Counterparty Risk Methodology

Structured Finance / Covered Bonds / Project Finance / Aviation Finance

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1. Introduction

1.1 Scope of application

This methodology explains our approach to assess counterparty risks for debt instruments that rely on structured finance techniques. It complements the General Structured Finance Rating Methodology, the Covered Bond Rating Methodology, the General Project Finance Rating Methodology, the Aviation Finance Rating Methodology, as well as related sub-sector methodologies[1], all available at scoperatings.com. Rating scales and definitions of ratings are available separately on scoperatings.com.

Counterparties in the context of this methodology include third-party agents that provide critical financial or operational services to the issuer. Financial counterparties include issuer account banks, derivative counterparties, liquidity providers, insurance providers and credit guarantors. Operational counterparties include roles as such asset managers, special and master servicers, paying agents, calculation agents or trustees.

Risks related to the exposure to the originator and seller of the securitised assets, such as set-off and claw-back risks, are addressed in our General Structured Finance Rating Methodology.

This methodology applies to both the assignment of new and monitoring ratings under the above-mentioned methodologies.

1.2 Key components

Key methodology components include a) counterparty credit quality assessments, b) counterparty risk materiality assessments, and c) counterparty risk rating impact assessments.

Our analytical framework is detailed in section 3. First, we assess the type of risk exposures and consider the credit quality of relevant counterparties. Second, we classify each counterparty exposure as excessive, material or immaterial, based on its potential rating impact, assuming no contractual remedies or other risk mitigants are in place. Third, we assess the effectiveness of transaction-specific risk mitigants. Finally, we assess the rating impact of any material or excessive residual risks remaining after accounting for such mitigants.

1.3 Data sources

The materiality assessment of counterparty risks relies primarily on a detailed review of the transaction structure, the transaction's legal documentation and on the characteristics of the underlying collateral. To assess and monitor the credit quality of relevant financial counterparties, we rely on public or private ratings issued by Scope, or on public ratings from other regulated and supervised credit rating agencies. To assess and monitor the performance and credit quality of relevant operational counterparties we may rely on regulated ratings, internal credit estimates or fallback assumptions.

If available information on the credit quality of a given counterparty is considered insufficient and the counterparty's risk exposure is classified as material or excessive after accounting for transaction-specific remedies, we might be unable to rate the transaction or limit the achievable ratings.

2. Executive summary

This document is the latest update of Scope Ratings' Counterparty Risk Methodology. Relative to the methodology published on 10th of July 2024, it incorporates a full editorial redrafting of the methodology to enhance clarity and the following non-material analytical updates:

- Clarification that credit risk exposures to the originator and seller of the assets are addressed under our General Structured Finance methodology (see section 1.1)
- Removal of the reference of a specific rating limit (i.e. BB+) in case where available information would not be enough or counterparty's risk exposure is classified as material or excessive after accounting for transaction-specific remedies (section 1.3).
- Removal of Appendix I ('Definitions and applicable conventions'): 1) methodology-relevant details have been integrated into the body of the methodology; 2) non-methodology-relevant details have been removed, 3) counterparty type definitions and

[1] Applicability to sector-specific methodologies may be limited to specific sections of the Counterparty Risk Methodology.

conventions have been moved to previous appendix IV (now Appendix, 'Examples of counterparty types, standard materiality assessments and selected remedies').

