MORNINGSTAR | DBRS

Methodology
Legal Criteria for European Structured Finance Transactions

DBRS Morningstar
July 2022

Previous Release
July 2021

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Related Research

For a list of the Structured Finance related methodologies for our principal Structured Finance asset class methodologies that may be used during the rating process, please see the *DBRS Morningstar Global Structured Finance Related Methodologies* document. Please note that not every related methodology listed under a principal Structured Finance asset class methodology may be used to rate or monitor an individual structured finance or debt obligation.

Key Updates

For key updates in this methodology, please refer to the press release titled "DBRS Morningstar Publishes Updated Legal Criteria for European Structured Finance Transactions" dated 22 July 2022.

Scope & Limitations

A methodology sets forth the key analytical considerations and applicable analytics used when DBRS Morningstar assigns or monitors credit ratings or other opinions. DBRS Morningstar applies approved methodologies in the evaluation of a structured finance transaction or debt obligation. Quantitative and qualitative factors set forth in a methodology or in a combination of methodologies are evaluated by a DBRS Morningstar rating committee or discussion group that exercises analytical judgment and considers the regulatory environment, market standards, and customary practices in addition to other factors deemed relevant to the analysis.

As part of the evaluation process, DBRS Morningstar may opine as to whether a sponsor's proposed capital structure supports the assignment of a given rating(s), the loss level(s) the capital structure is able to withstand, or the rating level(s) supported by a sponsor's proposed capital structure. Once completed, this process facilitates the assignment of a DBRS Morningstar rating, at a given rating level.

In cases when an applicable methodology does not address one or more elements of a structured finance transaction or obligation, or such element(s) differs from the expectations contemplated when an applicable methodology was approved, DBRS Morningstar may apply analytical judgment in the determination of any related analytical factor, assumption, rating, or other opinion. For a methodology that incorporates the use of a predictive model, DBRS Morningstar may also depart from the rating stress(es) implied by the predictive model. DBRS Morningstar typically expects there to be a substantial likelihood that a reasonable investor or other user of the credit rating(s) would consider a three-notch or more deviation from the rating stress(es) implied by the predictive model

to be a significant factor in evaluating the rating(s). When a rating committee determines a material deviation, DBRS Morningstar discloses the material deviation and its analytical judgment for the material deviation.

Executive Summary

Structured finance is a dynamic and evolving form of debt financing that involves the transfer (or ring-fencing) of assets to special-purpose vehicles (SPVs), which then use the transferred assets as collateral for secured borrowing.

While each transaction is unique and variations continue to emerge, there are a number of legal issues common to most European structured finance transactions. These common legal issues are the focus of this publication. Despite the common themes addressed herein, each European jurisdiction has its own legal and regulatory environment in which each local transaction must be structured. In practice, because of the location of the parties or assets involved, many structured finance transactions in Europe involve more than one jurisdiction, which can add an additional layer of complexity to the analysis.

This methodology represents the current DBRS Morningstar approach to reviewing various legal and structural elements that DBRS Morningstar considers important to European structured finance transactions. The purpose of this publication is to provide greater transparency to the rating process by outlining to market participants the principal legal criteria that DBRS Morningstar applies when rating a structured finance transaction in Europe. The scope of this guide includes the securitisation of residential mortgages, auto loans, trade receivables, leases, secured and unsecured consumer loans, lines of credit, small and medium-size enterprise loans, and other corporate debt. References in this publication are also applied by DBRS Morningstar, where applicable, to covered bond programmes and structured finance transactions backed by other asset types, including commercial mortgage-backed securitisation transactions (CMBS)[1]. Where applicable, DBRS Morningstar considers this methodology for expected loss ratings assigned to untranched debt or equity securities (pass-through instruments) whose performance depends predominantly on the credit performance of a loan portfolio backing such instruments. It is important to note that the various topics discussed in this methodology may not be applicable or relevant in all cases, depending on the legal structure and issuance in question and the related rating or transaction assessment level.

The criteria in this publication should not be seen as static. DBRS Morningstar reviews market, legislative and case law developments on an ongoing basis to assess whether the criteria set forth herein remain relevant. The matters set out in this publication are typically relevant for securities rated in the highest DBRS Morningstar structured finance rating categories (AAA (sf)/R-1 (high) (sf)). In circumstances where a security rating is lower than AAA (sf)/R-1 (high) (sf), DBRS

1. References to CMBS in this document will generally refer to true sale CMBS (where an originating bank transfers a portfolio of commercial mortgages) as opposed to secured loan transactions (where an issuer conduits the bond proceeds to a property company by way of a secured loan facility). Because of the nature of secured loan CMBS transactions, not all the issues discussed in these criteria apply, and DBRS Morningstar considers the structure of each secured loan CMBS on a case-by-case basis. Also, while CMBS transactions have a number of features in common with other securitisations, the legal analysis of CMBS transactions involves additional features, including the structure, ownership, and control of the property holding company; its tax position; the security created over its assets; and the nature of its contractual obligations. For more information on CMBS transactions, refer to DBRS Morningstar's *European CMBS Rating and Surveillance Methodology*.

Morningstar may take this into consideration as it deems appropriate under the circumstances and in relation to the applicable rating category.

As described in more detail in the following sections, the legal criteria outlined in this publication can typically be satisfied in a number of ways, including by the provision of opinions of counsel in each relevant jurisdiction, adequately covering relevant legal and tax matters and/or of legal memoranda and/or of relevant due-diligence reports as well as by the inclusion of provisions within transaction structures designed to mitigate the relevant risks. This publication should not, however, be seen as prescribing a rigid template applicable in all circumstances to every transaction. Finally, the purpose of this publication is to explain DBRS Morningstar's approach to analysing certain risks in European structured finance transactions. The criteria described herein are not requirements, and DBRS Morningstar is not responsible for structuring transactions.

Originators and their advisors may choose to incorporate features in their transaction structures and documents that differ from those discussed in this publication and DBRS Morningstar assesses those structures to determine whether those transactions may be rated, and if so, what rating may be appropriate. However, DBRS Morningstar will typically rely on the best practice or a market standard utilised in a jurisdiction after review of the related risks.

Originators and their advisors may contact DBRS Morningstar to discuss the legal aspects of any structured finance transaction.

Securitisation Defined

A securitisation is a form of financing in which financial assets are pooled and used as collateral for a security's issuance through financial structuring. Securitisation has many applications, although it was initially designed as a debt-financing tool for lenders. A DBRS Morningstar structured finance credit rating reflects an opinion as to the issuer's ability to pay interest and principal on some debt securities (the Rated Securities) in accordance with the terms of the investment or as otherwise specified. The higher a security's credit rating, the more likely it is that, in DBRS Morningstar's opinion, payment obligations will be met when due under the terms of the related debt securities.

A defining characteristic of securitisation is the legal isolation of financial and/or other types of contractual rights usually associated with some form of financial assets (e.g., contracts, debt, securities, etc.) from the asset seller (the originator). The isolation is usually achieved by way of asset assignment to an entity that is created specifically for this purpose and designed to be independent of the liabilities and risks associated with the seller or transferor[2].

The principal goal is the separation of the assets from the financial risk of the originator so that the assets are beyond the reach of the originator's creditors in the event of its insolvency.

2. Transactions in some jurisdictions may instead use a loan and security arrangement and, in some cases, a form of trust is used to achieve asset isolation. DBRS Morningstar reviews such transactions on a case-by-case basis.

Consequently, a securitisation transaction's legal structure is typically designed to ensure that the cash flow to the holders of the securities is adequately protected from the insolvency of, or existence of claims against, other entities involved in the transaction. In specific circumstances, a certain degree of linkage in relation to part of the cash flows may be acceptable, but in such circumstances, the rating may be affected by changes in the creditworthiness of the transaction counterparties[3].

Bankruptcy remoteness is another essential concept in structured finance and is referred to throughout this publication. Achieving bankruptcy remoteness is dependent on the legal structure of the transaction, the transaction documentation, the relationship between the transaction counterparties, and the issuer and the relevant laws of the applicable or jurisdiction(s).

By converting potentially illiquid assets into securities with greater marketability, securitisation provides the originator with an additional source of funding and liquidity. In addition, the SPV insulates the assets from the general liabilities and creditors of the originator and the transactions are typically structured to provide credit enhancement to the noteholders. Consequently, the debts issued by the SPV may obtain a higher credit rating than that of the related originator, resulting in more attractive funding costs.

The DBRS Morningstar legal criteria presented in this methodology provide a general overview of the typical structural features that protect the noteholders and address various other issues that may arise during the life of the transaction, such as the proper servicing of the assets and the collection of the cash flows they generate.

Insolvency Risk and Bankruptcy Remoteness

A securitisation transaction usually involves one or more SPV incorporated for the exclusive purpose of a securitisation transaction, either as an issuer or a guarantee provider. The SPV is usually designed as a bankruptcy-remote entity, meaning that significant limitations exist with respect to the likelihood that the SPV would enter bankruptcy. Bankruptcy remoteness is usually achieved by limiting the scope of practical and financial activities that the SPV is permitted to undertake. In most cases, the SPV is a public or private company with limited liability or a fund with isolated assets, no employees or debt other than the securitisation bonds, and limits on the performance or provision of any form of service. In fact, an SPV will avail itself of services provided by external parties, usually under strict terms of limited recourse and non-petition vis-à-vis the SPV.

For certain assets classes, intermediate SPVs can be established (e.g., real estate owned companies (ReoCos), generally used for the purpose of corporate acquisition, management, improvement (and valuation) of real estate assets, and other immovable assets). ReoCos can also hold other assets and rights granted or established, in any form, constituting the collateral of assets assigned to the SPV. The proceeds arising from these assets are applied for financing the activities of ReoCos and then transferred to the SPV issuing the securities. The way the transfer is achieved depends on the relevant jurisdiction.

3. Full delinkage from the credit quality of the originator/servicer or other transaction parties may not be achieved. DBRS Morningstar highlights in its rating reports credit linkage with transaction counterparties where it deems such linkage substantial.

Bankruptcy remoteness is an important concept in structured finance and consideration of the legal aspects of structured finance typically begins with an understanding of the applicable bankruptcy and insolvency law. Identifying the relevant insolvency framework is obviously important for the issuer, but at various levels may be relevant to other transaction parties, depending on their roles and required activity. Within the European Union (EU) and the UK, uniform rules generally apply[4] to determine the jurisdiction in which insolvency proceedings can be initiated in relation to most[5] companies, partnerships or, individuals which have their centre of main interests (COMI) situated within a member state of the EU or the UK.

DBRS Morningstar typically reviews the insolvency analysis carried out by transaction counsel and/or the originator's counsel when provided.

Asset Transfer

One of the key concepts of a securitisation is the isolation of the assets for the benefit of the holders of notes issued by the issuer. For the benefits of securitisation to be realised, the transferred assets must be isolated from the insolvency risk of the originator (and the seller, if they are different entities). Such isolation also applies to assets transferred to ReoCos.

The majority of securitisation structures currently used in Europe are based on "true sale," reflecting the recognition that a simple way of isolating the assets from the insolvency of the originator is to effect their true sale. DBRS Morningstar will consider other structures not based on a true sale (such as a secured loan transaction) on a case-by-case basis.

The way the transfer is achieved may depend on the asset class and on the jurisdiction involved; however, to achieve a true sale, it is important that assets are transferred (or isolated) in such a manner that they are no longer considered the property of the originator (and seller) or part of its bankruptcy estate in the case of insolvency.

True sale is a concept that has a variety of different meanings in different European jurisdictions and, in some cases, the actual sale is not necessary since isolation, pledge, or declaration of trust in favour of an SPV—or intermediate company or ReoCo—is possible (since the issuer or the noteholders may acquire title of and interest in the assets by different legal means).

The term "true sale" is used as a simple means of describing the principle that DBRS Morningstar generally anticipates being incorporated in the transaction structure.

4. Under the European Union Regulation (EU) 2015/848 on Insolvency Proceedings, which came into force on 26 June 2015.
5. Under the European Union Regulation (EU) 2015/848 on Insolvency Proceedings, which came into force on 26 June 2015.

True Sale

A number of alternatives to the true sale structure have been developed, reflecting the variety of assets securitised and the different jurisdictions[6] in which securitisation takes place. In some jurisdictions, specific securitisation legislation and frameworks have been enacted, usually imposing a true sale securitisation structure. In others, no statutory framework exists and general legal principles have to be applied.

Where a statutory framework for securitisation exists, considerable comfort as to the existence of a true sale can be obtained simply by considering whether the various criteria for such framework have, in fact, been satisfied[7]. Typically, the legal documents list the undertakings of the parties to complete all necessary steps, and, in some cases, the legal opinion covers the validity and enforceability of the assignment (or isolation) of the assets. This also applies to assets assigned to an intermediate company or ReoCo.

