



Counterparty Risk Methodology

Structured Finance / Covered Bonds / Project Finance

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1. Introduction

This document is an update of Scope Ratings' Counterparty Risk Methodology. Updates to the document only concern editorial changes, clarifications and structural reorganisation to improve comprehension and readability.

2. Areas of application

We apply this methodology to assess counterparty risk in structured finance transactions, covered bonds, project finance and aviation finance transactions, and other debt ratings that rely on structured finance techniques. The methodology should be read in conjunction with our [General Structured Finance Rating Methodology](#), [General Project Finance Rating Methodology](#) and asset-specific methodologies¹, which can be found on www.scooperatings.com. Covered bond ratings specifically are strongly linked to the issuer's credit quality and reflect rating uplifts determined according to the [Covered Bond Rating Methodology](#).

Counterparties in the context of this methodology are third-party agents that provide services to a transaction and in most cases are banks and non-bank financial institutions.

3. Summary

This methodology explains our approach to incorporating counterparty risks and their mitigants into our rating analysis. Counterparties introduce financial and/or operational risks to a transaction. Non-performance or mal-performance by a counterparty on its obligations may result in liquidity risk (e.g. payment interruption) or solvency risk and ultimately results in losses for the transaction. Our key concepts for assessing counterparty risk are:

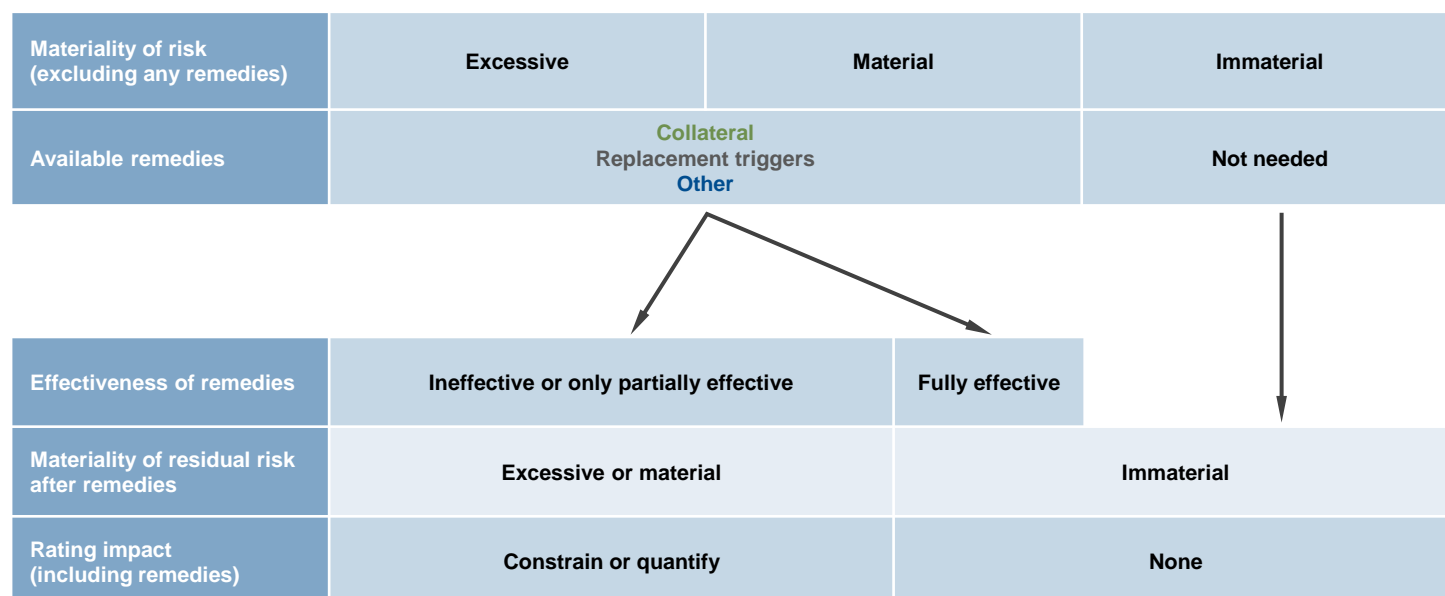
- **Type of exposure.** Our analysis differentiates between financial and operational risks.
- **Materiality of exposure.** We classify counterparty exposures as excessive, material or immaterial before accounting for any remedies that may mitigate these risks.
- **Effectiveness of remedies.** We assess the proposed remedies in terms of their ability to mitigate or reduce a counterparty exposure in the transaction.