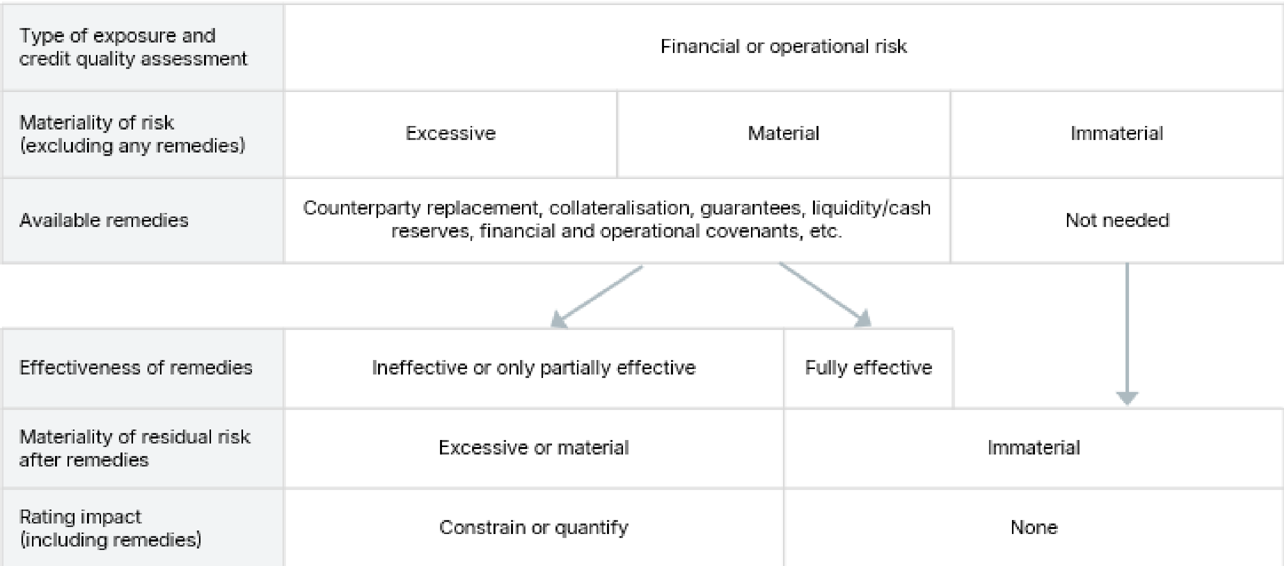
- Removal of Appendix II ('Servicer Risk') and Appendix III ('Quantifying expected loss from financial exposure to counterparties') have been removed, redrafted and integrated, respectively, into section 5.3. ('Operational accounts analysis') and 5.4. ('Servicing discontinuity risk analysis') of the new methodology.

Transaction counterparties may expose securitisation investors to the risk of temporary payment shortfalls under the terms of the securitisation instruments (i.e. liquidity risk), or to an increase of the securitisation instruments' expected losses, resulting from a potential counterparty event of default (i.e. credit risk).

In section 3, we detail our analytical framework to assess counterparty risk. In section 4, we address common financial counterparty risk mitigants and related rating triggers. In section 5 we discuss qualitative and quantitative components of our operational counterparty risk analysis. Finally, in the Appendix, we provide some practical examples of standard materiality assessments, remedial action and rating impact of common securitization counterparty risk exposures.

3. Analytical framework

Figure 1: Counterparty risk classification and rating impact



Source: Scope Ratings

3.1 Type of exposure and credit quality assessments

The assessment of counterparty risk hinges on the type of counterparty, which we classify as financial or operational.

Financial counterparties primarily expose investors the risk of credit losses in a counterparty event of default. To assess and monitor credit quality of relevant financial counterparties, we rely on regulated credit ratings.

Operational counterparties primarily expose investors to liquidity risks and portfolio underperformance risks[2], if they fail to comply diligently with their contractual obligations. Additionally, certain operational counterparties (primarily collateral servicers and paying agents) may also expose investors to credit risk in an event of default, as they may manage and hold issuer funds as part of their operations. To assess the operational strength and credit quality of operational counterparties, we may rely on a variety financial or operational metrics, as well as on a qualitative assessment of their track-record and capabilities.

[2] The performance of securitised portfolios (i.e. delinquencies, defaults and recoveries) may largely depend on the capacity of collateral servicers and asset managers, especially in the case of complex or managed portfolios such as NPL and CLO portfolios. This counterparty risk is addressed within the frameworks of our General Structured Finance and subsector methodologies, as part of the Asset Analysis. In such context, we focus on the counterparty's track record, economic incentives such as fee structure and performance replacement triggers, and operational standards including standard of care and general liability standards.

3.2 Risk materiality assessment

The materiality of a counterparty exposure is assessed before and after considering mitigating factors (see Figure 1).

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. We deem an exposure material if the counterparty's credit failure or non-performance could result in a rating downgrade of up to 6 notches. We deem an exposure excessive if the counterparty's credit failure or non-performance could result in a rating downgrade of more than 6 notches.

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 are considered immaterial.

The materiality is primarily assessed through qualitative judgment, guided by precedents and industry standards, particularly for well-established roles and market-standard remedies (see the Appendix for illustrative examples). In non-standard cases, a quantitative assessment may be conducted to support the evaluation of materiality. A quantitative assessment will also be performed when the classification is uncertain (e.g. immaterial vs. material, material vs. excessive), if the financial exposure at risk exceed 5% of the portfolio balance, or when the residual exposure, after accounting for transaction-specific remedies, is not considered immaterial.

