Global Structured Finance Rating Criteria

Master Rating Criteria

This report replaces the previous report of the same title, dated 27 June 2016. The revisions reflect the incorporation of our *Criteria for Rating Caps and Limitations in Global Structured Finance Transactions* (16 June 2016) as an appendix to this criteria.

Related Criteria

Structured Finance and Covered Bonds Counterparty Rating Criteria (March 2017)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (March 2017)

Criteria for Country Risk in Global Structured Finance and Covered Bonds (September 2016)

Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria (February 2017)

Criteria for Rating Currency Swap Obligations of an SPV in Structured Finance Transactions and Covered Bonds (August 2016)

Non-Performing Loan Securitisations Rating Criteria (March 2017)

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Scope

The criteria discussed herein provide an overarching framework applicable to all structured finance (SF) transactions globally, including residential and commercial mortgage-backed securities (RMBS and CMBS, respectively), asset-backed securities (ABS), and structured credit transactions. Any detailed asset class-specific rating criteria published by Fitch Ratings should be considered in addition to these criteria.

These criteria may apply directly or be supplemented with sector-specific criteria. Where master criteria apply without sector-specific criteria, these criteria must address all rating drivers and key rating assumptions. All of the key ratings drivers listed below are equally important for analysis purposes.

Key Rating Drivers

Asset Isolation and Legal Structure: SF transactions are structured to isolate, or “de-link,” an underlying pool of assets from the corporate credit risk of the original owner, or “originator” of those assets. This is intended to ensure that the primary credit risk of the transaction relates to that of the pool of assets, rather than the idiosyncratic credit risk of the originator. In the absence of other factors, the effective isolation of the assets from the credit risk of the corporate originator can allow SF securities to achieve a rating higher than that of the originator.

Asset Quality: Fitch analyses the assets' credit characteristics to derive a loss expectation under a base case scenario. This assumption is stressed further in each successive rating category, such that securities rated in the high investment-grade categories (ie ‘AAAsf’ and ‘AAsf’) have loss expectations that are consistent with remote, high-severity stress scenarios.

Financial Structure: Credit enhancement, structural features and counterparty risks are key considerations in the assessment of the financial structure. Fitch's rating for each bond reflects whether there is sufficient credit enhancement available to withstand default, given potential losses on the underlying collateral pool in the relevant rating stress scenario. Fitch will analyse the structural features of the transaction, including the bond repayment structure and counterparty risk.

Operational Risk: The originator, servicer, and CDO asset manager, as transaction participants, can affect the performance of the underlying assets and, ultimately, the SF transaction. Where applicable, Fitch's operational risk team, or asset-specific rating analysts, review the operational processes for each originator, servicer, or asset manager participating in a SF transaction rated by Fitch.

Surveillance: Fitch monitors the evolution of the asset quality, credit enhancement, financial structure and operational risk against its expectations through the agency's surveillance process, until the securities have been paid in full or the rating has been withdrawn. Of these four key rating factors, asset quality, financial structure, and operational risk often evolve over the term of a transaction. In contrast, asset isolation and legal structure are usually stable and affected only by specific events.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions and available at https://www.fitchratings.com/site/definitions.

In addition ratings within the scope of these criteria are subject to the following specific limitations:

Fitch's rating analysis is based upon the prevailing relevant legal framework and generally does not address the impact of unforeseen changes to the law (including taxation related legislation) Changes to the law are analysed as credit events as outlined in the *Surveillance* section of this report. The implementation of a previously unforeseen change in the law may have an impact upon assigned ratings. Where the relevant legal framework is not considered sufficiently robust, Fitch may apply a rating cap or Fitch may not assign a rating at any level (see a discussion of this and other reasons for capping and limitng ratings in *Appendix 4: Rating Caps and Limitations*).

Specifically regarding SPVs, Fitch' rating analysis does not address the risk of a vexatious or nuisance challenge, the potential for a change in the legal or tax regime and fraud.

