

SEPTEMBER 2017



METHODOLOGY

Legal Criteria for European Structured Finance Transactions

Contact Information

Christian Aufsatz

Managing Director,
Head of European Structured Finance
Global Structured Finance
+44 (0)20 7855 6664
caufsatz@dbrs.com

Claire J. Mezzanotte

Group Managing Director,
Head of Global Structured Finance
Global Structured Finance
+44 (0)20 7855 6672
cmezzanotte@dbrs.com

Jerry van Koolbergen

Managing Director,
Head of US and European SC
Global Structured Finance
+1 212 806 3260
jvankoolbergen@dbrs.com

Erin Stafford

Managing Director,
Head of North American CMBS
Global Structured Finance
+1 312 332 3291
estafford@dbrs.com

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 Global Structured Finance Related Methodologies document on www.dbrs.com. 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.

Related Commentaries

- Legal Commentary - Belgium
- Legal Commentary - France
- Legal Commentary - Germany
- Legal Commentary - Ireland
- Legal Commentary - Italy
- Legal Commentary - Netherlands
- Legal Commentary - Portugal
- Legal Commentary - Spain
- Legal Commentary - United Kingdom
- Structured Finance Commentary - Greece

DBRS is a full-service credit rating agency established in 1976. Spanning North America, Europe and Asia, DBRS is respected for its independent, third-party evaluations of corporate and government issues. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

Table of Contents

Key Updates	3
Scope & Limitations	3
Executive Summary	3
Securitisation Defined	4
Insolvency Risk and Bankruptcy Remoteness	5
Asset Transfer	5
Special-Purpose Vehicles	8
Security	12
Credit Enhancement	13
Transaction Parties	14
Asset-Specific Considerations	23
Other Features of Documentation	25
Legal Opinions	27
Taxation	27

Key Updates

For key updates in this methodology, please refer to the press release titled “DBRS Publishes Updated Legal Criteria for European Structured Finance Transactions Methodology” dated 28 September 2017.

Scope & Limitations

DBRS evaluates both qualitative and quantitative factors when assigning ratings to (or confirming ratings on) a European structured finance instrument. This methodology represents the current DBRS approach to reviewing various legal and structural elements that DBRS considers important to European structured finance transactions. It describes the DBRS approach to reviewing the underlying transaction documents and related information provided in connection with assigning or maintaining a rating or a transaction assessment, each as more fully described in this methodology. 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. Further, this methodology is meant to provide guidance regarding the DBRS methods used in European structured finance and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

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. Some of the intricacies and distinctions of the legal and regulatory environment in selected European jurisdictions may be described in commentaries published by DBRS. 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.

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 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 to medium-sized enterprise loans and other corporate debt. References in this publication are also applied by DBRS, where applicable, to covered bond programmes and structured finance transactions backed by other asset types, including commercial mortgage-backed securitisation transactions (CMBS)¹.

The criteria in this publication should not be seen as static. DBRS 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 relevant for securities rated in the highest DBRS 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 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 by the inclusion of provisions within transaction structure 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’s approach to analysing certain risks in European structured finance transactions. The criteria described herein are not requirements, and DBRS is not responsible for structuring transactions.

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 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’s *European CMBS Rating and Surveillance Methodology*.

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 assesses those structures to determine whether those transactions may be rated, and if so, what rating may be appropriate. However, DBRS 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 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 securities issuance in a transaction that transfers risk (usually in the form of collateral losses and other liabilities) and revenues through financial structuring. Securitisation has many applications, although it was initially designed as a debt-financing tool for lenders. In each case, the legal framework for securitisation is the same, but the structures themselves can vary substantially. A DBRS 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'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 a pool of assets (or the associated cash flows and contractual rights) 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. Consequently, the legal structure of a securitisation transaction 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. Bankruptcy remoteness is an 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 an originator and the SPV and the relevant laws of the applicable or jurisdiction(s). In this regard, the jurisdictional commentaries provide additional guidance regarding legal specifics of the related jurisdiction.

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.

DBRS legal criteria presented in this methodology provides a general overview of the typical structural features that protect the noteholders and addresses 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.