3.3 Rating impact assessment

For non-immaterial exposures, we analyse the effectiveness of the contractual remedies. If remedies are ineffective or only partially effective, we may quantitatively assess the expected economic loss derived from such exposures and factor it into our cash flow analysis, or qualitatively constrain an instrument's 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.

4. Financial counterparty risk analysis

4.1 Financial counterparty risk mitigants

Financial counterparty risks can be mitigated through replacement commitments, guarantees, or collateralisation, which are typically contractually implemented if the counterparty is downgraded below a certain rating threshold (i.e. rating trigger). We expect a contractual commitment to execute remedial action within 30 calendar days and the outgoing counterparty to agree upfront to cover the replacement costs. If these criteria are not met or breached, we analyse the rating implications case-by-case.[3]

To be fully effective, replacement parties must commit to the same obligations and have similar capabilities as the outgoing party, while guarantees must be unconditional, irrevocable and on first demand. Collateralisation remedies may include pre-funding or draw-to-cash provisions in the case of liquidity facilities, while collateral posted by derivative counterparties 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 exposure (the combined value of the gross exposure and the posted collateral) up to its next valuation.

We assess the clarity, transparency and enforceability of contractual provisions outlining the actions related to the implemented structural mitigants.

4.2 Rating triggers

If triggers are not linked 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.

Rating triggers required to fully mitigate financial counterparty risk may vary based on i) the rated instrument's target rating level, ii) the materiality of the exposure (material or excessive), and iii) the type of financial counterparty. Figure 3 below shows

[3] For instance, we may quantify replacement costs and assume that they are borne by the transaction cash flows, or consider ongoing efforts by transaction agents to execute remedial actions

minimum trigger levels appropriate for financial institutions that are systemically relevant within the transaction's jurisdiction or across Europe and would therefore be likely to enter into a resolution regime[4].

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 or whether the entity is likely to be bailed-in in case of default. If we conclude that regulatory actions comparable to those under the Bank Resolution and Recovery Directive are unlikely, we apply a transaction-specific approach to determine the minimum credit quality required on a counterparty to mitigate credit risk.

Derivative counterparties which are subject to contractual frequent margining provisions to collateralise net exposures towards the issuer may be able to support 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[5]. For instance, 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.

Figure 2: Minimum rating triggers on systemic financial counterparties

Minimum counterparty rating (long-term or short-term[6])	Highest achievable instrument's rating	
	Material exposure	Excessive exposure
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+

Source: Scope Ratings

Our ongoing monitoring of ratings includes verifying that triggers have not been breached. If a breach occurs and no remedial actions are taken in accordance to the transaction documents, this may have negative implications on the rating of the instrument. A trigger breach will not automatically result in the instrument's rating to be placed 'under review for downgrade'; however Scope will reassess the transaction to evaluate any changes in counterparty exposure and their potential credit impact.

5. Operational counterparty risk analysis

The counterparty risk methodology addresses the risk of temporary payment shortfalls on the rated instruments resulting from the underperformance or default of an operational counterparty (liquidity risk), and the risk of credit losses resulting from financial exposures to a defaulted operational counterparty (i.e. credit risk). The adequacy of risk mitigants described below hinges partly on the assumed credit quality of the relevant counterparty.

Liquidity risk can be primarily mitigated through liquidity reserves and through contractual provisions ensuring the continuity of operations upon a credit event, or a timely replacement in case of counterparty underperformance.

Credit risk can be primarily mitigated through contractual provisions minimizing issuer funds' exposure to operational counterparties (e.g. frequent issuer funds' sweeps from the counterparty accounts to the issuer accounts) and through

[4] 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-like 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

[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.

[6] Short-term ratings apply only for transaction where the rated instruments have a short maturity.

contractual provisions triggering the counterparty's replacement upon a credit event. Whenever we consider credit risk not fully mitigated, we factor in an expected economic loss into our cash flow analysis.

Collateral servicers are generally the most critical operational counterparty and may expose investors to material liquidity and credit risks. Credit risk exposure to paying agents is generally effectively mitigated by securitization standards (such as highly rated entities and daily fund sweeps from the agent's into the issuer's accounts). Exposure to other operational counterparties is generally considered immaterial (see Appendix for further guidance).

5.1 Liquidity provisions

Our minimum requirement for liquidity coverage in a structured finance transaction is outlined in General Structured Finance Rating Methodology. The minimum liquidity requirements are subject to the securitisation instrument´s target rating; the complexity of the securitised portfolio; the counterparties´ operational capacity and financial strength; the presence of structural mechanisms to replace relevant counterparties; and the transaction´s liability structure.