In jurisdictions where express statutory guidance is not available, courts or insolvency receivers may consider a variety of factors to determine whether a true sale has occurred, including:

- **Intent and Conduct of the Parties:** The form of the transaction may be key to determine whether the transfer more closely resembles a sale than a security interest to secure a debt, often seeking to understand the intent of the parties. In other cases, the substance of the transaction is analysed to determine whether the seller has transferred the benefits and burdens of ownership for a price that represents a fair market value of the transferred assets. DBRS Morningstar therefore examines whether the sale agreement is on arm's-length terms and expresses, as clearly as possible, that the transfer is a sale.
- **Accounting and Tax Treatment:** Whether in their accounting records and tax filings, the parties have treated the transaction as a true sale.
- **Servicing and Commingling:** Whether the seller continues to service the assets and interact with the underlying customers and, if so, whether collections will be commingled within the seller's funds. It is generally accepted that, subject to certain safeguards described in the Commingling subsection under the Transaction Parties section below, the seller may continue to service the assets. To the extent that funds are commingled, however, additional steps may need to be taken, depending on the circumstances of the transaction (such as a declaration of a trust or other segregation provisions) to ensure that such amounts are protected as assets of the SPV.
- **Control of the Assets:** The degree of control that the seller retains over the assets and the right it may have to modify the terms agreed with the underlying customers. The seller should generally retain limited control over the assets once sold, although it is often anticipated that some degree of control is retained by the servicer in the context of the servicing activity.
- **Economic Benefits:** Existence of an option to repurchase the assets and the purchase price of the assets (whether it is fixed at the time of sale, or can change because of events occurring after the sale). Can the originator or seller demand payment of collections on the assets in excess of those originally considered in the purchase price?

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6. DBRS Morningstar acknowledges that the laws and regulations relevant to securitisations and other structured financings vary across Europe, and consequently so do the legal means of implementing true sale or any other form of asset isolation.
7. As with all statutory initiatives, however, the relevant legislation can also lead to lacunae, inflexibility and uncertainty which, because of the legislative process, can take considerable time to remedy.

- **Risk of Loss:** Which party bears the risk of loss on the assets? The sale agreement should clearly document the passing of ownership risk to the SPV or the ReoCo. However, in the case of the SPV, provisions in the transaction documents requiring the originator or seller to repurchase or substitute a transferred asset if transferred in breach of a representation or warranty, or that is otherwise an ineligible asset, are common as they do not transfer credit risk back to the originator or seller; rather, they merely ensure that all parties receive what they are entitled to under the agreed terms of the transaction.

A court (or regulator) may consider these and other factors to determine if the asset transfer is in fact a valid true sale or if it should be recharacterised as a form of secured lending. If the transfer is recharacterised, the seller would then retain an ownership interest in the assets and any security deemed to have been created may be void for want of registration, leaving the SPV and the noteholders with an unsecured claim against the originator and/or the seller.

A true sale legal opinion[8] is usually provided by the transaction legal counsel within the context of a securitisation transaction (see further below). The opinion typically describes the legal basis of the transfer of the relevant assets and reviews the relevant statuses and case law in relation to the nature and enforceability of the transfer.

Formalities for the Transfer

Some jurisdictions have enacted legislation that clearly sets out the formalities for a true sale. In other jurisdictions, the unequivocal transfer of title to certain asset classes may be difficult to achieve from a legal, timing, and/or cost perspective. In certain cases, legal title to the assets is transferred to the SPV, while in others, only the equitable[9] or beneficial title to the assets is transferred[10]. Additionally, the perfection[11] requirements of transfer vary by jurisdiction and may range from publication in an Official Gazette (as in Italy), or enrollment in a company register, to the requirement to notify the underlying obligors.

Many originators do not wish to make their clients or customers aware of their securitisation programmes through notices and, in any event, it may not always be practical to provide notice to each underlying obligor. For some originators, this may be a burdensome and potentially costly exercise. This is especially true in transactions that involve a large revolving pool of assets that change daily, such as in credit card securitisations. Other factors, such as stamp or other taxes that might arise on the transfer, may also inhibit the ability to securitise assets. It is important that any fees or taxes which result in cash outflow or stress to the originator be considered.

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8. In Leveraged Loan Collateralised Loan Obligations (CLOs), a true sale opinion is often not needed because of the nature of the transfer as an arm's-length, open-market transaction; however, where a CLO transaction is structured as a transfer of assets from an originator to an SPV, DBRS Morningstar typically expects a true sale legal opinion. Likewise, in secured loan CMBS (agented CMBS) there is no sale of the loan; therefore, a true sale opinion is generally not needed.
9. An equitable assignment is one which does not fulfil the statutory or other criteria for a legal assignment, but which may nevertheless be effective to transfer benefits to the assignee. Different systems of law stipulate different requirements for a legal assignment. For example, English law provides a simple process for the transfer of both current and future intangible assets (but not obligations) in accordance with section 136 of the Law of Property Act 1925. In some civil law jurisdictions, a legal assignment may require formal notice procedures, including court processes. In others, specific legislation has been enacted to facilitate the assignment of receivables and other legal rights for the purposes of securitisation.
10. This may be applicable in jurisdictions based on common law.
11. The perfection of transfers or of security interests can have different meanings in different jurisdictions. For the purposes of this publication, it is generally intended to refer to any steps required to ensure that the transfer or security interest is enforceable against third parties and, in particular, any steps required to ensure that the transfer or security interest remains enforceable on the bankruptcy of the transferor or party granting the security interest.

DBRS Morningstar usually reviews the transaction documents and/or the legal opinions to assess whether the transaction meets the requirements of the laws of the relevant jurisdiction(s) to achieve a true sale of the assets, together with the practical steps contemplated in connection with the perfection of the transfer. DBRS Morningstar typically considers (1) whether any further steps that might be required to complete or perfect the transfer have been adequately provided for within the structure[12] and are likely to remain within the control of the SPV and (2) the implications for the structure and, in particular, the Rated Securities while those steps remain unfulfilled.

Preference and Avoidance of Transfer

Insolvency laws in most jurisdictions include provisions that give rise to a risk that the transfer of assets could be set aside and declared void because of the insolvency of the seller (usually in circumstances where the insolvency occurs as a result of such transfer, or within a specified time frame of the date of such transfer). Across Europe, it is typical to find legislation creating a statutory basis for the unwinding of any such transfer transaction that, in public policy terms, is regarded as unfairly prejudicing the creditors of an entity that is insolvent or, soon after the relevant transfer, enters into formal insolvency proceedings. The risk periods and other factual matters vary from jurisdiction to jurisdiction, as do the evidential and legal criteria required to be shown for the relevant transaction to be successfully challenged.

As a result of the complexity of the analysis, DBRS Morningstar normally anticipates that counsel appointed to the transaction conducts an analysis of this so-called clawback risk in the relevant jurisdictions to determine if appropriate mitigants are in place. As the clawback is predicated on the insolvency of the originator, its current and historic credit ratings are relevant considerations. Below investment-grade or deteriorating credits typically warrant greater consideration of these clawback risks. DBRS Morningstar considers legal opinions covering certain clawback-related risks (e.g., treatment under certain statutory clawback periods and the length of such periods). DBRS Morningstar also considers representations in the transaction documentation from the originator as to its solvency, as well as support that can be provided through searches of public registries. DBRS Morningstar anticipates, where applicable, director’s solvency certificates to have been issued and may request additional information following their production.

12. Where the obligors are not notified immediately of the asset assignment, the provision for subsequent notification is often triggered by a reduction in the creditworthiness of the originator. In such cases, DBRS Morningstar evaluates whether the events triggering such notification are commensurate with the assigned rating.

True Sale Opinion

Where relevant, to gain comfort that the transfer of assets from an originator or seller to the SPV constitutes a true sale, DBRS Morningstar typically reviews a true sale legal opinion. This opinion is expected to clearly describe the legal basis of the transfer of the relevant assets. A number of matters are expected to be covered to ensure that an SPV is considered bankruptcy remote from the originator, including confirmation of the following:

- The transfer of the assets from the seller to the SPV[13] constitutes a true sale;
- In jurisdictions where a statutory framework for securitisation exists, the various criteria for such framework have in fact been satisfied;
- The transfer is valid and would not be expected to be recharacterised by a court as a secured loan;
- The assets transferred to the SPV would not form part of the originator's bankruptcy estate on its insolvency;
- In the event of the bankruptcy or insolvency of the originator, neither the SPV nor any of its assets would be substantively consolidated into the estate of the originator; and
- The transfer would not be capable of being legally challenged, set aside, or otherwise determined to be void under any applicable preference), fraudulent transfer, or other similar legislation designed to protect creditors.

DBRS Morningstar expects the opinion to describe the legal basis of the transfer of the relevant assets and to review the relevant statutes and case law in relation to the above points in order to provide an analysis of each of these considerations in light of the circumstances and context of the transaction[14].

The same considerations described above apply, mutatis mutandis, to the assignments carried out in favour of a ReoCo.

Secured Loan Structures

As an alternative to a true sale structure, it may be possible to separate the assets from the insolvency risk of an originator by using a secured loan structure. In such structures, an insolvency or similar proceeding of the originator either should not interfere with the payments due or the interference should be limited in time and a source of liquidity is available to cover any payment delays to the investors. Many of the issues and considerations that apply to true sale structures apply equally here and have to be addressed in secured loan structures. DBRS Morningstar typically reviews such transactions on a case-by-case basis.

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13. Where the transaction involves an intermediate transfer to another entity before the assets are transferred to the SPV issuing the asset-backed security (ABS), each transfer must be on a true sale basis.

14. Nevertheless, DBRS Morningstar may modify its expectation to receive true sale opinions if, in its view, such opinions would be unduly onerous or add little benefit, such as in cases of open-market arm's-length transfers of assets between unaffiliated parties. DBRS Morningstar considers such transfers and the need for legal opinions on a case-by-case basis.

Special-Purpose Vehicles

An SPV is an important element in a structured finance transaction, as it is the SPV which purchases the assets from the seller (which may be the originator) and issues the securities. Therefore, the SPV is the linchpin that allows the credit risk of the originator to be separated from that of the assets transferred. Given its pivotal role, the SPV must be established and structured carefully to be able to perform its function as required by the transaction documents and to ensure that additional insolvency risks of the originator (or seller) are not introduced by its formation or its conduct, including any relationships it may have with third parties. Since the formation and subsequent activities are of integral importance, there has generally been a preference for newly formed SPVs. Where an entity is newly formed, its organisers can create the SPV with a singular purpose in mind. Furthermore, as a newly formed entity, the SPV would not have had the opportunity to have engaged in activities or relationships which could negatively affect the structured finance transaction.

The most important characteristic of an SPV is bankruptcy remoteness. An SPV can only be considered bankruptcy remote when it, along with the assets it holds, is isolated from the insolvency of any other party to the transaction or from the claims of the creditors of any party to the transaction (in each case, including but not limited to the seller or the originator), and when the possibility of the SPV's own insolvency is limited. These limitations include restrictions on holding other assets and engaging in other activities that could attract liability or additional risk.

Certain structured finance transactions involve more SPVs in addition to the issuer SPV. These additional SPVs—intermediate companies or ReoCos, as mentioned above—also need to be structured as bankruptcy-remote entities and are expected to comply with the SPV criteria set out below; however, there may be circumstances where it is difficult for all SPVs to meet the criteria because of the anticipated activities of the relevant entity and the nature of the underlying assets[15]. In these circumstances, DBRS Morningstar generally expects the transaction to be structured to mitigate these risks to the greatest extent possible and analyses any remaining risks on a case-by-case basis.

Forms of SPVs

Several types of legal entities are available to be used as an SPV. The type of legal entity used depends on the jurisdiction of its establishment and, in Europe, the entity is typically either a corporation (for example, in the UK, France, the Netherlands, and Italy) or a fund (for example, in Spain, Portugal, and France). In the jurisdictions with specific securitisation laws, the form of the SPV is generally driven by the relevant securitisation statute. In other cases, the transaction parties select the type of entity and structure that best suits their needs and the objectives of the transaction. For example, the choice of structure may be driven by the desire to obtain tax neutrality for the SPV and/or by the asset class involved. Regardless of the structure chosen, bankruptcy remoteness is a prerequisite of any SPV used in a securitisation and must be present in order to obtain the benefits of securitisation.

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15. This may be the case, for example, for property holding companies in CMBS transactions. Such SPVs may not meet the criteria because they own and/or manage commercial properties and may also be part of a separate corporate group.

Characteristics of an SPV

While each transaction and structure exhibits its own unique traits, DBRS Morningstar expects all SPVs to display certain common characteristics[16]. These characteristics are dictated by the need to ensure bankruptcy remoteness, and generally fall under one of two categories:

- Those intended to ensure that the SPV does not engage in any activities (other than those incidental to the setup of the securitisation) or make any changes to its ownership and/or organisational structure and/or funding that could (1) produce creditors other than the holders of the Rated Securities and certain other anticipated parties or (2) put itself, its assets, or the credit rating of the Rated Securities at risk; or
- Those intended to ensure that the SPV maintains an identity independent from that of its parent, if any, and the seller and/or the originator[17].

