are designed to help isolate the performance of the securitized assets from the performance of the entity that originated and sold them, a lender's mortgage origination and underwriting process may affect the performance of the loans it originates.

We will issue a credit rating only when we possess sufficient information upon which to base the credit rating. Information may be deemed sufficient only when there is sufficient quantity of information to enable the assignment of a credit rating, the information is received on a timely basis, and we consider that the information received is reliable.

For each asset class we have defined the minimum data requirements regarding the underlying assets or collateral and the transaction structure. We use the most up-to-date information, and have established a maximum acceptable "age" of information used when assigning new ratings.

To evaluate the reliability of the data received, we request that an independent external collateral assessment is provided for each new transaction where we consider it to be relevant. When reviewing these due diligence reports we usually focus on the experience of the third party to carry out its tasks and the scope and depth of the third-party review. The scope determines the extent to which the third party reviews the accuracy of the data provided, and that exceptions identified are limited and reasonable. We reflect the conclusions and quality of the third-party collateral report in our analysis.

If such an assessment is not provided for certain transactions or where the conclusions of the report indicate data quality below acceptable standards, then that may preclude us from rating the transaction. However, in other circumstances, depending on the nature of the assets under review for example, the absence of a third-party independent collateral assessment would not, in itself, stop us from rating the transaction.

In certain instances, it may still be appropriate to proceed even if one or more of the information sufficiency standards is not met. Alternate procedures, such as using older information, or making conservative assumptions in place of missing information, may be appropriate.

Combined with the various qualitative factors, each EMEA structured finance asset class may use various quantitative models to assist in the assessment of the credit quality of asset pools or to analyze cash flows under various stressed scenarios. For more information, see "Table Of Contents: Standard & Poor's Credit Rating Models").

Credit models are rules-based models that use a combination of loan-level and transaction-level information to calculate default risk and asset recovery assumptions under different stress scenarios for pools of assets.

We use cash flow models to simulate a transaction's cash flows under various economic scenarios, ranging from benign/moderate to more stressful conditions, commensurate with the ratings on the securities. We use the model results to evaluate whether a security will be paid timely interest and full principal under these various scenarios.

How We Monitor EMEA Structured Finance Ratings

The monitoring of EMEA structured finance ratings involves the analysis of transaction characteristics to determine whether we consider that the current ratings, based on the five rating factors, are consistent with developments and trends we have observed in the transaction and macroeconomic conditions.

For a given transaction, primarily based on information in performance reports that we typically receive quarterly, we monitor the variables that can vary over the transaction's life. For the other factors less likely to change over the

transaction's life, we review them at least annually.

Monitoring of the five rating factors

Credit quality of the securitized assets

Our view on the credit quality of a pool of assets may change over time. The performance of the pool may diverge from expectations and that divergence may reveal credit strengths or weaknesses that were not previously apparent. Through our surveillance processes, we reassess the credit quality of the pool based on certain information regarding the observed performance and other factors we deem relevant.

In doing so, we apply relevant criteria for determining the credit quality of securitized assets to the changed circumstances of a pool.

For certain asset classes, a number of asset characteristics that we consider in the application of our EMEA structured finance methodologies and assumptions remain unchanged for the transaction's life.

Our quarterly monitoring of the transactions therefore focuses on factors that may vary, such as delinquencies, arrears, defaults, recoveries and their timing, prepayment rates, or seasoning of the underlying assets. For asset classes where criteria call for the use of other Standard & Poor's ratings, such as leveraged loan collateralized loan obligations (CLOs), we will also reflect the transition in rating categories of underlying asset pools in the surveillance of existing liability ratings.

For asset classes where we use quantitative tools to assist in our assessment of the credit quality of the asset pools, we also run applicable credit models at least annually.

Legal and regulatory risks

Our initial asset isolation and SPE insolvency analysis is unlikely to change during the transaction's life, unless a change of law occurs or the transaction parties decide to modify the deal structure.

On an ongoing basis, and at least annually, we assess whether any legal or regulatory change has occurred, based on the information we receive in the context of our monitoring process. When changes materialize, we assess them and reflect their potential impact in our ratings.

Operational and administrative risks

The contractual arrangements—such as the replacement framework—are usually set for the transaction's life unless the transaction parties modify them. We would reflect any impact resulting from modifications made to the documentation in our ratings.