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 reviews such transactions on a case-by-case basis.

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 ABS notes, 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.

In the cases where the isolation of the underlying assets is possible within the issuer's bankruptcy estate, the issued securities may benefit from the ring-fencing of assets. However, to ensure continuity of payments, the asset isolation in favour of the securities must be ensured, even in the case of default of the issuer.

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 of relevance for other transaction parties, depending on their roles and required activity. Within the European Union (EU), uniform rules generally apply³ to determine the jurisdiction in which insolvency proceedings can be initiated in relation to most⁴ companies, partnerships or individuals which have their centre of main interests (COMI) situated within a member state of the EU.

DBRS typically reviews the insolvency analysis carried out by transaction counsel and/or the originator's counsel when provided. In addition, as the determination of the COMI is ultimately a question of fact not law, DBRS generally expects representations to be given in the transaction documentation by the SPV and, where relevant, the originator as to their respective COMIs.

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 SPV. For the benefits of securitisation to be realised, the assets transferred to the SPV must be isolated from the insolvency risk of the originator (and the seller, if they are different entities).

The majority of securitisation structures currently used in Europe are based on "true sale," reflecting the roots of securitisation in the United States and the recognition that a simple way of isolating the assets from the insolvency of the originator is to effect a true sale of the assets. Other structures without a true sale (such as a secured loan transaction) can be considered by DBRS on a case-by-case basis.

The way a 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 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 actual sale is not necessary since isolation or declaration of trust in favour of an SPV 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 generally anticipates to be incorporated in the transaction structure.

True Sale

A number of alternatives to the true sale structure have been developed, reflecting the variety of assets securitised and the different jurisdictions⁵ 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.

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

4. These rules do not apply to certain types of entities within the EU, such as banks, which are subject to their own specific insolvency regimes.

5. DBRS 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. For selected jurisdictions, relevant differences are referred to in the commentaries attached to this publication.

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.⁶ 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.

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 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 below in the section "Transaction Parties – The Servicer: Collection Accounts and Commingling," 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?
- **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. However, 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.

These and other factors may be considered by a court (or regulator) to determine if the sale is in fact a valid true sale or if it should be re-characterised as a form of secured lending. If the transfer is re-characterised, 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 opinion⁷ 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, reviews the relevant statuses and case law in relation to the nature, and enforceability of the transfer.

6. 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.

7. In Leveraged Loan CLOs, a true sale opinion is generally 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 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.

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 equitable⁸ or beneficial title to the assets is transferred.⁹ Additionally, the perfection¹⁰ requirements of transfer vary by jurisdiction and may range from publication in an Official Gazette (as in Italy), 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.

DBRS 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. The existence of remaining formalities (if any) and the obligations of transaction parties to effectuate these formalities in relation to the transfer should be commensurate with the assigned rating. In particular, DBRS typically considers (1) whether any further steps that might be required to complete or perfect the transfer have been adequately provided for within the structure¹¹ 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.¹²

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 normally anticipates that counsel appointed to the transaction conduct 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 considers legal opinions covering certain clawback-related risks (e.g., treatment under certain statutory clawback periods and the length of such periods). DBRS 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 anticipates, where applicable, director's solvency certificates to have been issued and may request additional information following their production.

8. 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 for the purposes of securitisation.

9. This may be applicable in jurisdictions based on common law.

10. 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.

11. 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 evaluates whether the events triggering such notification are commensurate with the assigned rating.

12. The consequences of failure to meet each of the formalities required in connection with the transfer are further discussed in the country-specific commentaries published by DBRS from time to time.

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 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 SPV¹³ 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 re-characterised 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 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

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 typically reviews such transactions on a case-by-case basis.

Special-Purpose Vehicles

The SPV is an important element in a structured finance transaction, as it is that 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. Further, 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.

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

14. Nevertheless, DBRS 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 considers such transfers and the need for legal opinions on a case-by-case basis.

Certain structured finance transactions involve more SPVs in addition to the issuer SPV. These additional SPVs 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 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 U.K., 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.

Characteristics of an SPV

While each transaction and structure exhibits its own unique traits, DBRS expects all SPVs to display certain common characteristics. 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 or make any changes to its organisational structure 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.