Activities and Changes That Could Put Assets at Risk

Structured finance transactions can achieve a better credit rating than that of a seller or an originator's own credit rating, partly because the SPV has no existing creditors other than those related to the securitisation and has not been engaged in any activities other than those incidental to the setup of the securitisation[18]. To avoid assuming obligations to unexpected creditors, the SPV should be prohibited from engaging in any activities that are likely to produce creditors other than the holders of the Rated Securities and certain other transaction parties contemplated. In addition, the activities that the SPV will be required to perform in connection with the transaction and the legal relationships involved must be specifically delineated in the transaction documentation to ensure that these activities and relationships (1) meet certain criteria and (2) do not change in a manner not contemplated by the transaction documentation while the Rated Securities remain outstanding.

Limited Powers

The constitutive documents that set out the powers and limitations of the SPV, together with the transaction documentation, should confine the SPV's activities to those that are necessary to carry out its functions in the transaction.[19] This principally includes purchasing the assets from the seller, creating first-ranking security interests in such assets, issuing the Rated Securities, and servicing its obligations (or causing its obligations to be serviced) under such Rated Securities. Curtailing the SPV's powers must be done carefully to ensure it retains the power to enforce its rights and perform its obligations under the transaction documentation.

Debt Limitation

The SPV's ability to issue additional debt must be subject to restrictions so that holders of the Rated Securities are adequately protected[20]. The SPV generally should also be prohibited from

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16. Certain structured finance transactions, including in many cases covered bonds, do not rely on a true sale structure or include an issuing SPV.
17. There are exceptions to this general principle which DBRS Morningstar assesses on a case-by-case basis.
18. DBRS Morningstar examines exceptions to this principle and applicable mitigants, on a case-by-case basis.
19. In some jurisdictions (e.g., the UK), it is not common practice to limit powers in the constitutive documents (because of the concerns related to such doctrines as the doctrine of ultra vires), but instead to do so contractually under the transaction documents.
20. In most cases, there will be a prohibition on the issuance of further debt by the SPV, unless such debt is subordinated or pari passu with the existing securities. Where a transaction has been structured to allow for the issuance of further debt, DBRS Morningstar expects to receive prior written notice of the further issuance.

guaranteeing any other entity's obligations or pledging the assets to secure any other entity's obligations.

Limited Recourse

The documentation in any structured finance transaction should provide that all anticipated creditors of the SPV (which would include all parties to the transaction who enter into contractual relations with the SPV) agree that (1) their claims at any time against the SPV will be limited in recourse solely to the underlying assets securing the SPV's obligations[21] and (2) their claims will only be payable in accordance with the payment priorities (or waterfall) set out in the transaction documentation. Each such creditor is typically also required to agree that any claim for a shortfall will be extinguished after the assets within the SPV are fully liquidated and no further action may be taken in respect of such claim against the SPV. This, however, could give rise to taxation in a given jurisdiction so deferral of a debt extinguishment may be preferable.

Non-Petition

The limited-recourse provisions described above are usually supported by contractual undertakings from each of the creditors of the SPV that it will not use any claim for payment to seek the SPV's dissolution, winding-up, bankruptcy, or similar insolvency or court proceeding under applicable law. This undertaking is sometimes limited in time to a given period after the discharge of the obligations of the SPV towards the noteholders, the period being sufficient to exclude the possibility of a court invalidating the payments to noteholders. These so-called non-petition provisions ensure that the assets of the SPV may only be accessed by creditors in accordance with the intended transaction structure and also factors in the bankruptcy-remoteness analysis.

Intermediate Companies and ReoCos

The features described above apply, mutatis mutandis, also to intermediate companies and ReoCos. In the jurisdictions where a statutory framework exists (e.g., for intermediate companies in Luxembourg or for ReoCos in Italy), the various criteria for such framework will have been satisfied. DBRS Morningstar reviews a legal opinion confirming (among other things) that the necessary actions will be perfected. In the context of a typical crossborder European structured finance transaction, intermediate companies and ReoCos may be established in the country where the assets are located while the SPV issuing the securities may be established in a different jurisdiction. In such cases, specific legal opinions will be required for the relevant jurisdictions.

21. In the case of SPVs that are used for multiple issuances of Rated Securities (such as segregated repackaged securities or compartments), it is important that the recourse available to creditors is limited to those assets which are intended to secure only the specific series of Rated Securities, not to other assets which the SPV may hold (no cross-collateralisation).

Consolidation Risk

The purpose of using an SPV to issue debt is to separate the risks associated with a pool of assets from those of any entity that previously owned the assets. The objective is to have the SPV and the assets free from the liabilities and risks associated with the originator/seller or any parent/affiliate of the SPV, and that the cash flows of the assets support the SPV's obligations exclusively. In transactions where the use of a ReoCo is envisaged, risk associated with assets transferred to a ReoCo should be separate from the liabilities and risks associated with the previous owner of these assets.

As a result, the structure and operations of the SPV must ensure that a court would respect its legal separateness and not substantively consolidate the SPV with the originator, seller, or any parent or affiliate of the SPV.

Substantive consolidation (also sometimes referred to as the principle of piercing the corporate veil) is a doctrine that allows courts, in applicable circumstances[22], to disregard the separate legal existence of two or more entities and treat them as one entity for resolution of bankruptcy matters and any related liquidation. To avoid substantive consolidation, the SPV must maintain a separate existence and substance, and not be a sham or facade engineered for the purpose of obscuring the originator, seller, or any parent/affiliate. Furthermore, in a structured finance transaction, safeguards must be in place to minimise the possibility of the SPV's assets being consolidated with those of the originator, seller, or the SPV's parent/affiliate in the event of such originator's, seller's, or the SPV parent's insolvency.

The risk of consolidation of the SPV with the originator or any other entity and the factors taken into account by the courts varies from jurisdiction to jurisdiction[23] and there is generally no clearly defined test as to when consolidation might occur.

Nevertheless, practical steps can be taken to reduce the risk of substantive consolidation. For example, the SPV may be structured as an orphan company so that its shares are held by a trustee on trust for a charity. In addition, separateness covenants are typically built into the constitutive documents of the SPV and the transaction documents.

Separateness Covenants

To ensure the separate identity of the SPV, the transaction documents to which the SPV is a party, and where appropriate, its constitutive documents, should each contain a number of separateness covenants to contractually restrict the SPV from engaging in certain activities that would be detrimental to the integrity of the structure, while at the same time require the SPV to engage in certain others that maintain such integrity.

22. For instance, where relevant entities fail to respect the separateness of their operations, governance, administration, or organisational formalities.

23. For example, English law does not have a principle of substantive consolidation, and English courts are generally reluctant to lift the corporate veil in order to treat the assets of a separate legal entity as the assets of its parent.

Accordingly, the SPV is typically required to accept certain covenants including, but not limited to:

- To maintain its accounts, books, and financial statements separately from any other entity;
- To maintain its own office space, letterhead, and stationery;
- To pay its expenses and liabilities out of its own funds;
- To observe all formalities of its constitutive documents and not change its constitutive documents or legal status;

  To conduct business in its own name and maintain an arm's-length relationship with any parent, affiliate, and the seller or originator;
- To immediately clarify any misunderstanding as to the separation of SPV's corporate identity from that of the originator;
- To maintain adequate capital to meet its operational needs;
- To not commingle its assets with those of any other entity; and
- To refrain from acquiring any interest in, making loans to, or guaranteeing the debt of any originator.

Independent Directors

An originator (or seller) should not be in a position to control the activities of the SPV. This is especially important with respect to any decision by the SPV to voluntarily enter into winding-up, liquidation, or other formal insolvency or solvent liquidation proceedings as there may be an incentive for an originator (or seller) experiencing financial difficulty to have an SPV it controls make such a voluntary entry into proceedings in order to gain access to the SPV's assets.

In order to protect against this possibility, DBRS Morningstar typically expects that independent directors represent the majority of a corporate SPV's board of directors. A mitigant to independent board members not constituting the majority can be provisions that important corporate decisions (including amendments to the issuer's constitutive documents) cannot be made without the agreement of the independent board member(s).

Absent a board, DBRS Morningstar expects the sole director to be independent.

Corporate Benefit

In many jurisdictions, the directors of the SPV are required to be satisfied that assuming the liabilities under the terms of the securities and entering into the related transaction documentation has a corporate benefit for the SPV. This requirement can usually be satisfied by paying a fee to the SPV out of the issuance proceeds, in combination with the limited recourse and other protections afforded to the SPV to shield it from insolvency.

No Merger or Reorganisation

To ensure that the transaction cannot be affected by risk associated with other entities, the transaction documentation normally contains restrictions on the ability of the SPV to merge, consolidate, or otherwise join with another entity.

All of the features described above also apply, mutatis mutandis, to intermediate companies and ReoCos.

Security

In structured finance transactions, a security interest over the relevant assets is created to ensure that those assets will be available to satisfy the claims of the holders of the Rated Securities, but not the claims of other parties. In European structured finance transactions, the interests of the holders of the Rated Securities and other secured creditors are typically represented by a trustee, common representative, or similar entity (referred to in this methodology as the Noteholder Representative). Security is typically granted to a security trustee or security agent or its equivalent (the Security Representative) on behalf of and for the benefit of the holders of Rated Securities and specified creditors. Even in jurisdictions where a security interest is created by specific securitisation legislation over the assets transferred to the SPV, there is usually the need for a third party to assist the holders of the Rated Securities in enforcing such security interest. DBRS Morningstar expects whatever type of representative is appointed to represent the interest of the holders of the Rated Securities, to be independent, and to demonstrate sufficient experience in performing the functions required within the transaction documentation.

Security Interest and Security Opinions

In a number of European jurisdictions (such as Greece, Spain, Italy, France, and Portugal), specific legislation has been established to facilitate structured finance transactions. Provided that the relevant formalities, rules, and regulations prescribed for such transactions are complied with, the transaction may be able to benefit from statutory protections addressing key issues such as the segregation of assets and bankruptcy remoteness from the originator or seller. Such regimes may also provide other advantageous tax or regulatory incentives. Where such legislation exists and is complied with, it may not be necessary to create additional security interests as the desired result is automatically achieved under the law. When additional security is provided, however, careful consideration has to be given to security interests in transactions where there is a combination of security created under the statutory regime and security created under another set of law outside the statutory regime.

In other jurisdictions, such as the UK, there is no specific statutory regime governing the establishment of structured finance transactions[24]. In these instances, the security depends on the nature of the transaction as well as the securitised assets, but typically involves the granting of a first-ranking security interest over all its material assets by the SPV to a Security Representative on behalf of and for the benefit of the holders of Rated Securities and other specified creditors[25]. The transaction documentation should restrict the SPV (and other relevant SPVs) from creating any security interests over any of its assets other than those contemplated by the transaction documents.

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24. Although there may, of course, be specific legislation dealing with discrete aspects of structured financing, such as the UK tax regime set out in the Securitisation Companies Regulations 2006, as well as other legislation not necessarily specific only to structured finance transactions, that may nevertheless be essential to the analysis of any structured finance transaction, such as the various regulations relating to insolvency that apply throughout the EU.
25. Additional security arrangements may also be appropriate. In CMBS transactions, for instance, the holding company of the property companies generally creates security over the shares of those companies in favour of the issuer SPV and each property company grants security over its assets to the issuer SPV.

Security generally needs to be created in accordance with applicable local laws. DBRS Morningstar typically reviews a legal opinion confirming (among other things) that the security interest has been validly created and, upon completion of the necessary actions, would be perfected. In the context of a typical cross-border European structured finance transaction, assets may exist in a number of different jurisdictions and a combination of techniques may be used to create security. In such cases, opinions as to the laws of multiple jurisdictions are likely to be reviewed. DBRS Morningstar also expects certain representations, warranties, and undertakings in the transaction documents and certificates from the officers of the SPV, or originator, and/or seller confirming certain corporate and factual matters in connection with the creation and/or perfection of the security.

In common law jurisdictions and other jurisdictions in which the trust is recognised, a trust structure may often be used. Depending on the jurisdiction, other arrangements in addition to a trust structure may also be necessary to ensure that the benefit of the security avail the Noteholder Representative for the benefit of the holders of the Rated Securities[26].

Events of Default

The terms and conditions of the Rated Securities set out the events of default applicable to the transaction and the occurrence of any event of default allows the enforcement of the security and any other remedies available to the secured parties under the transaction documents by the Security Representative on behalf of the noteholders and the other secured creditors. The occurrence of certain events of default may be subject to grace or cure periods during which a particular event can be remedied. DBRS Morningstar typically reviews specified grace periods to determine whether they are consistent with the ratings assigned.

The Security Representative under the terms of the transaction documents usually has the ability to consent to or waive certain minor or technical defaults in certain circumstances, provided that doing so would not be materially prejudicial to noteholders. In practice, if the Security Representative has any doubts about the due exercise of its discretion, it typically seeks the instruction of noteholders by resolution prior to executing any such amendment, consent, or waiver. DBRS Morningstar expects to be notified promptly of any event of default that occurs, as well as prior notice of any amendment, consent, or waiver.