Our monitoring therefore focuses on the capability of the various KTPs, in terms of how their practices and strategies continue to affect transactions' collateral performance.

Some asset classes publish indexes for various jurisdictions capturing the evolution of delinquencies and prepayment rates. We use such indexes to perform a peer comparison and benchmark the performance of the various servicers.

Other asset classes rely on the ranking that we assign to some servicers. A servicer ranking is one of our assessments

of a company's ability to mitigate operational risk. The ranking represents a comparison of certain characteristics—including a company's policies and procedures, quality control and internal audit reports, training methodologies, and technology, along with a number of loan-servicing performance metrics—to industry averages and similar metrics for peer companies, as well as to our own ranking criteria.

Finally, we monitor the quantity, timeliness, and reliability of the information provided by the various performance KTPs (see "Information Used To Monitor Our Ratings").

Counterparty risks

Our analysis of counterparty risk can evolve when the agreements between the issuer and the counterparty are modified, when the counterparty's rating changes, or when the initial counterparty is replaced.

We continually assess any changes and reflect their possible impact in our ratings on a timely basis.

Based on the information we receive at least annually, we confirm whether the various counterparties to the transaction (or their ratings) have changed.

Payment structure and cash flow mechanisms

Based on the performance of the underlying pool of assets (see "Credit quality of the securitized assets"), the level of credit enhancement and external credit support available in the transaction may evolve over time.

For example, while high prepayment rates increase credit enhancement, they can reduce excess spread available to cover losses. Consequently, the issuer may need to use external cash support, such as liquidity facilities or reserves, to cover interest shortfalls or losses.

We therefore monitor variables such as prepayment rates, excess spread, changes in credit enhancement, reserve amounts, and liquidity facility drawings quarterly.

For asset classes using quantitative tools to analyze cash flows under various stressed scenarios, we also run applicable cash flow models at least annually. When running models, we reflect any change in macroeconomic conditions as they directly affect the magnitude of the stresses applied as part of our payment structure and cash flow mechanisms review.

Information Used To Monitor Our Ratings

We require a minimum amount of information to maintain a rating. We expect that relevant third parties associated with the transaction, such as servicers, collateral managers, trustees, and cash managers provide complete, timely, and accurate information over the transaction's life. We will maintain a credit rating only when we possess sufficient information, received on a timely basis and from a source we consider to be reliable.

We have defined asset-specific critical data points required for surveillance: performance of the underlying assets (e.g., updated loan-level information when relevant, losses, delinquencies, prepayments), payment default information (e.g., principal losses, interest shortfalls) or bond information (e.g., outstanding balance, application of funds). We also have

minimum standards for the timeliness and the reliability of the information we receive.

On an ongoing basis, we assess that the information we receive meets these minimum standards. We do this in various ways.

Primarily, we assess the quality of the performance data used in our ongoing analysis of credit risk. Initially, our data teams perform internal verifications on the data we receive and identify any discrepancies through a combination of automated validations and manual checks. Our assessment also monitors any delays in the timeliness of the data and any anomalies or gaps in the information required for surveillance. This assessment ultimately determines the "reliability" of our data providers.

These verifications by the data teams complement the analytical assessments of both performance data and other surveillance information. When taking a rating action, analysts answer a series of questions on the sufficiency, timeliness, and reliability of the information used. This assessment records whether the analyst made any adjustments to their rating inputs as a result of information quality concerns. Such concerns are deliberated in the committee.

We also monitor adherence to our information quality standards and process through a periodic review by an autonomous data assurance team.

If any of our information quality assessments identify recurrent or material concerns, we escalate the concern to senior analytical management and assess whether this has any potential rating impact up to and including the suspension or withdrawal of the rating if required.

Related Criteria And Research

- Global Framework For Assessing Operational Risk In Structured Finance Transactions, Oct. 9, 2014
- Asset Isolation And Special-Purpose Entity Criteria--Structured Finance, Sept. 13, 2013
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Principles Of Credit Ratings, Feb. 6, 2011
- Understanding Standard & Poor's Rating Definitions, June 3, 2009
- Table Of Contents: Standard & Poor's Structured Finance Ratings Criteria (only global and EMEA criteria apply)
- Table Of Contents: Standard & Poor's Credit Rating Models

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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