5.2 Contract analysis

We qualitatively assess the clarity, transparency and enforceability of contractual provisions case-by-case. Contractual provisions may address counterparty operational underperformance or solvency risks. Below we provide some potential examples:

- counterparty replacement triggers linked to counterparty's financial or operational performance metrics
- 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
- regular updates on pool and debtor data including specified data back-up provisions
- public ownership with a strong governance and operational track-record as well as restrictions on changes to ownership structure or business strategy
- regular confirmation of positive net cash flow, along with regular audits and independent verifications by reputable firms

5.3 Operational accounts analysis

Operational counterparties (primarily paying agents and collateral servicers) may hold issuer´s funds as part of their operations, exposing investors to the credit risk of the counterparty and potentially to commingling risk. Commingling risk arises when the issuer's funds are not adequately segregated from the operator's own funds and may be lost or temporarily blocked if it becomes insolvent.

5.3.1 Segregated accounts[7]

If the operational counterparty manages issuer's funds in a segregated account under the issuer's name (i.e. there is no commingling risk), we consider the credit exposure to the counterparty as effectively mitigated if a) the segregated account is 'eligible', i.e. the account bank is a rated entity subject to replacement triggers in line with those outlined in Section 4, or b) if the account bank is highly rated but no replacement triggers are in place, the funds are transferred into an eligible account at least every two days.

If none of the above conditions are met, we assess the materiality of the risk case-by-case. Alternative mitigants may still render the operational account exposure immaterial. For instance, less regular cash sweeps may be acceptable provided collections are evenly distributed along the month. Contractual covenants could also provide for payments to be made into a lockbox account in case of account bank insolvency, with the purpose of limiting the agent´s access and ensuring money is transferred to an eligible account.

If after consideration of all available mitigants the exposure is considered material, we factor in a stressed probability of default of the counterparty into our analysis. Figure 3 provides guidance on how we would generally quantify the implied expected economic:

Figure 3: Assumptions to quantify economic loss from material exposures to issuer account banks

Counterparty credit quality	Counterparty rating minus three notches
Periodic exposure amounts[8]	Scheduled collections over the holding period with a floor of one month

[7] While the analysis described below applies typically to paying agents, the principles described herein may apply to any type of counterparty.
[8] In the case of reserves, the periodic exposure amount would equate to the full deposited amount.

5.3.2 Commingling risk analysis[9]

If the operational counterparty does not hold issuer's funds in an adequately segregated account under the issuer's name (i.e. there is commingling risk), we first qualitatively assess whether structural protection features are effective at delinking the transaction from commingling risks. Examples of potentially effective structural mitigants are dedicated commingling reserves, third party guarantees, or operational triggers to instruct borrowers to pay directly into eligible accounts.

We may also assess qualitative factors which include, among others: a) the legal and regulatory framework (jurisdictional legal protections related to account segregation, trust arrangements, and bankruptcy remoteness); b) operational capabilities (e.g. the ability to notify obligors and redirect payments away from a defaulted servicer in a timely and effective manner is a critical mitigating factor; c) contractual and cash management provisions (e.g. frequency of cash sweeps, maximum allowable cash-holding periods, and any triggers for accelerated sweeps or account transfers); and d) the characteristics of the receivables (e.g. timing of collections, potential payments clustering, and the presence of prepayment incentives).

If after consideration of all available mitigants the exposure is considered material, we factor in a stressed probability of default of the counterparty into our analysis. To quantify the implied expected economic, we generally take the following underlying assumptions:

Figure 4: Expected commingling loss underlying assumptions[10]

Element	Assumptions
Counterparty credit quality*	Counterparty rating or rating proxy (e.g. credit estimate) minus three notches
Periodic commingling exposure amounts	Scheduled collections over Stressed Holding Period (assuming zero defaults and expected prepayments)
Stressed Holding Period	Stressed Exposure Period + Obligor Notification Period
Stressed Exposure Period	Maximum of i) one month; and ii) two times the cash sweep frequency
Obligor Notification Period	Based on transaction's documentation

*If no public rating is available from Scope we can rely on ratings from another regulated credit rating agencies.

5.4 Servicing discontinuity risk analysis

While minimum liquidity coverage requirements are set forth in our General Structured Finance Rating Methodology, its adequacy ultimately hinges on a qualitative assessment servicing discontinuity risk.