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 Rated Securities. 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 matter 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.¹⁶ 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 Rated Securities are adequately protected.¹⁷ The SPV generally should also be prohibited from guaranteeing any other entity's obligations or pledging the assets to secure any other entity's obligations.

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.

16. In some jurisdictions (e.g., the U.K.), it is not the common practice to limit powers in the constitutive documents (because of the concerns related to such doctrines as *ultra vires*), but instead to do so contractually under the transaction documents.

17. 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 expects to receive prior written notice of the further issuance.

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 obligations¹⁸ 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 to ensure that the assets of the SPV may only be accessed by creditors in accordance with the intended transaction structure and are also factors in the bankruptcy remoteness analysis.

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.

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,¹⁹ 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 jurisdiction²⁰ 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.

18. 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).

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

20. 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 Director

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 typically expects that the board of directors of a corporate SPV contains at least one independent director and that equivalent safeguards are included for any other form of SPV. The vote of the independent director should be required for the SPV's decision to enter into solvent or insolvent liquidation or winding-up proceedings²¹ or for the SPV to amend its constitutive documents. In casting its vote, the independent director should be required by the SPV's constitutive documents (or shareholders' agreement, as applicable) to take into account the interests of all interested parties in the SPV with explicit reference, to the extent consistent with applicable statutory requirements and the independent director's fiduciary duties to the corporation, as well as to the holders of the Rated Securities.

The definition of independent director found in the SPV's constitutive documents must ensure that the individual appointed is not an employee of or otherwise affiliated with an originator (or seller). Persons who had been employed by or associated with the originator or seller within a given number of previous years should also be typically ineligible.

DBRS typically expects SPVs to be structured to comply with the above criteria and opinions confirming the status of the SPV as well as the enforceability of, inter alia, limited recourse and non-petition provisions, in addition to a non-consolidation opinion.

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 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.

21. The SPV's constitutive documents (or shareholders' agreement, as applicable) should also contain provisions that the SPV cannot be terminated by dissolution, liquidation, winding-up or other applicable process while the SPV's obligations remain outstanding.

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 Rated Securities, but not the claims of other parties. In European structured finance transactions, the interests of the holders of 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 receivables transferred to the SPV, there is usually the need for a third party to assist the holders of Rated Securities in enforcing such security interest. DBRS expects whatever type of representative is appointed to represent the interest of the holders of 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 U.K., there is no specific statutory regime governing the establishment of structured finance transactions.²² 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.²³ 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.

Security generally needs to be created in accordance with applicable local laws. DBRS 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 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.²⁴

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 typically reviews specified grace periods to determine whether they are consistent with the ratings assigned.

22. Although there may, of course, be specific legislation dealing with discrete aspects of structured financing, such as the U.K. 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.

23. 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.

24. 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.

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 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.²⁵

Credit Enhancement

The provision of credit enhancement to the holders of Rated Securities is one of the elements of a securitisation that allows the credit rating of the Rated Securities to be above that of the seller or originator. Enhancement can be in the form of overcollateralisation (OC), subordination, excess spread, reserve funds and financial guarantees or surety insurance. These criteria address those forms of credit enhancement that are most often seen in a structured finance context.

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 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.

Subordination

Subordination is the most common form of credit enhancement in European structured finance transactions. As the SPV issues different tranches of notes to pay for the assets, the holders of the 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 (excess spread). The transaction may be structured such that in certain circumstances the SPV retains some or all of excess spread through the mechanism of trapping or a deficiency ledger, thus improving the credit enhancement available to the Rated Securities it issues.²⁶

Reserve Funds

Transactions may be structured with one or more reserve funds. The purpose of the reserve funds may be to provide liquidity and/or credit support to one or more classes of securities. Reserve funds are typically funded at closing by the sponsor or from the proceeds of the notes and, to the extent that they are used during the transaction's life, such reserves may be topped up to specified target levels through the payment waterfall.