Enforceability by Holders of the Rated Securities

To ensure an orderly realisation of the security in accordance with the transaction documents, the right to enforce the security is usually exercised by the Security Representative on behalf of the noteholders, who typically have no unilaterally exercisable rights of enforcement except in exceptional circumstances[27].

26. For instance, in order to ensure the valid creation of security rights in favour of a security trustee under Dutch law, the SPV typically undertakes via a parallel debt arrangement to pay to the security trustee, by way of a parallel debt under the same terms and conditions, an amount equal to the aggregate of all its obligations to the beneficiaries of the security pursuant to the transaction documents.

27. Such as where the Security Representative, having become bound to do so, fails to perform its responsibilities within a reasonable time.

Credit Enhancement

DBRS Morningstar's rating analysis focuses on the assessment of credit enhancement available to support the securities issued in connection with the transaction, and the relative ranking of the issuer's obligations, which is usually provided in the priority of payments and may include triggers related to asset performance. Credit support can be provided in various forms including overcollateralisation (OC), excess spread, reserve accounts, and subordination, each of which is discussed in greater detail in the next section. Transactions may also include third-party support agreements, such as guarantees or surety insurance.

Subordination

European structured finance transactions typically include multiple classes (i.e., tranches) of debt where the noteholders have either senior or subordinate claims on collateral cash flows. Including subordinate debt in the SPV's capital structure creates protection for the more senior noteholders. Collateral losses are typically applied in reverse order, with the most junior bond absorbing losses first. The most senior bond will be the last bond to absorb losses and will receive principal payments ahead of the other bondholders given its priority claim on the collateral. The holders of senior tranches have priority over junior tranches in respect of payments due, enforcement claims, and/or acceleration of the debt until the claims of the holders of the senior tranches are satisfied.

Excess Spread

Another form of credit enhancement which may be present in a transaction is excess spread. Excess spread arises when the amount that the SPV pays in respect of its liabilities is less than the yield amount it receives from the underlying assets. The transaction may be structured such that, in certain circumstances, the SPV retains some or all of excess spread through the mechanism of trapping in a reserve fund or a principal deficiency ledger (PDL), thus improving the credit enhancement available to the Rated Securities it issues[28].

Reserve Funds

Transactions may be structured with one or more reserve funds. The purpose of the reserve funds is to supplement the cash flows from the collateral and to provide liquidity and/or credit support to one or more classes of securities. Reserve funds are typically funded at issuance although they can also be designed to trap excess spread until a targeted balance is achieved. Reserve funds are typically held in a deposit account with an eligible institution and are invested in high-quality, short-term securities. Reserve funds can provide liquidity to a transaction when there is a sharp spike in arrears or losses.

Overcollateralisation

OC refers to the situation where the SPV issues securities in an amount less than the value of the collateral (meaning the advance rate is less than 100%) and where the SPV's securities are overcollateralised in terms of face values. OC is available if the assets of the SPV are greater than its

28. For instance, it is common in RMBS or certain ABS transactions to have a principal deficiency ledger to record losses taken on the underlying assets. Excess spread is then used to reduce the losses accumulated in the ledger on an ongoing basis. Excess spread may also be used to ensure that reserve accounts remain funded at target levels.

liabilities. Consequently, when some assets do not perform, or the assets have to be liquidated, sufficient assets may still be available to cover the SPV's remaining obligations.

Financial Guarantee or Surety Insurance – Wraps

Transactions may include a financial guarantee or surety insurance from a third party to provide additional credit support. DBRS Morningstar assesses the value of any additional credit enhancement provided by such insurance on a case-by-case basis. In order for DBRS Morningstar to rate a security on the basis of the guarantor's credit strength, DBRS Morningstar would expect the guarantee to present the same characteristics as those listed in the subsection Guarantees below under the Transaction Parties section.

Liquidity Facilities

Liquidity facilities from an eligible institution can be an essential part of structured finance transactions to cover temporary cash flow interruptions. However, to the extent that liquidity facility draws have to be repaid senior in the priority of payments when collections become available, the liquidity facility provides temporary liquidity versus credit enhancement. See the Liquidity Providers section for more details.

Transaction Parties

The performance of a securitisation transaction depends not only on the credit quality of the underlying assets, but also on the performance of transaction parties in respect of their respective obligations. A transaction may rely on a counterparty for its operational performance, such as servicer or calculation or paying agent, or on a counterparty's credit performance to fulfil its payment obligations, such as derivative counterparty, liquidity provider, account bank with whom funds are held, or providers of securities or investments in which funds may be invested from time to time[29].

Depending on the role performed by a transaction party, additional risk may exist, such as the risk that assets or cash flows needed to meet the SPV's obligations in respect of the Rated Securities may be lost or delayed as a result of an insolvency or other failure to perform of such party. In analysing that risk, DBRS Morningstar typically reviews not just the specific role the counterparty is expected to perform, but also the exposure to that party in the context of the transaction. For instance, the exposure of the transaction to a bank account holding periodic interest payments, which may not comprise a significant percentage of the overall transaction size and may only be held in the account for a day or two, is likely to be very different from the exposure to a bank account holding all or a significant portion of the cash that will allow the SPV to repay the principal on the Rated Securities and may be held over the life of the transaction. Likewise, mitigating structural features such as liquidity facilities or reserve accounts may reduce the likelihood that the noteholders suffer a loss even if certain counterparties, such as a servicer, were to default. The default of other counterparties may inevitably have a direct impact on the position of the Rated Securities in respect of which no mitigation may be possible.

29. DBRS Morningstar recognises that, in reality, a counterparty's role typically involves elements of both operational and credit performance.

By complying with the criteria for transaction parties described below, the risk associated with a particular party to the transaction may be removed or at least significantly reduced,[30] which may allow higher ratings in respect of the Rated Securities. In addition, assuming the criteria described herein are met, the exposure of the Rated Securities to the performance of the counterparty may be mitigated to an extent sufficient to avoid analysing the risk associated with the counterparty. This is typically achieved by the inclusion of structural features by the issuer sufficient to ensure that the party will be replaced or its obligations will be collateralised, prefunded, or guaranteed as its creditworthiness deteriorates, as typically evidenced by its ratings[31], prior to the point of its default. The structural features necessary to mitigate the risk depend on a variety of factors, including the nature of the role being performed by the counterparty and its importance to the ability of the SPV to meet its obligations[32].

The transaction parties common in securitisation are described below, together with a summary of the role they perform and relevant criteria applied by DBRS Morningstar[33].

Unless otherwise stated, the criteria described in this section are generally commensurate with a AAA (sf) rating for the Rated Securities. As a general rule, less stringent criteria may result in lower ratings.

Originator/Seller

Notwithstanding a true sale of the assets, the ongoing performance of the originator or seller (in its capacity as an originator or as servicer) may be important for the transaction for a variety of reasons. A deterioration of the originator's business or financial condition may for instance reduce its ability to replace, repurchase, or substitute assets (for example, for failing to meet the eligibility criteria). As the financial health of an originator deteriorates, it may also be more inclined to relax or fail to maintain underwriting standards in an attempt to generate or maintain business volume. This risk may be more acute in a revolving transaction with frequent asset purchases or additions[34].

When the assets are transferred on the basis that underlying obligors would only be subsequently notified of the assignment, but rather that such notification would occur subsequently, the

30. DBRS Morningstar understands that it may not be possible to mitigate counterparty risk entirely and, therefore, the assumptions underlying the criteria need to be assessed in the context of the particular transaction and the counterparties involved. As a result, DBRS Morningstar may deem it appropriate to depart from the described framework in the criteria in certain cases.

31. For instance, DBRS Morningstar reviews an originator's financial condition or considers compensating factors. In its analysis, DBRS Morningstar generally classifies an originator or its group as investment grade or non investment grade. Review of the originator may include an internal assessment consistent with DBRS Morningstar policies (see Internal Assessments Global Policy at www.dbrsmorningstar.com). To the extent that no public rating is maintained on the originator and no internal assessment is performed or maintained, DBRS Morningstar generally assumes that the originator is non investment grade.

32. For instance, where the transaction party is responsible for repayment of the Rated Securities in full or in significant part it is unlikely that any set of structural features would be successful in removing the risk of that party's default from the analysis of the transaction.

33. It should be noted, however, that while DBRS Morningstar expects that the transaction framework should substantially mitigate the risk associated with exposure to a counterparty, no framework can completely remove the risk that a counterparty might nevertheless cease to perform its obligations prior to its replacement or those obligations are not fully guaranteed or adequately collateralised. DBRS Morningstar may, therefore, determine in specific cases that a rating action is warranted, notwithstanding compliance with the criteria described herein.

34. DBRS Morningstar typically reviews an originator's financial condition or considers compensating factors. In its analysis, DBRS Morningstar generally classifies an originator as investment grade or non investment grade. Review of the originator may include an internal assessment consistent with DBRS Morningstar policies (see Internal Assessments Global Policy at www.dbrsmorningstar.com). To the extent that no public rating is maintained on the originator and no internal assessment is performed or maintained, DBRS Morningstar generally assumes that the originator is non investment grade.

requirement for such notification is typically triggered by a deterioration in the creditworthiness of the originator/seller, as is often reflected in its ratings.

DBRS Morningstar also considers whether physical contracts, documents, and records of the assets purported to be sold are transferred day one, whether they will be transferred at the breach of a trigger and how this may affect the transaction. In addition, DBRS Morningstar considers in its analysis set-off (typically arising when the seller is a deposit-taking bank and/or performs other financial or nonfinancial services for the underlying borrowers), dilution, and commingling risk (see specific sections below).

Servicing

While the structure of the transaction and the quality of the assets are key factors in assigning ratings, it is collections on the securitised assets which ultimately provide the cash flows necessary for the SPV to meet its payment obligations under the Rated Securities. As the SPV does not itself possess the capability to service the assets, a third-party servicer is therefore appointed to carry out this function, acting as a point of contact with the underlying obligors and either collecting payments due on the assets itself and remitting the collections to the SPV or procuring payment by the underlying obligors to the SPV or a third-party collection agent, for ultimate distribution to the holders of the Rated Securities and other specified creditors in accordance with the transaction’s priority of payments. Furthermore, any right of the servicer to renegotiate or otherwise affect the issuer’s rights[35] under assets are considered by DBRS Morningstar.

The originator is very often the initial servicer of the securitised assets as a result of a number of economic and practical considerations[36]. The servicer (whether the originator, an affiliate, or a third party) is expected to carry out its duties in a manner consistent with which it would manage its own portfolio.

Given the importance of these cash flows to the SPV’s ability to pay amounts due on the Rated Securities, the servicer is expected to maximise collections and minimise the risk of a cash flow interruption from the underlying obligors. An insolvency or a default of the servicer in the performance is likely to increase liquidity and credit risks for the transaction. Liquidity risks may arise either as a result of a disruption in servicing activities generally and an ensuing reduction in collected funds, or, if the collections are received by the servicer and remitted to the SPV, the trapping of payments received by the servicer from underlying obligors in its insolvency proceedings (commingling). Even if servicing activities are eventually resumed or funds trapped in the servicer’s insolvency are ultimately released to the SPV, the transaction structure should ensure that sufficient funds are available from an alternate source to cover any required payments on the Rated Securities in the interim. Credit risks may arise where funds collected by the servicer are deemed to form part of the servicer’s insolvency estate, leaving the SPV with a claim as an unsecured creditor. Credit risks may also arise where, as a result of an interruption or a degradation in the servicing

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35. Such rights of modification, when there is no indemnification, are typically contractually limited.

36. In CMBS and Leveraged Loan CLO transactions, the servicing arrangements may differ substantially from those of other securitisation transactions. In CMBS transactions, the servicing functions are typically wider in scope to reflect the nature and requirements of the underlying assets, often being split between a primary servicer, master servicer, and special servicer and carried out by a combination of the originator and/or third-party servicers. Furthermore, if the role of billing and collecting may not be handled by the originator, it may present reduced risks related to servicer insolvency. In Leveraged Loan CLOs, the investment manager will typically be responsible for the management and servicing of the asset portfolio.

function, the performance of the assets themselves deteriorates, resulting in increased delinquencies and defaults[37].

There are a number of ways these risks may be mitigated.

Replacement and Backup Servicing

As the transaction should benefit from a servicer willing and capable of performing its function, DBRS Morningstar reviews the transaction documentation to determine whether a servicer is permitted to resign without a suitable replacement in place. The servicing agreement should also contain provisions allowing the termination of the initial servicer and appointment of a replacement servicer if the initial servicer becomes unable or unwilling to perform its duties under the contract[38], or if the servicer defaults on certain material obligations or under the instructions of the servicer's regulators. Termination events are expected to be proactive with early warning triggers that allow the servicing contract to be terminated before the insolvency of the servicer and may include (subject to appropriate notice and cure periods):

- Failure of the servicer to make a required payment or remittance,
- A material breach of representation or warranty given by the servicer in the servicing agreement,
- Any failure of the servicer to observe or perform a material term or covenant in the servicing agreement, and
- Appropriate bankruptcy and insolvency triggers.