Asset quality (including portfolio and data adequacy), credit enhancement, financial structure, operational risks, sovereign dependency, counterparty aspects or specific legal structure issues may prevent Fitch from rating a transaction, or may limit the highest achievable ratings in the agency's analysis. The core areas where such restrictions may apply are generally those detailed in Appendix 4: *Rating Caps and Limitations* and in Fitch's. *Criteria for Country Risk in Global Structured Finance and Covered Bonds*.

Asset Isolation and Legal Structure

In its analysis of SF transactions, Fitch reviews whether the following principles are adequately integrated in the transaction structure.

The distinguishing feature of a SF transaction is the isolation, or "de-linking," of an underlying pool of assets from the corporate credit risk of the original owner, or "originator," or "asset manager" of those assets. The aim is that the primary credit risk of the transaction relates to that of the pool of assets themselves rather than the idiosyncratic credit risk of the originator. Except where and to the extent set out in the asset class-specific criteria, this is typically achieved in SF by the sale of an identifiable and specific pool of assets, either directly or indirectly, to a special purpose vehicle (SPV) so that neither the assets nor their proceeds will be clawed back as part of the insolvency estate of the originator or seller in the event of its insolvency.

The SPV typically issues debt and uses proceeds of that issuance to acquire cash-generating assets (or charged assets in the case of funded synthetic transactions). The SPV passes through cash it receives from the assets to pay interest on the debt and, in most cases, to amortise (fully or partially) the SPV's debt. An example of one exception to this is synthetic transactions that may not issue debt but provide for an unfunded exposure to reference assets.

SPVs are often described as "insolvency remote" in that the risk of the transaction being disrupted by the insolvency of the originator of the assets, or the parent of the SPV, is rendered a remote risk through various structural features. Unlike operating companies, SPVs are restricted by their formation and transaction documents and do not have the ability to borrow or raise capital to remedy cash flow shortfalls or asset, security, or transaction structural problems. Legal restrictions on an SPV limit the business activities it is allowed to undertake. Therefore, the transaction is protected as far as possible from credit risks posed by any ancillary activities that an SPV could otherwise undertake unrelated to the transaction.

As their name suggests, SPVs for SF transactions are established for a specific and limited purpose, namely for issuing the SF notes, and have a separate and independent legal existence from their parents. Thus, the SPV provides improved predictability of outcome relative to corporate credit, as the risk factors associated with a SF transaction are confined primarily to the asset pool transferred to the SPV.

Fitch assigns ratings to a variety of transactions using many different legal forms of SPV. The legal form of organisation will be regulated by local law in the jurisdiction where the SPV was created and determined by the sponsor. Typically, an SPV in a SF transaction is a limited liability company, a trust, limited liability partnership, or other form of body corporate (depending on the local law in the place of establishment). Fitch's analysis of insolvency remoteness and the principles applied are detailed in *Appendix 1* of this report.

Legal Opinions and Transaction Documents

The SPV formation documents, the documents relating to a particular transaction, and associated legal opinions indicate the extent of the separation of the assets from insolvency risk of the seller and the robustness of the structure of a particular transaction and, consequently, the extent of de-linkage of the assets from the transferor and the SPV from affiliates.

Fitch analysts will review key transaction documents to determine whether they reflect the transaction and its structure as represented to Fitch. Analysts may direct questions to the transaction sponsor or other transaction parties, and/or their counsel, about the contents of these documents or seek an explanation of the impact on the rating analysis of certain provisions in these documents.

Fitch expects legal opinions to address the following with respect to the enforceability of the transaction documents: (i) the laws of the jurisdiction(s) where each relevant SPV, and certain other transaction parties, are formed/incorporated; (ii) the laws governing the transaction documents; and (iii) the laws governing the transfer of the assets, except where and to the extent set out in the asset class-specific criteria.