Financial Guarantee or Surety Insurance – (Wraps)

Transactions may include the existence of financial guarantee or surety insurance from a third party to enhance the credit protection of the transaction. DBRS assesses on a case-by-case basis the value of any additional credit enhancement provided by such insurance. In order for DBRS to rate a security on the basis of the credit strength of a guarantor, DBRS would expect the guarantee to present the same characteristics as those listed in the sub-section Guarantees within the section Transaction Parties.

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

26. 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.

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 a servicer or a calculation or paying agent, or on a counterparty's credit performance to fulfil its payment obligations, such as derivative counterparties, liquidity providers, account banks with whom funds are held or providers of securities or investments in which funds may be invested from time to time.²⁷

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 as a result of an insolvency or other failure to perform of such party. In analysing that risk, DBRS 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.

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,²⁸ which may allow higher ratings in respect of the Rated Securities. In addition, assuming the criteria described herein are met in certain transactions, 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, pre-funded or guaranteed as its creditworthiness deteriorates, as typically evidenced by its ratings,²⁹ 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.³⁰

The transaction parties common in securitisation are described below, together with a summary of the roles performed and relevant criteria applied by DBRS.³¹

Unless otherwise stated, the criteria described in this section are generally commensurate with a AAA (sf) rating for the Rated Securities.

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 reduce its ability to replace assets as they are repaid, repurchased or substituted (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.³²

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

28. DBRS 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 may deem it appropriate to depart from the described framework in the criteria in certain cases.

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

30. 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.

31. It should be noted, however, that while DBRS 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 may, therefore, determine in specific cases that a rating action is warranted, notwithstanding compliance with the criteria described herein.

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

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

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 receivables, 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. The originator is very often the initial servicer of the securitised assets as a result of a number of economic and practical considerations.³³ 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 function, the performance of the receivables themselves deteriorates, resulting in increased delinquencies and defaults.³⁴

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 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,³⁵ or if the servicer defaults on certain material obligations. 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):

1. Failure of the servicer to make a required payment or remittance,
2. A material breach of representation or warranty given by the servicer in the servicing agreement,
3. Any failure of the servicer to observe or perform a material term or covenant in the servicing agreement, and
4. 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.

33. 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.

34. 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.

35. 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. Provision for these expenses and for any other reduction in cash flows associated with the replacement must be made to ensure that the changeover does not adversely affect the holders of the Rated Securities.

DBRS 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 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 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 cases, DBRS usually reviews its capacity to assume the servicing function within given time periods.

Commingling

Commingling occurs where funds collected by the servicer or a third-party collection agent from the underlying obligors on behalf of the SPV are deposited in its own general collection account and mixed with other funds until remitted to the SPV's account. If collections from securitised assets 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 relevant entity should it enter into insolvency proceedings. Even in jurisdictions such as Portugal, where statutory frameworks help to ring-fence the assets of the SPV, the considerations set out in this section remain relevant, as liquidity risk may still arise in circumstances where it would take time to identify and distribute the funds due to the SPV from the insolvent entity'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 involved³⁶. In the Netherlands, for instance, it is possible for collections to be paid directly into an account in the name of a bankruptcy remote *stichting* or collection foundation, 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.

In jurisdictions where such arrangements are not available, DBRS assesses the likely consequences of the insolvency of the party collecting payments by reference to (1) the amount of collections that would likely be commingled 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.

The amount of collections likely to be commingled is affected by the period within which the collections are to be swept to a segregated or trust collection account in the name of the SPV and the period of time that would be necessary to redirect the payments of the underlying obligors to a replacement servicer or collection agent, the sum of these two periods being the period of time during which collections would be received by the ultimately insolvent collection agent and not remitted to the SPV. The time period necessary to redirect payments is likely to vary depending on the means by which underlying obligors pay; payments by direct debit usually allow the collecting party to redirect the payments unilaterally whereas payments instructed by the obligors require notice to be sent to the obligors. If the party that has the responsibility for redirecting the payments is the insolvent collecting party and it is unable to carry out its duties, a further period may be necessary to appoint a replacement. DBRS generally assumes it would take a few days for a solvent party to redirect direct debit payments and otherwise could take up to 180 days, depending on whether it would be necessary to appoint a replacement party, whether such a replacement party is identified ex-ante and the nature of the means of payment. Having assessed how long this commingling period might last, DBRS can consider what the total amount of collections in that period is likely to be based on the payment frequency of the assets, their amortisation profile and the granularity of the securitised assets.