After accounting for proposed remedies, we look at the residual counterparty risk exposure and assess it in terms of its nature, size, probability of materialisation and quantitative impact on the rating. Figure 1 summarises the different steps of the analysis.

Our rating communication generally provides a list of the relevant financial and operational counterparties along with details on their roles, as well as transaction-specific remedies to mitigate identified risks and our opinion on the adequacy of these remedies. We disclose any alternative considerations or assumptions made on a specific transaction, including instrument rating constraints due to an unremedied counterparty risk exposure.

¹ Asset-specific methodologies will highlight in case only parts of this methodology apply. For example, an asset-class specific methodology might refer to the Counterparty Risk Methodology only for the incorporation of financial counterparty risk, but not for operational counterparty risk.

Figure 1. Counterparty risk classification and rating impact



Source: Scope Ratings

4. Methodology

Our assessment of counterparty risk reflects our transaction-specific understanding of:

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

4.1 Type of exposure

4.1.1 Financial counterparty risk

Financial counterparties provide financial services related to the transaction. They include account banks (where collections or reserve funds are held), servicers, derivative counterparties, liquidity providers, credit enhancement providers and guarantors of such entities.

A financial counterparty's failure to perform may result in liquidity risk (e.g. payment interruption) or solvency risk and ultimately lead to losses for the transaction. Constant performance by a financial counterparty is essential for timely and full payment under the rated instrument.

4.1.2 Operational counterparty risk

Operational counterparties provide non-financial services related to the transaction. They include collection agents, paying agents, calculation agents, trustees, asset managers, servicers and special servicers/agents.

An operational counterparty's failure to perform may also be disruptive for the transaction and result in payment interruptions or losses for the transaction.

4.2 Materiality of counterparty risk

We classify counterparty exposures as 'excessive', 'material' or 'immaterial' based on the potential impact of a materialised risk, using the table in Figure 2 as the guiding principle. For roles not mentioned in Figure 2, we assess materiality on a case-by-case basis.

Figure 2. Standard materiality for certain counterparty roles (non-exhaustive)

Counterparty	Exposure	Standard materiality of risk (excluding any remedies)
Derivative counterparty	Financial	Material
Clearing house	Financial	Immaterial
Bank account provider	Financial	Material
Reserve bank account provider	Financial	Material, or excessive for lower-seniority rated instruments ²
Collateral holding entity in a synthetic securitisation	Financial	Excessive
Liquidity facility provider	Financial	Material
Guarantor	Financial	Role-dependent ³
Servicer	Financial/operational	Material
Paying agent	Financial/operational	Immaterial, unless there are significant cash flow concentrations
Collection or calculation agents	Operational	Immaterial
Trustee	Operational	Immaterial

Source: Scope Ratings

For the assessment of risk materiality before accounting for remedies, we deem an exposure **immaterial** if the counterparty's credit failure or non-performance would not result in a downgrade of the instrument's rating.

In addition, for the assessment of risk materiality before remedies, if the loss potential of this counterparty's default equates to more than 5% of the portfolio balance, we test whether a **material** exposure as determined per above table shall be treated as **excessive**. To perform this test or make determinations for counterparty roles not listed in Figure 2, we use the following principles:

- an unremedied counterparty exposure with a negative rating impact of seven notches or more is deemed **excessive**; and
- an unremedied counterparty exposure with a negative rating impact of one to six notches is deemed **material**.