It should be noted that any or all of the relevant laws may be different; and Fitch expects legal opinions to cover all relevant laws. This practice may vary for certain jurisdictions related to National Scale ratings. Except where and to the extent set out in the asset class-specific criteria, legal opinions are expected to address the nature of the various transfers in the transaction and provide assurance that the assets transferred to the SPV (i) are not subject to be recovered or “clawed back” by the seller of the assets in the event of the insolvency of the seller of such assets to the SPV, and (ii) will not be consolidated with the assets of the parent or other controlling party upon the occurrence of the insolvency of such party (nor will the SPV itself be consolidated with such party in the event of such party’s insolvency). Except where and to the extent set out in the asset class-specific criteria, Fitch also expects opinions to address the enforceability (including in the event of insolvency of any of the relevant parties) of the transfer of related security interests, if any, between the transferors and transferees, including but not limited to, any security interest in favor of the indenture trustee or security trustee.

General corporate and enforceability opinions indicate that the duties and obligations imposed on, and the agreements executed by, the issuer and other relevant parties are valid and binding, and enforceable against the issuer (and such other parties) in accordance with their terms. Tax opinions or memoranda address the status of the issuer (and any other relevant parties) in the transaction and, in certain circumstances, indicate whether such entity will be liable for payment of taxes, and if so, quantifying such amounts. Legal opinions should also address other matters relevant to a particular asset class, as set forth in the criteria for such asset class.

To the extent transaction counsel cannot provide a “clean” opinion on a particular matter, Fitch expects such counsel to identify and explain the impact of such risks. It could be the case that residual legal risk(s) make it impossible for Fitch to rate the relevant securities.

Asset Quality

Asset Classes

SF transactions are collateralised by a broad spectrum of financial assets. Mortgage loans secured by residential and commercial properties, consumer assets such as credit card receivables and auto loans, and corporate loans and securities are the most common assets that are securitised. Fitch broadly classifies SF transactions into four main sectors: RMBS, CMBS, ABS, and Structured Credit. Within these sectors, there is a variety of subsectors; for example, the ABS sector encompasses consumer (eg auto loans, credit cards, and student loans, among others) and commercial assets (aircraft leases, franchise loans, and corporate-linked future flows, among others), as well as asset-backed commercial paper (ABCP) conduits.

See *Fitch sector-specific criteria* available at www.fitchratings.com.

Default and Loss Analysis

Repayment of principal and interest on the underlying loans and collateral are used to service and repay the rated notes in SF transactions. Fitch typically analyses the assets' credit characteristics to derive a loss expectation under a scenario that reflects Fitch's current macroeconomic expectations. This is commonly referred to as the base case or expected case scenario, and it is assessed at rating committees or in the preparation of sector-specific criteria. The base case scenario describes expected asset losses only, without reflecting potential loss-reducing structural features of the transaction. Fitch's opinions regarding base case loss expectations are considered by a rating committee, typically based on values derived by one of the approaches listed below.

- Assigning a default probability and loss severity or recovery rate to each individual loan based on loan-level characteristics using the output of rating models as a basis for committee discussion. The underlying pool's loss rate is calculated using default and loss severity or recovery rate models or loan loss models. This approach is typically used in the analysis of RMBS and US CMBS multi borrower transactions.
- Analysing the asset portfolio based on the originators' historical performance for a rating committee to derive an expected loss. This approach is often used in the rating of consumer ABS transactions.
- Assigning default probabilities and recovery rates on the basis of ratings, credit opinions or bank internal rating systems (for granular portfolios only) for individual assets. This approach is most commonly applied in structured credit transactions.

Fitch typically analyses credit characteristics to derive a loss expectation that reflects a highly probable outcome if conditions remain within current expectations, commonly referred to as the base case scenario.

In addition to deriving a base case, which generally corresponds to (or is marginally below) Fitch's 'Bsf' rating stress scenario, loss expectations are generated under increasingly severe assumptions. The loss expectation is higher for each successive rating category above 'Bsf', such that securities are rated in the high investment-grade categories (ie ‘AAAsf’ and ‘AAsf’) only if they have sufficient credit enhancement to insulate them from loss expectations that are consistent with higher stress scenarios.

Fitch employs a forward-looking rating philosophy that seeks to take a “through the cycle” rating approach in the higher rating scenarios and an expectations-based approach at the lower rating scenarios; that is, at the higher rating scenarios, the loss assumptions are expected to reflect a remote stress scenario that stays stable over time, while the lower rating scenarios reflect assumptions that are more closely related with expectations of collateral performance formed at that time. Fitch's 'AAAsf' and 'AAsf' ratings denote the lowest or very low relative default risk, and repayment capacity is unlikely to be adversely affected by foreseeable events.