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

DBRS 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. If the legal analysis suggests the SPV would have an unsecured claim against the insolvent collecting party for the commingled funds, DBRS 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 collecting party's rating being downgraded below investment grade³⁷, DBRS usually considers the risk of permanent loss to be mitigated. DBRS only rates securities at ratings higher than the credit strength of the collecting party if its insolvency would neither result in a liquidity shortfall for the SPV nor a material weakening of the credit strength of the rated securities.

Account Bank

A structured finance transaction typically involves the establishment of a number of accounts into which funds are deposited and held for the benefit of the SPV. An SPV may have one or more bank accounts for the following purposes:

1. Holding transaction cash flows for subsequent payments to investors

As transaction cash flows are held in the account(s), if the 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 account bank may not necessarily lead to a default on the securities, as the SPV after the bank default may still have sufficient amounts 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 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 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 account bank default.

However, if the default of the account bank 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 account bank from specific securitisation laws and/or any trust or security arrangements created. In analysing the risk of a default of the account bank, DBRS 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 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.

3. Evaluating Account Bank Risks

Where 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, DBRS considers whether the then-current rating of the institution acting in the capacity of an account bank is at a level at least commensurate with the minimum rating³⁸ specified in the table below (which provides some guidance regarding the highest rating typically assigned to a security for an account bank counterparty currently rated at or above the minimum institution rating). A rating at or above the minimum institution rating combined with a provision to replace the account bank within 30 calendar days of a downgrade below the minimum institution rating is generally sufficient to mitigate the default risk of account bank. 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 considers such structural mitigants on a case-by-case basis.

37. Long-term rating at least BBB (low), short-term rating at least R-2 (low). Of relevance to the case where the collecting party is the servicer, DBRS typically reviews a servicer's financial condition. Review of the servicer may include an internal assessment consistent with DBRS policies (see Internal Assessments Global Policy at www.dbrs.com) To the extent that no public rating is maintained on the servicer and no internal assessment is performed or maintained, DBRS generally assumes that the servicer is non-investment grade.

38. DBRS considers, on a case-by-case basis, circumstances where the counterparty's rating is at a relevant minimum rating threshold described in this section, but is Under Review with Negative Implications at the outset of the transaction.

If an account bank is rated at or above the level of the highest rating assigned to rated securities, the default risk arising from the account bank would typically be small enough not to constrain the ratings of the rated securities, even in the absence of a rating-based replacement provision. But the absence of a rating-based replacement provision introduces linkage between the ratings of the rated securities and the rating of the account bank. For transactions in which the account bank is rated at or above the minimum institution rating, but without a replacement trigger upon a downgrade to below the minimum institution rating, please see further below.

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

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

If a long-term COR is not available from DBRS on the institution, the rating reference below is generally the higher of the institution’s issuer rating, long-term senior unsecured debt rating or deposit rating.

Highest Rating Assigned to Rated Securities	Minimum Institution Rating
AAA (sf)	A
AA (high) (sf)	A (low)
AA (sf)	BBB (high)
AA (low) (sf)	BBB (high)
A (high) (sf)	BBB
A (sf)	BBB (low)
A (low) (sf)	BBB (low)
BBB (high) (sf)	BBB (low)
BBB (sf)	BBB (low)
BBB (low) (sf)	BBB (low)

There are circumstances where the criteria described above may not be sufficient 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 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. Nevertheless, compliance with the criteria in such circumstances serves to reduce the counterparty risk, allowing higher ratings to be assigned to Rated Securities than might otherwise have been possible. Alternatively, the SPV may also benefit from other structural features to mitigate the counterparty risk, such as the inclusion of an obligation on the counterparty to replace itself on loss of a higher rating. DBRS considers other structural mitigants on a case-by-case basis.