4.3 Transaction-specific assessment of remedies

Following the assessment of risk materiality, we analyse the effectiveness of the transaction's remedies to mitigate counterparty risk, distinguishing between financial and operational counterparties. For exposures that are not immaterial, we assess whether the proposed remedies can protect the rated instruments or reduce the exposure to non-performance or mal-performance by a counterparty.

Counterparty risks may affect the transaction, especially in times of stress. Even if legally binding remedies are in place, originators may be unable to find adequately rated or willing counterparties, while replacement tends to take longer than contractually agreed.

² The credit enhancement for rated instruments with low overcollateralisation may mainly consist of cash reserves, which we would consider an excessive exposure for such lower-seniority instruments.

³ The counterparty exposure towards a guarantor depends on the role of the respective agent, whose credit profile the guarantor is supporting. Asset-related guarantees will be reflected in the asset analysis.

Following our transaction-specific assessment of remedies, we determine whether a material or excessive counterparty exposure remains. When we deem a remedy effective, this residual counterparty risk would become immaterial and have no impact on the instrument rating.

Our analysis also considers concentrations of roles in a counterparty providing multiple services (financial or operational) to the transaction. Such concentrations may result in material residual exposures, even if the individual roles show immaterial exposures after applying proposed remedies.

4.3.1 Remedies for exposures to financial counterparties

Credit risk substitution, such as collateralisation, a guarantee, or a counterparty's replacement, is a common way that a transaction isolates its credit risk from any deterioration in the credit quality of a counterparty.

Adequate remedies include pre-funding or draw-to-cash provisions in the case of liquidity facilities or other easy-to-collateralise exposures. In our view, remedies are effective only if scheduled to occur within 30 calendar days. This also assumes the relevant contractual provisions are legally sound, which we determine as part of our bankruptcy-remoteness analysis.

The following sections describe our minimum conditions to deem a counterparty risk remedy, or a set thereof, as effective.

4.3.1.1 Adequate contractual provisions for replacement

Contractual provisions detail the actions following a downgrade of the counterparty below a certain replacement level. We consider such provisions to mitigate counterparty risk if:

1. institutions agree to replace themselves with an eligible counterparty or obtain unconditional, irrevocable and first-demand guarantees from another eligible entity within 30 calendar days;
2. for the most critical roles, outgoing counterparties agree upfront to cover counterparty replacement costs;
3. the incoming counterparty assumes similar obligations and commits to the same remedies as the outgoing counterparty; and
4. the incoming counterparty has the same operational capabilities to fulfil contractual obligations.

If such remedies are not implemented within 30 calendar days, we assess whether the outgoing institution has to post collateral from the day of expiry of the 30-calendar-days period until replacement is completed. This collateral must be at a level that covers the next payment obligation, the current mark-to-market of the exposure, and a buffer capturing the volatility of the net exposure⁴ up to its next valuation. Contractual replacement provisions may also provide for the nomination of an independent third party, in addition to the counterparty, that has both the responsibility and ability to find and effect a replacement.

4.3.1.2 Replacement trigger levels

The replacement trigger levels outlined in Figure 3 mark the minimum credit quality needed on a counterparty to shield a transaction from counterparty credit risk. These levels relate to financial institutions that are important for the economic and financial system of the relevant country or Europe as a whole and therefore are likely to enter into a resolution regime if needed (see Appendix I). For unregulated financial counterparties, or those not subject to the EU's Bank Resolution and Recovery Directive, we determine whether the applicable regulatory body is likely to follow a comparable resolution approach for the entity or whether the entity is likely to fail. If we conclude that similar regulatory actions as under the Bank Resolution and Recovery Directive are unlikely, we apply a transaction-specific approach to determine the minimum credit quality needed on a counterparty to shield a transaction from counterparty credit risk.