Loss expectations at the higher rating categories are often expressed as a multiple of the base case loss estimate. For instance, an asset pool may be expected to experience 2% losses in a base case scenario, but in a 'AAAsf' stress scenario, the collateral pool may be expected to experience losses 4.0 times(x) greater than the base case, or 8% of the collateral pool's balance.

For granular asset classes with homogenous portfolios, such as RMBS and consumer ABS, Fitch applies deterministic multiples. For asset classes with less granular portfolios or portfolios that show sector concentration and where asset correlation is assumed to be less than 100%, Fitch applies a stochastic approach based on a Monte Carlo simulation correlation model to determine the appropriate multiples for higher rating scenarios.

As an example of the calibration of rating default assumptions within sector-specific criteria, the report *Global Rating Criteria for Corporate CDOs*, outlines how Fitch calibrated its CDO methodology by benchmarking model outputs to peak observed default rates. Specifically, the default model was calibrated to reflect the view that CDO notes rated in the 'Asf' category and above should have survived the historical stress that produced the highest observed default rates since systematic data gathering started in the early 1980s. Similarly, notes rated in the 'BBBsf' category should perform robustly in times of peak default rates, although they may show some vulnerability to default should the worst of the historical peak rates be repeated, or exceeded.

Certain SF transactions are not reliant on a diversified pool of assets; some may be credit-linked to underlying entities or guarantee providers, while others are backed by more concentrated pools.

While the majority of SF transactions are backed by a granular pool of assets, others are backed by more concentrated pools (for example, collateralised loan obligations and CMBS). Furthermore, some transactions are not fully reliant on a pool of assets for their credit quality but are credit-linked to underlying entities or guarantee providers. These underlying entities include single-name corporate entities, financial institutions, municipalities, sovereign entities, and financial guarantors.

Where structures are not backed by a single entity or a diversified pool of assets but have a concentrated pool with several large exposures, historical default data can become less relevant. This can also occur with formerly granular pools that become concentrated over time as they amortise approaching maturity. Fitch will employ certain deterministic stresses to evaluate whether the pool is overly exposed to these large exposures' default risk. Many asset classes use concentration matrices that will default several of the large exposures within the pool. The number of defaulted exposures will depend on the rating level desired.

Data Adequacy

Fitch's SF rating criteria assumptions are derived with reference to data specified in sector-specific rating criteria. The adequacy of such sector-specific data will also be described in the sector-specific rating criteria, as well as whether limitations in data adequacy have led to a rating cap in that sector.

As part of the transaction analysis, where applicable, Fitch expects to receive originator-specific historical performance data relevant to the securitised asset pool for the longer of the following: (a) five years; and (b) a period covering all phases of at least one economic cycle. If sufficient originator-specific information is not available, significant market-wide historical performance data covering at least the same timeframe may often provide proxy information. This would be the case, in particular, for asset classes where the originator information may provide a limited contribution to the expected asset performance (for example, assets originated for the syndicated loan market).

Fitch performs a cash flow analysis to assess the financial structure, especially where derivatives are embedded or where there is a material reliance on excess interest.

Financial Structure

Credit Enhancement

Credit enhancement is a key component in SF as it is the mechanism that provides bondholders with protection from losses on the underlying pool. Fitch's ratings for each bond reflect whether the bonds have sufficient credit enhancement available to withstand default given losses on the underlying collateral pool that Fitch expects under the rating stress scenario associated with the relevant bond rating. Credit enhancement can be sourced internally by means of subordination, excess interest, or overcollateralisation (O/C) or externally by a third-party provider in the form of a financial guarantee, the provision of a reserve fund account, external equity, or a combination of the above. Credit-linked SF transactions typically do not have additional credit enhancement; rather, the rating is dependent on the underlying entity or guarantee provider.