In a situation where such exposure needs to be further analysed (for example, where the replacement rating threshold in the related transaction documents does not align with the table above), such additional analysis would focus on the consequences for the SPV from a failure of the account bank, in conjunction with any potential risk mitigations from the proposed rating triggers. Generally the lack of an appropriate rating-based replacement provision can introduce linkage between the ratings of the rated securities and the rating of the account bank. Relevant considerations include:

- The current rating of the transaction counterparty.
- The likelihood of continued access to the funds on deposit by the SPV under the resolution of the bank permitted by the relevant authorities. The assessment is based on the local financial supervisory arrangements, the authorities’ track record in dealing with failed institutions and the importance of the asset-backed market to the functioning of the financial system.
- The likely treatment of the SPV’s claims against the bank following its bankruptcy. The assessment is based on the bankruptcy laws, enforceability and the strength and independence of the judicial system.
- The size and tenor of the potential exposure.

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 below.

Eligible Investments

Where a transaction contemplates amounts standing to the credit of the various accounts being held otherwise than in cash, DBRS expects investments to meet the following criteria:

- a. For eligible investments maturing in 30 days or less:

Highest Rating Assigned to Rated Securities	Minimum Rating
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

- b. For eligible investments maturing in greater than 30 days:

Maximum Maturity	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
	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:

- 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 return invested principal at maturity.

DBRS also 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 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 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.³⁹ 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 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 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 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 considers such structural mitigants on a case-by-case basis.

Consistent with the provisions in relation to the account banks and eligible investments, the criteria discussed in this 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.

GIC 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 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. In the case 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 typically expects the custodian or securities intermediaries to have the same ratings as those applicable to account banks holding cash deposits. DBRS 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’s satisfaction that no additional liquidity risk may arise upon the insolvency of the securities intermediary.⁴⁰

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

40. 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.

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. 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.⁴¹ 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 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 to apply the rating of the guarantor 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 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.

DBRS recognises that guarantees need to address specific jurisdictional and structural requirements, and therefore reviews each guarantee on a case-by-case basis; nonetheless, DBRS 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;⁴²
- 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;

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

42. 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 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 is 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 with 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 receiving prior notice of proposed amendment or modification.

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

General Provisions Relating to Transaction Counterparties

DBRS 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 reasonable or commercial efforts may not be regarded as providing sufficient certainty that the remedy will occur within the time frame considered by DBRS to allow the risk associated with the counterparty to be mitigated in the manner described above.

DBRS 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 also considers which party in the transaction will be responsible for assisting the SPV in managing relationships with counterparties generally.

Unless equivalent protections exist under the laws of the relevant jurisdiction, DBRS typically expects to see the creation of a first-ranking security in favour of the Security Representative over any accounts, investments and the rights the SPV may have in relation to counterparties with a legal opinion(s) addressing the effectiveness of such security and rights of set-off.⁴³

DBRS 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.

43. DBRS may also request shareholder resolutions to confirm that a corporate benefit has been recognised.

Asset-Specific Considerations

While structured finance transactions generally share a number of common characteristics, as discussed in the preceding sections, there are, however, 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 pay interest and principal on the Rated Securities, a rigorous evaluation of the quality of those assets is essential to the rating analysis. DBRS 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 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.

Enforceability of Receivables

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 released⁴⁴ from part or all of its obligations under a non-compliant loan agreement, resulting in a reduction or extinguishment of payments to the SPV.

In analysing the risk for the transaction, DBRS 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.⁴⁵ 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 section further below on Other Features of Documentation – Asset Eligibility Criteria) 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, representations and indemnities/warranties 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 receivable, with the result that a reduced payment or no payment is made to the SPV in respect of that receivable. Set-off risk would not typically exist in transactions where the underlying obligor has no other contractual relationships with the originator other than the relevant receivable. On the other hand, if the originator maintains relationships with the underlying obligor in other capacities, such as a deposit account bank, 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 if DBRS believes that, notwithstanding the explicit legal provisions, underlying obligors may continue to seek to set off deposits or other amounts that they felt might be owed to them at the time of the originator's insolvency. Although the SPV might be entitled to bring legal actions to recover amounts incorrectly set off by those underlying obligors, 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.

44. 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.

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

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 expects the documentation in each case to mitigate the risk of set-off and the effectiveness of any mitigating mechanisms (including the deposit guarantee schemes) is considered 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 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 with those assets that 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 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 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.