The achievable rating levels described in Figure 3 are contingent upon appropriate risk substitution triggers and adequate, legally sound contractual provisions being in place. Aligned with Figure 2, Figure 6 in Appendix IV gives examples of potential remedies and rating triggers that support the highest instrument ratings for counterparty roles that we deem at least material pre-remedies.

⁴ The volatility of the net exposure is our view on changes in the combined value of the gross exposure and the posted collateral.

Figure 3. Replacement triggers for financial counterparties

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

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

Source: Scope Ratings

For **material exposures**, counterparties that are financial institutions with a minimum replacement trigger level of BBB/S-2 can support the highest achievable rating of AAA on rated instruments, while counterparties with a minimum replacement trigger level of B-/S-4 can still support the lowest investment grade instrument rating of BBB-. Counterparties with a minimum replacement trigger level of B-/S-4 can support all non-investment grade instrument ratings.

For **excessive exposures**, counterparties that are financial institutions with a minimum replacement trigger level of A/S-1 can support the highest achievable rating of AAA on rated instruments, while counterparties with a minimum replacement trigger level of BB/S-3 can still support a BBB investment grade instrument rating.

If a counterparty is subject to **contractual frequent margining** to collateralise its net exposure towards the issuer through payments to an issuer account, we account for the reduced exposure⁵. We deem this counterparty able to support, at the same replacement trigger level, a maximum instrument rating of one notch higher than those displayed in Figure 3, provided that the counterparty has a minimum replacement trigger level of BB/S-3. For example, a counterparty with a BBB credit quality subject to i) a replacement at loss of BB and ii) contractual daily margining would support instrument ratings up to AA- for material exposures and up to BBB+ for excessive exposures.

Counterparties whose ratings move close to a rating trigger will not automatically cause the instrument's rating to be placed 'under review for downgrade'. If a trigger has been breached and no replacement is found within the applicable timeframe, we consider efforts undertaken by the transaction's agents and the rating implications of the remaining counterparty exposure on a case-by-case basis in line with Section 4.4.

4.3.2 Remedies for exposures to operational counterparties

The operational failure of a counterparty that results in its non-performance or mal-performance may also be disruptive for the transaction, even if the issuer has **no financial** exposure to such parties. A swift replacement of such counterparties can shield the transaction from additional risk.

⁵ We review the derivative contracts to ensure that their terms result in an effective and timely reduction of the issuer's exposure to the derivative counterparty. In particular, threshold amounts and the frequency of the collateral transfer should be reasonable in the context of the transaction size and nature. Additionally, the posted collateral in favour of the issuer should be of a very low risk nature.

We analyse the risk of operational disruption in the transaction, focusing on the counterparties' track records, economic incentives and operational standards including standard of care and general liability standards. We also evaluate whether replacing the counterparty would be practical and analyse the strength and clarity of replacement mechanisms in the transaction. The analysis also considers the existence of fees covering not only a counterparty's replacement at a potentially higher cost⁶ but also the party tasked with finding the replacement. When such counterparties are rated, rating-based replacement triggers can simplify the monitoring of credit impacts for the rated notes (see Section 5: Credit quality assessment of counterparties).

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

4.4 Rating impact of residual counterparty risk after remedies

Inadequate risk mitigation or ineffective measures, such as the absence of replacement triggers, will result in counterparty risk remaining. Normally, we then account for the residual counterparty risk by constraining the instrument rating at a level linked to the counterparty's credit quality:

- For **material** residual exposures and counterparty credit qualities of **BB/S-3 or above**, instrument ratings can reach up to six notches above the counterparty's credit quality.
- For **material** residual exposures and counterparty credit qualities of **BB-/S-3 or below**, instrument ratings can reach up to four notches above the counterparty's credit quality.
- For **excessive** residual exposures, the instrument rating will be constrained at the level of the counterparty's credit quality.

Alternatively, we quantify the additional expected loss for the rated instrument arising from a materialisation of the counterparty risk. This could apply the principles outlined in Appendix III, accounting for the exposure at risk, the probability that counterparty risk materialises and the associated recovery rate upon a counterparty's failure. Further, quantification via computation of additional expected loss is recommended when the loss potential associated with a counterparty's default exceeds the exposure at risk. This could be due to uncovered replacement costs or a forced sale of collateral.