Upon a servicer disruption event, the continuity of timely payments to noteholders depends on the effectiveness and speed with which servicing activities are transferred to a new servicer, and the available transactions' liquidity to cover such payments and senior expenses during the transition 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 loan delinquencies if collections cannot be undertaken.

We assess servicer transferability risk by examining: i) the strength and clarity of contractual risk mitigants, such back-up servicer provisions and borrower notification procedures ii) the complexity of the servicing activities and the availability of suitable potential replacements; and iii) the legal framework's potential to inhibit or delay the transfer process.

An effective back-up servicer arrangement typically involves regular access to the securitised portfolio database and a contractual commitment at closing to replace the servicer following a termination event. Whereas hot back-up servicers already incorporate the relevant obligor data in their systems, perform parallel processing, and have established procedures to ensure a swift replacement, a cold back-up servicer only receives a back-up of the data file. A back-up servicer facilitator may also mitigate the risk of servicer disruption by assisting the issuer in finding a replacement, subject Its effectiveness depends on the back-up servicer facilitator's expertise and market knowledge, as well as the availability of suitable providers.

The suitability of 'cold' or 'hot' back-up servicers depends on the complexity of the assets or the servicing process. While standardized assets strongly mitigate servicing disruption risk, a servicer replacement within specialised asset classes (e.g. non-performing loans, or operational leasing with ancillary services) can be significantly more difficult, given the limited number of capable providers and the longer time required for servicers to become fully operational. Finally, we consider the jurisdiction's legal environment to identify factors that could impede the transfer of servicing activities, such as data protection laws.

[9] While commingling risk analysis generally applies to transaction servicers, the principles described herein may apply to any type of counterparty.

[10] A stressed probability of default of BBB- or better, combined with a stressed commingling amount exposure of one month or less renders the expected commingling loss immaterial.

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

Counterparty	Exposure	Standard pre-remedies materiality	Common remedies	Rating triggers supporting AAA rated instruments	Standard post-remedies rating impact
Derivative counterparties	Financial	Material	Collateralisation, guarantee or replacement	Loss of **BBB/S-2**	Compliant: immaterial Else: quantify
Liquidity facility providers	Financial	Material	Replacement/ draw to cash		
Bank account providers	Financial	Material	Guarantee or replacement		
Collateral holding entity in a synthetic securitisation	Financial	Excessive	Guarantee and replacement	Loss of **A/S-1**	Compliant: immaterial Else: link to the counterparty
Reserve bank account provider	Financial	Material or excessive for lower-seniority rated instruments[11]	Guarantee and replacement	Loss of **A/S-1**	Compliant: immaterial Else: quantify
Guarantor[12]	Financial	Role-dependent	Replacement	Role-dependent	Compliant: immaterial Else: quantify
Servicers	Operational	Material	Replacement/ operational covenants	Operational covenants: specific to the service provided (hot, or cold back-up/performance-based triggers); or Rating-based triggers considered case-by-case	Compliant: immaterial Else: quantify
Paying agent	Operational	Immaterial, unless there are significant cash flow concentrations	Replacement/reduction of exposure	Mitigating covenants specific to the service provided; or Rating-based triggers	Immaterial
Calculation or Computation agents	Operational	Immaterial	N/A	N/A	N/A
Trustee	Operational	Immaterial	N/A	N/A	N/A

Some applicable risk conventions:

- Issuer/transaction bank accounts

  Typically, funds used to repay the notes pass through bank accounts held with one or more banks making the repayment potentially vulnerable to the insolvency of any such bank. Account balances can be temporarily blocked or even lost if a bank is placed under moratorium, restructured or declared bankrupt by regulators.

  In certain jurisdictions, structural mitigants (e.g. investments in highly rated liquid securities with minimal additional risks) or legal mitigants, such as trust or custodian accounts, can protect transaction funds from the insolvency of the account-providing institution.

- Paying agents

  Paying agents are responsible for distributing funds to noteholders. While their failure to perform may lead to payment delays, the associated risk is typically limited, as funds are usually held for only one to two days. Selecting counterparties with a strong track record and relevant experience helps mitigate this operational risk.

[11] The credit enhancement for rated instruments with low levels of overcollateralisation may mainly consist of cash reserves.
[12] 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.

- Calculation agents

  Structured finance issuers, due to their typical set-up as special-purpose vehicles, rely on calculation agents to calculate interest and principal on the notes, target reserve amounts, or to value derivative exposures and establish collateralisation needs under derivative contracts. These calculations 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 limited operational risks. Choosing counterparties with a proven record and experience in the functions they are commissioned for can prevent these risks from materialising.

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