Servicer termination events may also include provisions for either a backup servicer to be appointed or for the servicing to be transferred when the initial servicer fails to maintain a certain rating level.

DBRS Morningstar typically does not prescribe minimum rating levels for servicers, but instead reviews the factors relevant to the performance by the identified servicer of its role and the feasibility of its replacement, if applicable. In addition to the financial strength of the servicer and its capabilities and track record of servicing similar assets, DBRS Morningstar considers the nature of the underlying assets, the protection afforded to the holders of the Rated Securities from the laws of the relevant jurisdiction and the security structure created and, if the servicer collects payments, the procedures to redirect the payments of the underlying obligors to another account in the name of a replacement servicer, as well as the existence of other capable servicers in the relevant jurisdiction.

DBRS Morningstar also typically examines whether the transaction structure includes a party tasked with facilitating a backup or replacement servicer, if no such servicer is appointed from the outset, as well as the ability of the transaction to afford servicing fee increases. In certain transactions, it may be appropriate to have additional provisions in place to support the replacement of the servicer, including a backup service provider effective from the closing of the transaction. In such

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37. The originator will have originated the assets and will have been responsible for servicing them prior to the transfer; it is, therefore, likely to exhibit a familiarity with the assets that a third-party servicer may lack.

38. Replacement of the servicer typically incurs additional costs because of the transfer of files and information, the provision of required notices to underlying obligors, and related costs associated with the replacement servicer's assumption of responsibilities.

cases, DBRS Morningstar usually reviews the backup servicing and/or backup servicing facilitating agreement, backup servicing trigger events, and the backup servicer's capacity to assume the servicing function within given time periods.

Commingling

Commingling occurs where funds collected by a servicer (whether in an account open in its own name or in an account open in the name of the originator, where they are different entities) from the underlying obligors on behalf of the SPV (collections) are deposited in the servicer's own collection account and, in some cases, mixed with other funds until remitted to the SPV's account. If collections are commingled with other funds, it may be impossible to separate the amounts due to the SPV from those due to other creditors in instances where funds are insufficient to satisfy all claims against the servicer, or where funds due to the SPV are paid out by the servicer to a third party not providing services to the SPV, leaving insufficient funds to make payments due to the SPV. In such a scenario, the SPV may be left with an unsecured claim against the collection account holder (whether it is the servicer or the originator) should it enter into insolvency proceedings. Even in jurisdictions where statutory frameworks help to ring-fence the assets of the SPV, or where the concept of trust is recognised, the considerations set out in this section remain relevant as liquidity risk may still arise in circumstances where it would take time to identify, reconcile, and distribute the funds due to the SPV from the insolvent collection account holder's estate. This may be particularly challenging where an insolvent servicer or third party uses one collection account for numerous transactions and purposes, potentially making the task of identifying the sums due to each of the entity's creditors complex and time-consuming.

There are different approaches to mitigating commingling risk, depending on the nature of the transaction, the parties, and the jurisdictions involved[39]. In the Netherlands, for instance, it is possible for collections to be paid directly into an account in the name of a bankruptcy-remote collection foundation (stichting) and, in France, commingling risk can be mitigated by the creation of a dedicated collection account (compte d'affection spéciale) of the servicer governed by Article L214-173 of the French Monetary and Financial Code. DBRS Morningstar analyses mitigating factors on a jurisdiction-by-jurisdiction basis, considering statutory frameworks, securitisation laws (if any), legislation implementing the EU's Bank Recovery and Resolution Directive (if relevant), insolvency laws, and the recognition of trust structures.

In jurisdictions where such arrangements are not available and if other mitigating factors are absent, DBRS Morningstar assesses the likely consequences of the insolvency of the party collecting payments by reference to (1) the amount of collections that would likely be in the collection account holder's account at the time of its insolvency and (2) the consequence of this shortfall in funds received by the SPV on its ability to meet its obligations to noteholders and other creditors on a timely basis.

39. Depending on the specifics of the legal arrangements, where the collections are identified and isolated from the collecting party, the credit risk of the bank holding the funds may need to be considered.

DBRS Morningstar then considers whether the SPV would have access to other sources of funds such that it would be able to remain current on its obligations to noteholders and other creditors (liquidity risk).

If the legal analysis suggests the SPV would have an unsecured claim against the insolvent collecting party for the commingled funds, DBRS Morningstar will consider whether the permanent loss of the commingled funds would materially weaken the credit strength of the Rated Securities. Where the transaction includes an adequately sized dedicated commingling reserve, either at inception or upon the collection account holder's rating being downgraded below investment grade[40], DBRS Morningstar usually considers the risk of permanent loss to be mitigated. When assessing the potential commingling loss, DBRS Morningstar considers the potential exposure at the time of the collection account holder's insolvency, which depends on sweep frequency to the SPV account(s) as well as the distribution of borrower payments dates, and the exposure after the collection account holder's insolvency. The latter depends on the jurisdiction, in particular how payments to an insolvent entity are treated legally, and the time it could take to redirect borrower payments. DBRS Morningstar only rates securities at ratings higher than the credit strength of the collection account holder if the transaction includes structural features (such as frequent sweeps, credit enhancement, and/or cash reserves and/or a liquidity facility) mitigating liquidity and, as the case may be, credit risks arising from its potential insolvency.

Whether or not DBRS Morningstar assesses commingling risk to represent a credit risk in a transaction, for investment-grade-rated bonds and for non-investment-grade-rated bonds when the servicer/collection account bank is rated lower than the notes, DBRS Morningstar typically expects the transaction to include structural features (such as cash reserves or a liquidity facility) providing three to six months of liquidity cover for (stressed) interest payment on the notes in relation to which the rating addresses timely payment of interest, as well as to cover senior transaction costs[41].

For jurisdictions and structures in relation to which commingling risk is assessed to be not only a liquidity risk, but also a credit loss risk (limited to amounts present in the collection account at the time of the collection account holder's insolvency), besides the liquidity support described above, DBRS Morningstar generally considers commingling risk to be adequately mitigated in the following examples:

1. If the collection account holder is rated below investment grade or is unrated, only where the credit amount at risk is such that the loss of such amount would not lead to a downgrade of the senior-most notes by more than three notches[42];

40. Long-term rating of at least BBB (low) and a short-term rating of at least R-2 (low). Of relevance to the case where the collecting party is the servicer, DBRS Morningstar typically reviews a servicer's financial condition or that of its holding group. Review of the servicer may include an internal assessment consistent with DBRS Morningstar policies which may mean that, in certain cases, DBRS Morningstar may rely on public ratings assigned and monitored by other credit rating agencies. To the extent that no public rating is maintained on the servicer and no internal assessment is performed or maintained, DBRS Morningstar generally assumes that the servicer is non investment grade.

41. This will be assessed on a case-by-case basis depending on whether certain mitigants (e.g. warm backup servicer, ease of redirection of payments, and/or notification to borrowers) are provided for in the structure. If the Interest Payment Dates (IPDs) are semiannual or annual, the available liquidity should be enough to cover at least one IPD. Note also that certain asset classes (e.g., CMBS, nonperforming loans) have specific, higher liquidity needs, which are not related to commingling (please refer to asset-specific methodologies in this respect).

42. This typically corresponds to a loss of up to 20% of credit enhancement (subordination and credit reserve funds) below the senior notes.

2. If the collection account holder is rated investment grade, only where credit amount at risk is such that the loss of such amount would not lead to a downgrade of the senior-most notes by more than six notches[43].

DBRS Morningstar may still assign high ratings if the commingling risk is limited and if the collection account holder carries a rating such that the overall risk is commensurate with the ratings assigned to the liabilities of the SPV. In such circumstances, unless other mitigants (such as a commingling reserve and/or credit enhancement) are included in the structure, the rating of the SPV's liabilities would likely be linked to some degree to the rating of the collection account holder

Account Banks

A structured finance transaction typically involves the establishment of a number of accounts into which funds are deposited and once transferred to the SPV's account, held for its benefit. In a securitisation, bank accounts are used for the purposes set out below.

1. Holding Transaction Cash Flows

A. Collection Account Bank Risk

When analysing collection account bank risk, DBRS Morningstar considers the current rating of the collection account bank, any collection account bank replacement trigger, the frequency of sweeps to the issuer's account(s), as well as the maximum collections likely to be held between two cash sweeps (based on historical collection patterns, the expected maturity of the assets, and prepayment rates).

For example, the combination of a collection account bank replacement trigger set at a loss of BBB (low) and a sweep within two business days will, in most circumstances[44], be commensurate (if all other elements of the transaction support this) with a AAA (sf) rating.

Where the collection account holder (typically the originator/servicer) is rated BBB (low) or above, DBRS Morningstar does not believe collection account bank risk to be material as such entity would generally be assumed to monitor and manage its credit risk against deposit banks. Likewise, where the collection account holder is rated below BBB (low) and where commingling credit risk has been assumed in its analysis, DBRS Morningstar will not usually consider collection account bank risk. DBRS Morningstar considers that the default risk of a non-investment-grade collection account holder and of its main deposit bank are correlated, such that the incremental risk arising from the deposit bank in excess of the default risk of the collection account holder is not significant. As such, DBRS Morningstar will usually account for collection account bank risk only when there is no commingling credit risk associated with the collection account holder.

43. This typically corresponds to a loss of up to 45% of credit enhancement (subordination and credit reserve funds) below the senior notes, assuming the servicer is rated in the BBB rating category.

44. Assuming, for example, that there is no expectation of an unusual concentration of collections on any given day.

B. Issuer Account Bank Risk
As transaction cash flows are held in the issuer's account(s), if the issuer account bank were to default unexpectedly, the SPV might be short of funds to make payments on the Rated Securities on the next scheduled interest payment date.

From a liquidity perspective, a default of the issuer account bank may not necessarily lead to a default on the securities as the SPV may still have sufficient amounts after the bank default to make the required payments on the obligations, depending on the length of the collection period, concentration/distribution of collections from underlying obligors within the collection period and the time period between the interest payment date and the issuer account bank default. This may be particularly relevant for transactions where the structure allows principal collections to be used to meet interest shortfalls. If a reserve account has been funded and is held at a different institution not affected by the insolvency of the issuer account bank, then immediate liquidity may not be affected. Similarly, if an entity other than the defaulted bank is providing a liquidity facility, sufficient funds might be available to cover the shortfall caused by the issuer account bank default. However, if the issuer account bank's default results in a permanent loss of collections, there may be an impact on the credit enhancement available to the Rated Securities, should the SPV not have some form of protected creditor status in the insolvency of the issuer account bank from specific securitisation laws and/or any trust or security arrangements created. In analysing the risk of a default of the issuer account bank, DBRS Morningstar considers the amount of collections likely to be lost, as well as any mitigating features.

2. Holding Reserve Funds

An SPV may also establish an account to hold reserve funds with the same or different financial institution holding the payment accounts. Similar to the above, a default of the institution holding the reserve fund may not immediately impair the ability of the SPV to make payments on its obligations as those payments would typically be expected to be met from ongoing collections.

When the SPV does not have some form of protected creditor status in the insolvency of the issuer account bank, the loss of any reserve fund may have an impact on the credit enhancement available to the obligations. As reserve funds are typically structured to be replenished through the trapping of excess cash flows in the waterfall, the ultimate loss to the noteholders may be mitigated.

Evaluating Account Bank Risks
The risk arising from exposure to an account bank depends on (1) the magnitude of the exposure and (2) the default risk of the account bank. To assess the default risk of a bank, DBRS Morningstar considers the account bank's ratings. Where a transaction includes a provision to replace the account bank within 60 calendar days (or less) of a downgrade below a specified rating level (i.e., a downgrade trigger), the risk of the transaction experiencing a loss due to the bank's default is greatly reduced. DBRS Morningstar uses the table below to assess the risk of loss due to an account bank's failure despite the presence of a downgrade trigger. The table shows the level of risk of loss, expressed as a rating level, as a function of the current rating of the bank and the minimum rating level below which the bank would be replaced.

	Minimum Institution Rating				
	A	**A (low)**	**BBB (high)**	**BBB**	**BBB (low)**
Current Bank Rating					
AAA	AAA	AAA	AAA	AAA	AAA
AA (high)	AAA	AAA	AAA	AAA	AAA
AA	AAA	AAA	AAA	AAA	AA (high)
AA (low)	AAA	AAA	AAA	AA (high)	AA (high)
A (high)	AAA	AAA	AAA	AA (high)	AA
A	AAA	AA (high)	AA (high)	AA	AA (low)
A (low)	NA	AA (high)	AA	AA (low)	A (high)
BBB (high)	NA	NA	AA	A (high)	A
BBB	NA	NA	NA	A (high)	A
BBB (low)	NA	NA	NA	NA	A

The rating for an institution acting in the capacity of an account bank is the higher of:

- A rating one notch below the institution's long-term Critical Obligations Rating (COR);
- The institution's issuer rating or long-term senior unsecured debt rating; and
- The institution's long-term deposit rating.