5. Credit quality assessment of counterparties

Our analysis of the remedies relating to the credit quality of a counterparty incorporates our ratings (public or not). These ratings are monitored over the life of the transaction. If we do not rate the counterparty, our counterparty assessment can also incorporate public ratings from other regulated and supervised credit rating agencies.

Rating-based counterparty replacement triggers can simplify the monitoring of credit impacts for the rated notes. Clear, transparent, independently monitored and enforceable covenants referencing financial or operational triggers may also prevent other counterparty exposures from impacting the credit quality of the notes. If replacement triggers do not refer to Scope's counterparty issuer ratings, we analyse whether available replacement mechanisms linked to other regulated and supervised credit rating agencies provide an equivalent level of protection.

For the quantification of additional expected loss from a financial exposure to counterparties as outlined in Section 4.4, Appendix II Commingling Risk Quantification and Appendix III, we incorporate ratings or credit estimates we have produced, or credit ratings from other regulated and supervised credit rating agencies.

If a counterparty risk exposure is material after the consideration of remedies and the counterparty has no rating from a regulated and supervised credit rating agency (including Scope) or other available credit quality-relevant information, we might be unable to rate the transaction or limit achievable instrument ratings at BB+.

Risks arising from unrated counterparties may also be structurally mitigated without having to refer to ratings. For example, provisions for daily cash sweeps (immaterial when considered individually) into a bank account under the issuer's name can mitigate commingling risks arising from an unrated servicer, although this method is only effective if the bank account is shielded in line with expectations for general financial counterparties (see Section 4.3.1 and Figure 6 in Appendix IV). Other remedies include additional

⁶ Our instrument rating analysis generally considers stressed senior costs to account for agent replacements at increased costs.



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credit enhancements, liquidity facilities, and payments made into a lockbox account, the latter with the purpose of limiting a service provider's access in case of insolvency and ensuring money is transferred to an eligible deposit account.

Appendix I Definitions and applicable conventions

General convention

We compare the issuer's or arranger's remedies with this methodology to establish a counterparty risk opinion. We can also assess other less standard counterparty roles and exposure mitigants.

Replacement commitment

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

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

Replacement period

Trigger levels to replace a counterparty are set to ensure the counterparty can provide services without exposing investors in rated debt to the risk potential of i) a resolution or moratorium of a regulated bank or ii) the insolvency of a service provider. We consider that a replacement period of 30 calendar days for uncollateralised exposures is enough to ensure an orderly transfer and prevent operational risks. A credit impact can even be prevented if the exposure is sufficiently collateralised after 30 days, and the counterparty is replaced within 60 calendar days. In the meantime, the provision of sufficiently detailed information reduces the uncertainty in our analysis regarding the replacement process outcome.

Other replacement triggers based on financial and operational covenants

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

Still, replacement may create new sources of risk. Maintaining smooth processes at an incrementally higher risk may even be preferable to switching service providers as it is less likely to cause disruption.

Financial and operational covenants

Liquidity risk

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

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

Solvency risk

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

We generally give credit to hot back-up servicers and incorporate the readiness and speed with which they take over servicing a portfolio. Whereas a cold back-up servicer only receives a back-up of the data file, hot back-up servicers already incorporate the relevant obligor data in their systems, perform parallel processing, and have established procedures to ensure a replacement can be deployed within days rather than weeks.

Other operational covenants

Our analysis of operational provisions considers the relevant third-party servicing market, successful past transfers and the amount of servicing fees. Regulatory or consumer-protection requirements could hinder timely replacement.

Other operational covenants include:

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

Issuer/transaction bank accounts

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

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

Collection accounts for servicers

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

Liquidity facilities

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

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

We regard as excessive any exposure to liquidity facilities that provide very substantial amounts or very material credit support to a transaction, typical for asset-backed commercial paper conduits.