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 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 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 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 typically expects assets that enter the asset pool, both at the time of closing and afterwards, 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 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, that asset quality is consistent and that increase the likelihood of the pool to perform as expected.

Eligibility criteria are expected to be reflected in transaction documents. Some frequently encountered eligibility criteria 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;
- Concentration levels should not exceed certain specified limits;
- 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.⁴⁶

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.

46. 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 expects this issue to be covered by the true sale opinion.

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;
- 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 as may be reasonably requested;
- Provide audited financial statements in a timely manner following the end of each fiscal year;

Notify the Noteholder Representative or the Security Representative and DBRS 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 structure⁴⁷ 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 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. As it is in the general interest of all transaction parties that the structure continues to function, DBRS typically expects that amounts payable to the SPVs to service providers that rank senior to the Rated Securities and for such amounts to be clearly identifiable and quantifiable, pre-determined or capped.⁴⁸ In cases where payable senior amounts are variable and not subject to a cap, DBRS reviews the transaction's sensitivity to estimated increases to determine consistency with the assigned rating.

47. Such as taxes (if any) and Trustee fees.

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

A separate waterfall may specify a different priority of payments upon the enforcement and realisation of the security. DBRS normally expects the Security Representative and/or the Noteholder Representative to have access to the funds available to meet the 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, wilful 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. Depending on the nature of the transaction, DBRS typically expects that payment of any indemnity amounts ranking senior in the waterfall to payments due to holders of the Rated Securities to be capped. In cases where senior indemnity amounts are variable and not subject to a cap, DBRS typically reviews the transaction's sensitivity to estimated increases to determine consistency with the assigned rating.

Amendments to the Transaction Documentation

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

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 and/or by legal opinions. 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 to assess whether that the legal structure is commensurate with the assigned rating:

- The authority and capacity of key transaction parties entering into the transaction documentation;
- The enforceability of the transaction documentation 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 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 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 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.

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 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 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 to cover this risk.



The DBRS group of companies consists of DBRS, Inc. (Delaware, U.S.)(NRSRO, DRO affiliate); DBRS Limited (Ontario, Canada)(DRO, NRSRO affiliate); DBRS Ratings Limited (England and Wales)(CRA, NRSRO affiliate, DRO affiliate); and DBRS Ratings México, Institución Calificadora de Valores S.A. de C.V. (Mexico)(CRA, NRSRO affiliate, DRO affiliate). Please note that DBRS Ratings Limited was registered as an NRSRO affiliate on July 14, 2017. For more information on regulatory registrations, recognitions and approvals, please see: <http://www.dbrs.com/research/225752/highlights.pdf>.

© 2017, DBRS. All rights reserved. The information upon which DBRS ratings and reports are based is obtained by DBRS from sources DBRS believes to be reliable. DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance. The extent of any factual investigation or independent verification depends on facts and circumstances. DBRS ratings, reports and any other information provided by DBRS are provided "as is" and without representation or warranty of any kind. DBRS hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS or its directors, officers, employees, independent contractors, agents and representatives (collectively, DBRS Representatives) be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting therefrom, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of ratings and rating reports or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS or any DBRS Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. Ratings and other opinions issued by DBRS are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness or recommendations to purchase, sell or hold any securities. A report providing a DBRS rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. DBRS receives compensation for its rating activities from issuers, insurers, guarantors and/or underwriters of debt securities for assigning ratings and from subscribers to its website. DBRS is not responsible for the content or operation of third party websites accessed through hypertext or other computer links and DBRS shall have no liability to any person or entity for the use of such third party websites. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS. ALL DBRS RATINGS ARE SUBJECT TO DISCLAIMERS AND CERTAIN LIMITATIONS. PLEASE READ THESE DISCLAIMERS AND LIMITATIONS AT <http://www.dbrs.com/about/disclaimer>. ADDITIONAL INFORMATION REGARDING DBRS RATINGS, INCLUDING DEFINITIONS, POLICIES AND METHODOLOGIES, ARE AVAILABLE ON <http://www.dbrs.com>.