If a long-term COR is not available from DBRS Morningstar on the institution, the rating reference below is generally the higher of (1) the institution's issuer rating (if available), (2) its long-term senior unsecured debt rating, and (3) its deposit rating[45].

DBRS Morningstar combines the result from the table above with an assessment of the magnitude of the exposure to the account bank, both in terms of any permanent credit loss the issuer would suffer and any potential liquidity shortfall that could arise. Where (1) exposure to the account bank in the transaction is limited to amounts consistent with typical reserve funds or periodic payments and other sources are expected to be available to the SPV to meet its imminent obligations, and (2) the bank is rated at the level of the highest-rated liabilities of the SPV or the combination of the bank's rating and a downgrade trigger results in a default risk of the bank commensurate with the rating of the highest rated liabilities of the SPV, the incremental risk arising from the account bank is generally negligible and does not constrain ratings on the issuer's liabilities. Note that the absence of a rating-based replacement provision introduces linkage between the ratings of the Rated Securities and the rating of the account bank.

There are circumstances in which either the exposure to the account bank or the default risk of the account bank (or both) is more substantial and additional analysis of the counterparty risk may be necessary. These circumstances may include situations in which (1) the counterparty performs a variety of roles (e.g., servicer, collection account bank, reserve account bank, issuer account bank, liquidity provider, and derivative provider) such that a default of the counterparty would not be fully

45. In cases where DBRS Morningstar does not maintain a public rating for a particular institution, the DBRS Morningstar Financial Institutions Group may provide a private rating or an internal assessment, which is monitored over the life of the transaction. DBRS Morningstar will notify the relevant institution and may notify the issuer and certain relevant transaction counterparties, if any such rating or assessment is downgraded to a level that results in the counterparty being rated below a relevant threshold, so that such institution may decide which of the applicable remedies to implement. In certain cases, DBRS Morningstar may rely on public ratings assigned and monitored by other credit rating agencies.

mitigated by the availability of alternative cash flows, or (2) the account bank holds all or a significant portion of the cash collateral supporting the Rated Securities for long periods during the life of the transaction, or (3) the account bank's rating is lower than that of the highest-rated liabilities of the SPV and no trigger (or too low a trigger) is present to reduce the risk of the transaction experiencing a loss due to the bank's failure.

When further analysis is necessary, DBRS Morningstar computes the additional default probability for the SPV's liabilities arising from the credit risk of the account bank by multiplying (1) the probability of the bank defaulting (including prior to the account bank being replaced, where a downgrade trigger is present) by (2) the conditional default probability of the SPV's liabilities in such a scenario of the account bank default. To measure the conditional probability of the SPV's liabilities in such a scenario, DBRS Morningstar repeats its analysis of the transaction after adjusting the structure to reflect the consequences of the bank's failure (e.g., if the account bank holds a reserve fund and periodic payments, the analysis would generally be repeated disregarding the reserve fund and assuming the loss of one period's collections, or a portion thereof). The probability of the bank failing is taken from DBRS Morningstar's Idealised Default Table using the rating of the bank (or, in presence of a downgrade trigger, the resulting risk of loss level indicated in the table above) and the weighted-average life of the SPV's liabilities. If the incremental default probability is small relative to the other sources of risk in the transaction, the risk arising from the account bank does not constrain the ratings. If it is more substantial, DBRS Morningstar will adjust its analysis to reflect the account bank risk.

The additional default probability for the SPV's liabilities arising as a result of the credit risk of the account bank is also affected by the correlation between the credit quality of the account bank and the performance of the assets. If the two risks are unrelated, the incremental default probability is higher. If the performance of the account bank and the asset pool are correlated, the account bank risk may not be fully incremental to the asset risk[46].

Funds held with an account bank should be available for withdrawal on short notice without penalty and should be held in the same currency as the transaction to avoid exchange-rate risk but may be held other than in cash, according to the criteria listed in the Eligible Investments section. Often, a structured finance transaction involves accounts into which funds are deposited and held for the benefit of a transaction counterparty, before being fully or partially transferred into an account of the SPV. Examples include servicer collection accounts and borrower accounts in CMBS. To assess a transaction's exposure to account banks of transactions parties, DBRS Morningstar considers the account bank's (or account banks') creditworthiness, potential replacement triggers and the exposure at risk, which in turn depends on payment frequency into such account(s), sweep mechanisms, and the ability of the transaction counterparty to change the account bank in case of an account bank default[47].

46. As a practical matter, most transactions where the account bank performs a variety of roles are securitisations of the bank's own assets. In such circumstances, DBRS Morningstar typically assesses the bank risk to be highly correlated with the asset risk such that, provided the bank has undertaken to replace itself upon its rating falling below "A", the account bank risk does not constrain the SPV's liabilities' ratings.

47. The (potentially negative) interest rate for cash on the account will also be considered.

Eligible Investments

Where a transaction contemplates amounts standing to the credit of the various accounts being held otherwise than in cash, DBRS Morningstar expects investments to meet the criteria set out in this section.

Eligible Investments Maturing in 30 Days or Less

Highest Rating Assigned to Rated Securities	Minimum Rating[48]
AAA (sf)	A or R-1 (low)
AA (high) (sf)	A (low) or R-1 (low)
AA (sf)	BBB (high) or R-1 (low)
AA (low) (sf)	BBB (high) or R-1 (low)
A (high) (sf)	BBB or R-2 (high)
A (sf)	BBB (low) or R-2 (middle)
A (low) (sf)	BBB (low) or R-2 (low)
BBB (high) (sf)	BBB (low) or R-2 (low)
BBB (sf)	BBB (low) or R-2 (low)
BBB (low) (sf)	BBB (low) or R-2 (low)
BB (high) (sf)	BB (high) or R-3
BB (sf)	BB or R-4
BB (low) (sf)	BB (low) or R-4
B (high) (sf)	B (high) or R-4
B (sf)	B or R-4
B (low) (sf)	B (low) or R-5

Eligible Investments Maturing in Greater Than 30 days

	Senior-Most Tranche Rated AA (low) (sf) and Above	Senior-Most Tranche Rated Between A (high) (sf) and A (low) (sf)	Senior-Most Tranche Rated BBB (high) (sf) and Below
Maximum Maturity	Rating	Rating	Rating
90 days	AA (low) or R-1 (middle)	A (low) or R-1 (low)	BBB (low) or R-2 (middle)
180 days	AA or R-1 (high)	A or R-1 (low)	BBB or R-2 (high)
365 days	AAA or R-1 (high)	A (high) or R-1 (middle)	BBB or R-2 (high)

In addition, the following criteria apply to all eligible investments:

- Eligible investments should mature no later than one business day before the date when the funds from the investments are required, taking into account any grace period that might apply to the relevant investment;
- Eligible investments should be denominated and payable in a specified currency such that no exchange rate risk is introduced to the transaction; and
- Eligible investments should normally return invested principal at maturity[49].

48. Long-term and short-term senior unsecured debt rating.

49. In a low or negative interest rate environment, DBRS Morningstar will consider investment which does not return the invested principal and will typically apply cash flow stresses to reflect negative carry.

DBRS Morningstar typically reviews the types of investment that are permitted by the transaction documentation. Such review generally includes any characteristics of the securities which would make such securities incompatible with the ratings contemplated. Depending on the nature of the proposed investment, DBRS Morningstar may also consider concentration limits commensurate with the assigned rating. Eligible investments generally do not include securities issued as part of the transaction itself or related transactions.

In the event that the relevant securities are downgraded below the rating threshold above, DBRS Morningstar does not expect the SPV to sell the securities (if allowed under the arrangement) unless this could be achieved without resulting in a loss. Instead, the securities would be allowed to mature, at which point the proceeds could be used to invest in eligible securities.

The criteria discussed above are relevant, similar to the criteria for account banks, where the funds invested are expected to be limited in amount and a default on the issuer of the eligible investments is unlikely to result in a default of the Rated Securities[50]. Different criteria may be appropriate where the relevant investments are expected to provide for the full repayment of the Rated Securities or were otherwise the primary collateral for those Rated Securities, which may be the case in synthetic transactions.

Liquidity Providers

Liquidity facilities can be an essential part of structured finance transactions to cover temporary cash flow interruptions. The appropriate size and importance of liquidity depend on a variety of factors, such as the type of assets securitised and their granularity, the rating of the servicer, the ability to transfer servicing functions quickly, the presence of an existing backup servicer, and the specifics of securitisation and/or insolvency laws in the relevant jurisdiction and their impact on the transaction.

The criteria that DBRS Morningstar uses to evaluate liquidity providers are generally consistent with those applied to other counterparties, with one notable exception: on a downgrade of the provider that no longer has a long-term COR of at least "A" or if a COR is not available on the provider, an issuer rating or long-term senior unsecured debt rating of at least "A", DBRS Morningstar typically expects the documentation to provide for a draw on the liquidity facility for the full amount within 30 calendar days of the downgrade, unless the liquidity provider transfers the facility to, or arranges a guarantee from, an eligible counterparty within a 30 calendar-day period or reserve funds are expected to be available to meet payment obligations due and such reserves are not held with the same entity that issues or holds the eligible investments. Any amount drawn should be deposited in an account with an eligible account bank. DBRS Morningstar also notes that, as liquidity facilities represent unfunded support, it may be possible for the SPV to engage a replacement liquidity provider following the default of the original counterparty as long as sufficient funds were available through transaction cash flows to meet any commitment fees. The SPV may also benefit from other structural features to mitigate the counterparty risk (for example, the inclusion of an obligation on the counterparty to replace itself on loss of a higher rating, but within a longer time frame). DBRS Morningstar considers such structural mitigants on a case-by-case basis.

50. For example, where a repo or put arrangement had been entered into allowing the SPV to sell the securities.

Consistent with the provisions in relation to the account banks and eligible investments, the criteria discussed in the section above are relevant where the exposure of the Rated Securities to the liquidity provider is generally limited (for example, where the liquidity offered is sized to cover only a number of interest periods in respect of the Rated Securities and the default of the liquidity provider is unlikely to result in a default of the Rated Securities). Different criteria would apply where the liquidity provides more substantial support, such as in the case of traditional asset-backed commercial paper conduits.

Guaranteed Investment Contract Providers

A structured finance transaction may include a guaranteed investment contract (GIC), pursuant to which the provider of the GIC agrees to provide a specific rate of return on one or more transaction accounts. To the extent that the transaction relies on the GIC to pay amounts due on or senior to the Rated Securities, DBRS Morningstar expects the GIC provider to be rated and the transaction documentation to provide for a replacement of the GIC provider should that entity's ratings fall below certain levels in a manner consistent with the criteria applicable to account banks. Similarly, when the transaction relies more heavily on the performance of the GIC provider to meet the obligations in respect of the Rated Securities, the criteria above are unlikely to be sufficient to fully mitigate the risk and the exposure of the transaction to the GIC provider may need to be specifically analysed. Where the GIC is expected to provide for the full repayment of the Rated Securities, a rating higher than that of the GIC provider may not be achievable.

Securities Intermediary and Custodians

When amounts standing to the credit of reserve or other accounts are invested, DBRS Morningstar typically expects the custodian or securities intermediaries to have the same rating requirements as those applicable to account banks holding cash deposits. DBRS Morningstar recognises, however, that securities intermediaries in certain jurisdictions may be regarded as merely holding those securities on behalf of their clients and, upon an insolvency of that intermediary, the investments would remain the property of their beneficial owners, not the assets of the intermediary. In such circumstances, it may be acceptable for such investments to be held by unrated securities intermediaries, subject to DBRS Morningstar's satisfaction that no additional liquidity risk may arise upon the insolvency of the securities intermediary[51].

Derivative Counterparty

Derivatives are typically used in structured finance transactions to exchange the cash flows received by the SPV from the underlying collateral pool for the cash flows it requires in order to meet its payment obligations in respect of the securities it has issued. For example, interest rate and basis swaps can be used to convert an obligation of a fixed payment to that of an amount based on a floating index (for example, LIBOR), or an obligation with amounts determined in accordance with one basis to another (for example, three-month Euribor to six-month Euribor). Currency swaps exchange a payment stream in one currency to another. Caps, floors, and options can also be used to limit exposure to movements in interest rates or currencies.

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51. Such as where the relevant provisions of the applicable insolvency law provide for a moratorium on payments for a period following the commencement of insolvency proceedings.

For collateral pools with an amortising or uncertain repayment profile, the derivative may specify a notional amount that is linked to either the actual or projected balance of the underlying collateral[52]. Revenue or total return swaps may also attempt to match transaction cash flows more closely, as with the swap counterparty typically agreeing to exchange whatever cash flows received in connection with an underlying pool of assets (or the performing portion) for cash flows necessary to make payments on the notes issued by the SPV. Total return swaps may also be used to exchange both interest and principal payments in respect of specified assets, regardless of whether those payments have actually been received, thus also providing protection against collateral default.