Paying agents

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

Clearing houses

Clearing houses are financial institutions that facilitate the exchange of payments, securities or derivative transactions. The institution stands between two clearing members and processes the payments due among these members. The clearing house acts as counterparty to both members, thereby substituting the members' counterparty risk with its own. To reliably operate the payment/settlement processes, the clearing house has a very good counterparty credit quality, which it ensures by demanding that its members provide proper collateralisation in line with the respective trade to be processed.

Calculation agents

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

Cash administrators or cash managers

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

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

Servicers

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

Commingling risk

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

Originator and seller related counterparty risks

Set-off risk

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

Set-off exercised by a debtor on an asset may either substantially reduce or cancel out the enforceable claim, i.e. the proceeds payable to the issuer. Where such cross-claims exist or are likely to come into existence, we examine whether potential offsetable amounts are crystallised or only will be crystallised upon future actions like a future notification of the sale. Also, we review documents relating to the assets whether there are waivers of set-off and whether these are valid under the relevant jurisdiction. In case such waivers are not agreed or recognised by the applicable jurisdiction, we assess whether the structure has features that could mitigate the negative impact of set-off. If mitigating measures do not take the form of appropriately sized reserves (or similar measures) but rather of indemnities or substitution rights granted by the originator, we evaluate whether those indemnities or substitution rights affect the true sale of the securitised asset.

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

Other originator and seller related risks

For further potential losses that are triggered by an originator or seller default, such as claw-back or re-characterisation, refer to Appendix VI Legal Considerations in Structured Finance in our [General Structured Finance Rating Methodology](#) or to Appendix XII Legal Risks in Infrastructure and Project Finance in our [General Project Finance Rating Methodology](#).

EU's Bank Resolution and Recovery Directive

Banks are highly regulated and supervised due to the important role they play in economic and financial stability. Consequently, this enables a more differentiated view of bank counterparties providing services in structured finance transactions.

Regulations and the supervisory framework ensure the close monitoring of banks and provide authorities the power to intervene early when needed. One such cornerstone is the EU's Bank Resolution and Recovery Directive, or the BRRD, which requires banks to maintain sufficient levels of loss absorption and recapitalisation capacity. Bail-in tools may be used if a bank is placed into resolution. Counterparty obligations such as deposits would then benefit from their relatively high ranking in the creditor hierarchy, above that of subordinated debt, capital instruments and shareholders' equity.

Appendix II Servicer risk

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

Servicer transferability

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

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

Liquidity risk when a servicer is replaced

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

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

Resolvable financial institutions as servicers

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

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

Servicer commingling risk

Commingling risk arises when the issuer's cash is mixed (commingled) with the servicer's and deposited in an account under the servicer's name. When the servicer is insolvent, there can be financial losses (collections are irretrievable) and/or payments are delayed (collections are blocked temporarily).

We consider whether structural protection features, such as a dedicated commingling reserve or third-party guarantee, are effective at delinking the transaction from servicer commingling risks. An example of an effective feature is a reserve account in the issuer's name that covers collections over a stressed servicer holding period.

Our analysis also considers servicer exposures that cannot be delinked from the transaction.

Commingling risk quantification

We quantify and assess the potential impact of commingling risk when risk mitigants are ineffective in delinking the transaction from the servicer's credit quality. Our analysis accounts for several factors, including i) servicer credit quality; ii) legal frameworks on account segregation and insolvency; iii) the operational setup for obligor notification; iv) contractual provisions on cash-holding periods and cash-sweep frequency; and v) the characteristics of the receivables with respect to collection methods, payment clustering potential and prepayment incentives.

We add the determined⁷ loss from servicer commingling to the credit losses from the portfolio to factor in the expected economic consequences of a servicing disruption. The loss from servicer commingling considers the stressed likelihood and severity of a default of the servicer, resulting in the loss of issuer moneys held by the servicer. We consider a stress of three notches when calculating the probability of default of the servicer.