In addition to derivatives that hedge cash flow mismatches, an SPV may also enter into derivatives that directly reference credit risk. Credit default swaps allow the default risk of one or more specified reference entity to be transferred, with one party (commonly referred to as the protection buyer) paying a periodic premium in exchange for the undertaking of its counterparty (protection seller) to either make a payment or purchase one or more specified obligations of the reference entity on its default. Credit default swaps may be used either to transfer risk synthetically to an SPV as a protection seller or to allow an SPV to buy protection against a credit risk to which it is exposed.

When the Rated Securities are dependent on the derivative counterparty to perform its obligations pursuant to the derivative, the transaction is exposed to the default risk of the counterparty on those obligations. DBRS Morningstar has published a separate methodology, *Derivative Criteria for European Structured Finance Transactions*, describing the criteria in the context of a structured finance transaction.

Guarantees

In traditional corporate debt financing, parent corporations often provide guarantees to support debt offered by their subsidiaries. An unconditional guarantee results in a legal obligation of the guarantor to pay the guaranteed obligations. If appropriately structured, this may allow DBRS Morningstar to apply the rating of the guarantor[53] to the obligations guaranteed.

There are a number of situations in which guarantees may be relevant in a structured finance transaction. Guarantees are frequently seen when the originator is a local or specialised subsidiary of a foreign parent. The foreign parent often guarantees the performance of the subsidiary originator's contractual obligations to the SPV as a servicer and the subsidiary originator's indemnity obligations to the SPV. In a similar manner, if a derivative counterparty or liquidity provider is a local subsidiary of a foreign company, a guarantee may allow the rating of the parent to flow through to the subsidiary's obligations if appropriately structured. The criteria for delinking transaction counterparties with rating thresholds described above typically contemplates that, on loss of the relevant rating, the counterparty would arrange a third party with a rating at or above such threshold to guarantee its obligations.

52. Derivatives that track the actual amortisation profile of a collateral pool are referred to as balance guaranteed.

53. COR when available, long-term unsecured debt rating when not.

DBRS Morningstar recognises that guarantees need to address specific jurisdictional and structural requirements, and therefore reviews each guarantee on a case-by-case basis; nonetheless, DBRS Morningstar typically expects to see the following characteristics:

- The guarantee should be an absolute, direct, irrevocable, and unconditional obligation of the guarantor;
- The guarantee should be provided by the guarantor as principal debtor rather than as surety;
- The guarantee should not be terminable until payment in full of the guaranteed obligations, unless all obligations in respect of Rated Securities have been fully discharged;
- The guarantor's obligations under the guarantee should typically rank senior to or pari passu with the guarantor's senior unsecured obligations[54];
- The guarantor should waive all defences that would otherwise be available to guarantors, including the requirement to first pursue the principal debtor;
- The guarantor should waive all rights of subrogation, reimbursement, contribution, indemnification, set-off, or participation against the principal debtor until the guaranteed obligations are paid in full;
- When the guarantee is issued for the benefit of the SPV, the SPV should be a party to the guarantee or be made a direct beneficiary of the guarantor's obligations with the guarantee being enforceable by the SPV;
- When the guarantee is issued for the benefit of the holders of Rated Securities, the Noteholder Representative or Security Representative should be a party to the guarantee or be made a direct beneficiary of the guarantor's obligations such that the guarantee is enforceable by the Noteholder Representative or Security Representative on behalf of holders of Rated Securities;
- The guarantee should be binding on successors and assigns of the guarantor;
- The guarantee should contain a statement that the guarantor has received good and valuable consideration; and
- The transaction documentation should state that the guarantee may not be amended or modified without the written consent of the Noteholder Representative or the Security Representative, with DBRS Morningstar receiving prior notice of proposed amendment or modification.

DBRS Morningstar generally expects a legal opinion from counsel for the guarantor stating that: (1) the guarantor has the capacity and authority to issue the guarantee; (2) the guarantee is an irrevocable and unconditional obligation of the guarantor, ranking equally with the senior unsecured debt of the guarantor; and (3) its legal, valid, and binding obligations are enforceable by the Noteholder Representative or the Security Representative on behalf of holders of Rated Securities in accordance with its terms. If the guarantor is located in a jurisdiction that differs from the governing law of the guarantee, DBRS Morningstar generally expects a legal opinion that a judgment obtained under the guarantee is enforceable in the guarantor's jurisdiction. The opinion also typically discusses whether any payments from the guarantor would be subject to withholding or other taxes.

DBRS Morningstar also reviews alternative forms of support offered in connection with transaction parties, such as comfort letters, keep-well agreements, and indemnities, on a case-by-case basis.

54. Occasionally, a guarantor may provide a guarantee that ranks equally with its subordinate debt and, in such circumstances, any benefit will be limited to the guarantor's subordinated debt rating.

When the support may be material to the rating analysis, DBRS Morningstar expects legal opinions confirming the validity and enforceability of such forms of support.

General Provisions Relating to Transaction Counterparties

DBRS Morningstar expects counterparties to put in place the relevant remedies on a downgrade below the relevant rating level. Unless the remedial action involves merely administrative acts (such as a draw on a liquidity facility), provisions such as the use of commercial efforts may not be regarded as providing sufficient certainty that the remedy will occur within the time frame considered by DBRS Morningstar to allow the risk associated with the counterparty to be mitigated in the manner described above.

DBRS Morningstar also considers the capability of the relevant counterparties to take the remedial actions specified, taking into account that the counterparty may be required to act at a time when it may be faced with obligations to act in other transactions. Notwithstanding that the failure of the counterparty to take the specified actions will typically entitle the SPV to terminate the contract and seek a replacement, in reality the termination may not be exercised by the SPV unless a replacement can be found. DBRS Morningstar also considers which party in the transaction will be responsible for assisting the SPV in managing relationships with counterparties generally.

DBRS Morningstar generally expects that any costs associated with the replacement of a counterparty or the guarantee of its obligations are borne by the counterparty and that the cash flows available to meet the SPV's obligations to the holders of Rated Securities would not be affected. In particular, with respect to the costs associated with the replacement of a counterparty, DBRS Morningstar expects such costs to be borne by the outgoing counterparty in case of (1) resignation of the relevant counterparty or (2) termination of its appointment for cause (i.e., where the relevant counterparty is in breach of its contractual obligations or the relevant counterparty has been downgraded)[55]. However, replacement costs might be borne by the SPV in circumstances where the replacement cannot be attributed to the outgoing counterparty (i.e., when the SPV elects to terminate the appointment of the relevant agent even where the latter is not at fault).

Asset-Specific Considerations

While structured finance transactions generally share a number of common characteristics, as discussed in the preceding sections, there are specific considerations for individual types of assets.

The nature of the underlying assets is obviously a key factor that can result in different analyses. As the underlying assets and their cash flows ultimately provide the funds that allow the SPV to fulfill payment obligations on the Rated Securities, a rigorous evaluation of the quality of those assets is essential to the rating analysis. In accordance with this methodology and its asset-specific methodologies, DBRS Morningstar typically examines factors such as the underlying credit risk, historical losses, delinquency rates and volatility, the nature and character of any interest component, payment options available to the underlying obligors, and the inherent liquidity of the assets. In addition to credit-related factors, the legal framework of the assets being securitised may

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55. Alternatively, DBRS Morningstar may address the issue by stressing the issuer's costs in its cash flow analysis.

have a bearing on the performance. This section considers issues arising from the legal nature of the assets and rights that may be associated with those assets.

Asset Warranties and Representations

Given the increasingly consumer-friendly legal and regulatory environment across Europe, it is expected that more restrictive consumer protection laws could occur in many jurisdictions, leading to modifications of credit agreements that do not comply with the new legislation or rendering the existing agreement unenforceable. As a result, there is a risk in structured finance transactions, particularly those involving assets such as credit cards or auto loans, that an underlying obligor could be released[56] from part or all of its obligations under a noncompliant loan agreement, resulting in a reduction or extinguishment of payments to the SPV.

In analysing the risk for the transaction, DBRS Morningstar generally reviews the relevant legal and regulatory framework, the expertise and experience of the originator (or seller), as well as any representations provided by the originator/seller in relation to the originated assets, among other things[57]. As the originator or seller is typically paid an asset price without such enforceability risk, it is expected to bear the risk by providing the contractual protections to the SPV, including the related eligibility criteria set out in the asset purchase agreement and, in particular, an obligation to repurchase assets that do not meet those criteria (see the Asset Eligibility Criteria subsection under the Other Features of Documentation section below) or otherwise hold harmless the SPV.

Dilution Risk

There is risk that the underlying obligor may, in certain circumstances, be legally entitled to reduce or withhold payment as a result of a breach of contract (for example, the service or asset is defective or not provided in accordance with the terms of the contract). Alternatively, the underlying obligor may be offered rebates, discounts, credit notes, or goodwill adjustments as part of the originator's customer management strategies. In either event, if the underlying obligor is able to withhold or reduce payments on assets owned by the SPV, there is a risk the cash flows available to the SPV may be reduced.

This risk may be mitigated by knowledge and practices of the originator, overcollateralisation, cash reserves, indemnities, representations and warranties (as well as, for example, renegotiation limits and repurchase obligations) from the originator or its guarantor, the eligibility criteria, and the contractual protections provided to the SPV following the breach of those criteria.

Set-Off Risk

Set-off occurs when the underlying obligor is able to apply a liability owed to it by the originator to reduce an obligation owed by it pursuant to the securitised assets, resulting in a reduced payment or no payment made to the SPV in respect of that asset. Set-off risk would not typically exist in transactions where the underlying obligor has no other contractual relationships with the originator

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56. Whether such release is automatic upon the occurrence of certain events, exercisable by the consumer during a specified period, or subject to a court or other procedure depends on the jurisdictions and the assets involved.

57. In the absence of sufficient representations or where the credit quality of the party providing the representations is insufficient to support the ratings, DBRS Morningstar reviews legal due-diligence reports and related legal opinions for matters pertaining to the legal nature of the assets.

other than the relevant securitised asset. However, the originator may maintain relationships with the underlying obligor in other capacities, such as a deposit-taking institution or a service provider, in which the risk needs to be analysed.

Even when the set-off right is validly excluded or waived by law or by contract, the behaviour of the underlying obligor would nevertheless be considered. For instance, where deposit balances with the originator were relied upon by the borrower to make payments under the relevant receivable or where DBRS Morningstar has valid reasons to believe that, notwithstanding the explicit legal provisions of the documents or the content of the opinions, underlying obligors may continue to seek to set off amounts that they felt might be owed to them at the time of the originator's insolvency. In some cases, the SPV might be entitled to bring legal actions to recover amounts incorrectly set off by those underlying obligors, but this may prove logistically challenging if the number of affected obligors is significant and especially if the SPV does not have access to individual bank account records.

While the originator is solvent and has the means to compensate the SPV for any reduction in cash flows from the assets as a result of set-off rights being exercised, there should be no loss to the holders of the Rated Securities; however, if the originator becomes insolvent, a claim by the SPV will typically be unsecured. As such, if set-off is perceived to be a material risk to the structure, an alternative compensation or cover mechanism may have to be introduced from the outset. The existence of structural features such as liquidity facilities or reserve accounts may assist the holders of Rated Securities in being better isolated from losses related to set-off following an originator default. DBRS Morningstar considers set-off risk and the effectiveness of any mitigating mechanisms (including the deposit guarantee schemes) on a case-by-case basis. Set-off risks are typically addressed by a legal opinion to ensure that related risks and mitigants are commensurate with the assigned rating.

Set-off risk may also arise from transaction parties if, for instance, a servicer seeks to apply balances standing to the credit of the collections account to set off any liabilities owed by the SPV to itself or other transaction parties in whose name the account may have been opened. DBRS Morningstar expects the transaction documentation to explicitly exclude rights of set-off between transaction parties to preserve the integrity of the payment priorities contemplated in the waterfall.

Revolving Versus Fixed Asset Pools

Structured finance transactions may involve structures with static or revolving asset pools. With a static asset pool, no new assets are added over the life of the transaction, except for ineligible assets that may need to be replaced.

By contrast, in a revolving asset pool, new assets may be added, those assets being eventually used to repay the notes upon maturity. Consequently, a current pool of collateral will not necessarily be the same as those that were initially securitised. DBRS Morningstar typically expects the transaction documentation to prescribe measures to identify the type of assets that may enter the pool after the closing date to address the potential credit migration in the pool. DBRS Morningstar may assume that the portfolio evolves in accordance with the portfolio criteria defined for the revolving period or include certain other stress factors in its analysis. DBRS Morningstar may

consider other mitigating factors that may limit, or provide insight into, portfolio migration during a revolving period.

The revolving element of an asset pool may also introduce other risks to a transaction. For example, there is the potential for clawback risk following a transferor's insolvency. For this reason, DBRS Morningstar reviews the risk of insolvency of the originator, taking into consideration its current and historic credit ratings. Non-investment-grade or deteriorating credits warrant greater consideration of these clawback risks. Accordingly, DBRS Morningstar typically reviews each transaction presenting these elements on a case-by-case basis to determine if appropriate structural mitigants are in place.

Underwriting and Eligibility Criteria

DBRS Morningstar generally examines the originator's underwriting criteria, with emphasis on underwriting standards, legal safeguards (including, for example, standard form legal agreements, procedures for security registrations, and searches for prior-ranking security interests), and collection policies. These standards and policies should be documented and formalised, and DBRS Morningstar typically expects assets that enter the asset pool, both at the time of closing and afterward, to have been originated in a manner consistent with those underwriting criteria and to be serviced in accordance with its collection policies. To the extent provided in the transaction documents, DBRS Morningstar expects to be notified in advance of any material changes in the originator's underwriting standards, legal safeguards, and collection policies and procedures to enable it to determine whether such changes present an additional risk to the Rated Securities before any additional assets may be permitted to enter the asset pool.

Even though the assets may have been originated in accordance with the originator's standard criteria, not all assets are suitable for securitisation. Eligibility criteria act as a filter, preventing unsuitable assets from entering the transaction. Typical eligibility criteria and the consequences of not meeting such criteria are described in the next section.

Other Features of Documentation

Asset Eligibility Criteria

Asset eligibility criteria is one structural mechanism used to ensure that the assets are eligible for securitisation and that asset quality is consistent, which increases the likelihood of the pool performing as expected.

Eligibility criteria are expected to be reflected in transaction documents. Some frequently encountered eligibility criteria that relate to the assets' legal status are listed below:

- Assets are freely assignable subject to proper notice to or consent from the underlying obligor;
- Assets are not in arrears (for more than a specified period) or defaulted;
- Assets have been originated according to the originator's written credit and collection policies;
- The originator and/or seller holds valid legal title to the assets;
- No liens, encumbrances, or other security exist over the assets (other than certain permitted encumbrances);
- The assets are not subject to any dispute, counterclaim, or repurchase obligation;

- The assets are not subject to set-off or other defences to payment, unless the risk is otherwise mitigated;
- No tax liabilities arise because of the transfer of the assets from an originator or seller to the SPV;
- No withholding tax will be imposed on payments made by the underlying debtors to the SPV;
- The assets create legal, binding and enforceable obligations on the underlying debtors (subject to applicable insolvency laws); and
- The assets comply with and have been originated in compliance with all applicable laws, including all relevant consumer and data protection regulations.

Different or additional eligibility criteria may be appropriate, depending on the relevant transaction and asset class. For example, Leveraged Loan CLOs may contain eligibility criteria for assets that may be added to the portfolio, although these are typically slightly different from the criteria listed above to reflect the different nature of those assets. The criteria for Leveraged Loan CLOs stipulate the type of assets that may be purchased, the currency in which the assets must be denominated, their maturity and rating, as well as prohibitions on certain assets (such as debtor-in-possession loans or payment-in-kind securities).

If it is determined that a transferred asset does not meet the eligibility criteria when it is transferred to the SPV, an originator or seller may be obligated under the transaction documentation to repurchase this ineligible asset at its outstanding principal amount, indemnify the SPV for the repurchase amount, or substitute an eligible asset of equivalent value. This obligation typically forms part of the asset purchase agreement between the originator and the SPV[58].

Covenants

To protect the interests of the holders of Rated Securities, the transaction documentation must contain contractual obligations on the SPV to perform or not to perform certain acts. In addition to the covenants related to the bankruptcy remoteness of the SPV set out above, covenants typically restrict the issuance of new debt (in particular, prior-ranking indebtedness), govern the ability of the SPV to acquire additional assets or dispose of existing ones. A breach of a covenant by the SPV generally triggers an event of default, subject to a grace period.

The following covenants are common to structured finance transactions but should be seen as an illustrative rather than an exhaustive list. The necessity, or lack thereof, of any particular covenant will be evaluated on a case-by-case basis.

Positive Covenants

The SPV typically undertakes to do the following during the life of the transaction:

- Pay interest and principal on the Rated Securities issued when due, and punctually pay all secured creditors and transaction parties in the manner provided for in the transaction documents;
- Maintain and protect the assets and the related security interests;

58. It is sometimes argued that the ability of the SPV to require an originator to repurchase an ineligible asset is detrimental to a true sale analysis, since it is suggestive of recourse back to an originator or the retention by an originator of an interest in the performance of the asset; however, provisions requiring the originator to repurchase or substitute a transferred asset if transferred in breach of a representation or warranty or that is otherwise an ineligible asset can generally be viewed instead as a mechanism for ensuring that the SPV receives assets of the nature that it has bargained (and paid) for pursuant to the transaction. DBRS Morningstar expects this issue to be covered by the true sale opinion.

- Do all things necessary to maintain the existence of the SPV under the laws of all applicable jurisdictions;
- Comply with all relevant laws and regulations;
- Pay all applicable taxes and fees levied by governments or governmental authorities;
- Take all actions necessary in connection with the granting and perfecting of the security;
- Pay the fees and expenses of the Noteholder Representative, the Security Representative, the paying agents, the servicer, credit enhancement providers, and each other agent or other third party required by the transaction documents;
- Ensure at all times the continuous appointment of each party required by the transaction documents including any successors or replacements, as required upon the resignation or removal of any of them;
- Deliver all information to the Noteholder Representative and DBRS Morningstar as may be reasonably requested;
- Provide audited financial statements in a timely manner following the end of each fiscal year; and
- Notify the Noteholder Representative or the Security Representative and DBRS Morningstar of any change of name or address of the SPV, the Noteholder Representative, or the Security Representative.

Negative Covenants

The SPV generally undertakes not to do any of the following during the life of the transaction (without the consent of the Security Representative and/or the Noteholder Representative, if applicable):

- Sell or dispose of the assets other than as contemplated by the transaction documents;
- Engage in any activities other than those contemplated by the transaction documents;
- Incur any additional debt or provide any guarantees other than those contemplated by the transaction documents;
- Permit the assets to be impaired or permit the validity or effectiveness of security created by the transaction documents to be released, impaired, or amended;
- Create new security interests over any assets of the SPV;
- Take any steps to amend, release, or revoke any guarantee or other credit enhancement relating to the transaction;
- Amend, vary, or grant any consent or waiver with respect to any transaction document;
- Consent to the resignation of any required party without the immediate appointment of a replacement in accordance with the terms of the transaction document;
- Commingle its assets with those of any other entity; and
- Merge with another entity or reorganise itself in a manner not contemplated by the transaction documentation.

Payment Priorities

The transaction documents typically contain a provision setting out the order of payments to various transaction parties. The priority of payments ensures that (1) essential payments required to maintain the structure[59] are paid first and (2) transaction parties are paid and, if applicable, reserve accounts and deficiency ledgers are credited in the order specified. This provision is often referred

59. Such as taxes (if any) and trustee fees.

to as the payment priorities provision or the waterfall. Transactions may have separate waterfalls in respect of interest and principal payments.

The priority in which amounts are paid is an essential consideration in the credit rating process. While it is in the general interest of all transaction parties that the structure continues to function, DBRS Morningstar typically expects that amounts payable to the SPVs service providers that rank senior to the Rated Securities be clearly identifiable and quantifiable, predetermined, or capped[60]. In cases where payable senior amounts are variable and not subject to a cap, DBRS Morningstar reviews the transaction's sensitivity to estimated increases to determine consistency with the assigned rating, also considering the likelihood of such costs occurring.

A separate waterfall may specify a different priority of payments upon the enforcement and realisation of the security. DBRS Morningstar normally expects the Security Representative and/or the Noteholder Representative to have access to the funds available to meet the fees, expenses, and costs of enforcement in such circumstances, which may be unknown in advance. This uncertainty is usually addressed by having such costs rank senior in the waterfall without a cap.

Indemnities

The transaction documentation usually contains provisions under which the SPV indemnifies the Noteholder Representative and/or Security Representative for most liabilities arising from actions taken in connection with the latter's responsibilities under the transaction documents (other than the liabilities arising from such parties' negligence, willful default, or fraud). The indemnity must be paid solely from the assets of the transaction security. A similar indemnity may also be granted by the SPV to other essential third parties. There could also be third-party costs related to such indemnities, such as legal costs relating to advice to the Issuer and/or transaction counterparties. DBRS Morningstar typically expects payment of any indemnity amounts ranking senior in the waterfall to payments due to holders of the Rated Securities to be capped but, in cases where indemnities are provided to third parties that take enforcement action that will benefit or protect the holders of the Rated Securities, it may be appropriate to pay the full amount of the indemnities ahead of the Rated Securities after enforcement action is commenced.

Amendments to the Transaction Documentation

The transaction documentation to which the SPV is a party is vital to the rating analysis, so DBRS Morningstar considers whether proposed variations, amendments and/or waivers will have a negative impact on holders of Rated Securities. To obtain this comfort, DBRS Morningstar typically expects that permitted variations to transaction documents are tightly controlled and that DBRS Morningstar is notified of any variation, amendment, and/or waiver in writing and in advance of effectiveness of any amendments.

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60. A notable exception may be fees and expenses of the security trustee and any receiver appointed in connection with the enforcement itself.

Legal Opinions

Satisfaction of the legal criteria outlined in this methodology can be evidenced by certificates of officers of the involved entities confirming the existence of certain factual matters or by legal opinions and/or by legal memoranda and/or by relevant due diligence reports. While the scope of the legal opinions will vary from transaction to transaction, they would typically be expected to cover the following to allow DBRS Morningstar to assess whether that the legal structure is commensurate with the assigned rating:

- The authority and capacity of the issuer, seller, and servicer;
- The legal, valid, binding, and enforceable nature of the obligations arising under each transaction document against each transaction counterparty[61] under applicable law;
- The effectiveness of the true sale (or other structural isolation) under applicable general law and, where applicable, specific securitisation statutes;
- The validity and effectiveness of all security interests created; and
- The impact of any tax regimes relevant to the structure or the parties involved on the transaction.

When DBRS Morningstar is asked to assign ratings to an existing transaction, bring-down opinions from transaction counsel may be expected to address any changes to the laws of the relevant jurisdictions since the original opinions were issued.

Taxation

An unexpected tax liability for the SPV could erode the value of the assets or the associated cash flows and affect the SPV's ability to make payments on the Rated Securities. The matters contained in this section are only an indication of various tax issues which may arise in a structured finance transaction. DBRS Morningstar expects a full tax analysis based upon the nature of the assets, the structure used, and the jurisdiction of the various parties.

Asset Level – Withholding Tax

At the asset level, the principal tax concern is to ensure that payments made in respect of the underlying assets are free of withholding tax once the assets are transferred to the SPV. This should be addressed in appropriate legal opinions and/or tax clearances.

If withholding tax is to be deducted from the payments on the underlying assets, DBRS Morningstar reviews the ability of transaction cash flows to support such taxes and/or any covenants of the underlying obligor to gross up payments for any withholding taxes.

Asset Level – Transfer of Assets

The tax opinion should confirm that the transfer of the assets from the originator to the SPV will not result in any tax liability being imposed on the SPV (for example, value-added tax (VAT)) or on the transfer itself (for example, stamp duties).

To the extent that a tax of this nature must be paid in order to ensure enforceability of the transfer, sufficient reserves or funds must be available to the SPV to meet such liabilities.

61. DBRS Morningstar will assess any exceptions to this criterion on a case-by-case basis.

SPV Level – Tax Neutrality

The principal concern at the SPV level is to ensure that all payments that flow through the SPV are tax neutral. This is generally achieved by one of three routes:

- Utilisation of a specific tax regime providing for tax neutrality in the SPV;
- All payments that flow through the SPV are fully brought into account for tax purposes, so that the SPV is taxed only on any residual profit which would typically be expected to be minimal; or
- The SPV is tax transparent and not subject to tax liabilities in its own right.

In each case, DBRS Morningstar expects satisfactory legal opinions confirming the nature of the regime in question and the assumptions (for example, in relation to accounting treatments) relied upon in determining that tax neutrality is achieved.

SPV Level – Sales Taxes

Generally speaking, it is unlikely that an EU-based securitisation SPV would be able to recover VAT paid by it in relation to services received and transaction costs. It is, therefore, important to demonstrate that the impact of such VAT has been taken into account in the cash flows of the SPV.

Residence of SPV

When an SPV is resident in a different jurisdiction from that in which other transaction parties reside, DBRS Morningstar may request confirmation of the legal framework in relevant jurisdictions and the safeguards that have been put in place to ensure that the SPV is not treated as resident for tax purposes or deemed to be carrying on business in a jurisdiction other than its jurisdiction of incorporation.

Secondary Tax Liabilities

Although SPVs are generally expected to be established to minimise the risk of consolidation with any other person for tax purposes, most jurisdictions allow tax authorities to impose taxes unpaid by one entity on other connected entities (such as the originator which owns the shares in the SPV). If there is a risk of any such taxes arising, specific comfort will be expected by DBRS Morningstar to cover this risk.

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