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

Figure 4. Typical stresses applied to the analysis of servicer commingling risk

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

⁷ For servicers where there is no credit assessment or rating, we deduct the full amount of the stressed exposure.

Appendix III Quantifying expected loss from financial exposure to counterparties

A financial counterparty exposure arises for the transaction when a default of a third party would expose the issuer to the risk of monetary loss. The transaction may incur losses if issuer funds form part of the insolvency estate of a third party. Counterparty exposures are often immaterial if counterparties are strong and proper risk mitigation measures are in place (see Figure 2). If this is not the case, we can estimate the additional expected loss from the counterparty exposure, considering the counterparty's credit quality (see Section 5), the amount at risk and the tenor of the exposure.

We add the loss expected in a counterparty default to the transaction's expected loss, accounting for all structural mitigants such as subordination and excess spread.

Figure 5. Typical considerations for the analysis of financial counterparty risk (for account-holding entities)

Element	Assumptions
Counterparty credit quality	The counterparty credit quality minus three notches.
Amount at risk	To determine the amount at risk we consider the actual cash sweep period.
Tenor of the exposure	The actual holding period with a floor at one month.

Our quantification of the additional expected loss from financial counterparty exposure often follows a similar logic as for the quantification of servicer commingling but is always individually tailored to the specific counterparty role.

Appendix IV Examples of counterparty types, standard materiality assessments and selected remedies

Figure 6. Examples of counterparty types, standard materiality assessments and selected remedies

Counterparty	Exposure	Standard pre-remedies materiality	Potential remedies ^{8,9}	Rating trigger to support highest instrument rating (see Figure 3)	Standard post-remedies materiality (see Section 4.4)
Derivative counterparties	Financial	Material	Collateralisation or guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2 Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify
Clearing house	Financial	Immaterial	N/A	N/A	N/A
Bank account providers	Financial	Material	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2 Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify
Reserve bank account provider	Financial	Excessive for lower-seniority rated instruments ¹⁰	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of A/S-1 Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify
Collateral holding entity in a synthetic securitisation	Financial	Excessive	Guarantee and replacement	<ul style="list-style-type: none"> AAA: risk substitution upon loss of A/S-1 Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: link to the counterparty
Liquidity facility providers	Financial	Material	Replacement/draw to cash	<ul style="list-style-type: none"> AAA: risk substitution upon loss of BBB/S-2 Alternatively: guarantee by a suitably rated institution or draw to cash at a suitably rated bank	Compliant: immaterial Else: quantify
Guarantor ¹¹	Financial	Role-dependent	Replacement	<ul style="list-style-type: none"> Role-dependent 	Compliant: immaterial Else: quantify
Servicers	Financial/operational	Material	Replacement/operational covenants	<ul style="list-style-type: none"> Operational covenants specific to the service provided (hot, or cold back-up/performance-based triggers); or Rating-based triggers to be considered on a case-by-case basis 	Compliant: immaterial Else: quantify
Paying agent	Financial/operational	Immaterial, unless there are significant cash flow concentrations	Replacement/reduction of exposure	<ul style="list-style-type: none"> Mitigating covenants specific to the service provided; or Rating-based triggers 	Immaterial
Collection or calculation agents	Operational	Immaterial	N/A	N/A	N/A
Trustee	Operational	Immaterial	N/A	N/A	N/A

⁸ Only the most common remedies are listed. We also assess for any other available remedies.

⁹ We only consider guarantees if they are payable on first demand, unconditional and irrevocable.

¹⁰ The credit enhancement for rated instruments with low levels of overcollateralisation may mainly consist of cash reserves, which we would consider an excessive exposure for such lower-seniority instruments.

¹¹ The counterparty exposure towards a guarantor depends on the role of the respective agent, whose credit profile the guarantor is supporting. Asset-related guarantees will be reflected in the asset analysis.



Counterparty Risk Methodology

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