Structural Features

Fitch's approach to analysing the various structures is described in asset-specific or cash flow criteria reports. Cash flow modelling will reflect the structure of the transaction concerned in assessing the adequacy of credit enhancement at each rating level. Fitch will generally customize the cash flow model to reflect any structural features that are not part of the base model. However, Fitch may not model certain structural features if the agency deems them to have an immaterial impact under the relevant ratings stress scenarios. Cash flow criteria include a number of stress assumptions that are applied at different rating levels. Stresses may include, but are not limited to:

- high and low prepayment stresses;
- asset coupon compression to stress revenue levels;
- front- or back-loaded (or other) timings for when defaults and losses occur;
- interest rate stresses to assess the materiality of unhedged exposures, as well as carrying costs associated with defaulted assets, see Fitch's *Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria*;
- basis risk stresses to assess unhedged exposures regarding different interest rate bases for assets and liabilities; and
- foreign exchange stresses to assess exposures to unhedged currency risks.

The extent and nature of cash flow stresses adopted will depend on the asset class and type involved and the financial structure of the transaction concerned. For example, stresses tailored specifically to transactions may be adopted where cash flows rely heavily on the terms and conditions of embedded derivatives.

Fitch's ratings of SF instruments typically address the likelihood of receiving payments in accordance with the terms and conditions of the notes, as described in transaction documents. The agency will thus model the different interest terms (ie interest deferral mechanisms) detailed in documents and analyse their impact. For details of instances where ratings may be assigned which do not reflect the terms and conditions of the notes, please refer to *Appendix 4: Rating Caps and Limitations*.

While repayment in full is typically based on an expected maturity date, Fitch's rating addresses full repayment of principal by the stated legal final maturity (plus any grace period allowed under the documentation), which can often be several years after the expected maturity date. Fitch's rating analysis assesses if the distribution of interest and principal proceeds, including recoveries after working out defaulted assets, will be sufficient to repay the notes principal by the legal final maturity.

Where the notes are not structured to allow for interest deferrals or shortfalls and the notes do not receive their full interest on a specified payment date, Fitch will almost always consider such notes as defaulted, and the ratings of the notes would be downgraded to ‘Dsf’ to register the default in Fitch’s transition studies. The ratings of the notes may subsequently be raised from ‘Dsf’ to reflect future performance expectations for the notes where all defaulted interest has been fully repaid, and no future interest deferrals are projected in its expected base case. This would be the expected treatment unless the defaulted amount is considered non-material to the rating opinion for example for a very small payment default as the result of a large one-off expense (See *Surveillance* below).

Where the notes allow for interest deferrals or shortfalls and the notes defer or capitalize interest on a specified payment date but, in Fitch’s opinion, funds will be insufficient to repay the deferred interest at legal final maturity, then Fitch will consider default on the notes as “imminent or inevitable,” and the ratings of the notes would be downgraded to ‘Csf’. At the final maturity date or termination of the transaction, if principal, interest and deferred interest are not paid in full, the notes will be downgraded to ‘Dsf’ to record the default.

Revolving Periods

SF transactions sometimes feature a revolving period, during which, for a specified period, principal collections are used to purchase additional receivables, rather than to repay principal on the notes. Revolving periods expose noteholders to additional risk through a longer risk horizon, adverse movements in portfolio asset quality and origination standards, and increased defaults compared to a static portfolio.

Fitch will analyse structural mitigants to these risks, some of which Fitch has observed are performance-based early amortisation triggers and portfolio limits regarding certain characteristics (for example, average LTV) which limit the extent to which a portfolio is permitted to evolve. Fitch will take such mitigants into account in its analysis. Due to the risks associated with revolving periods, Fitch expects them to be time-limited, with the length of the period dependent on the characteristics of the asset type being securitised. More detailed criteria with respect to asset types that see revolving periods in related transactions will be included in associated sector-level criteria. Fitch may decline to rate or may cap the maximum achievable rating of transactions with revolving periods that pose excessive risk (for example, very long revolving periods).

Master trusts are issuance vehicles with rolling revolving periods that issue multiple sets of liabilities off of a single pool of assets. Fitch analyses them in a similar way to transactions with fixed revolving periods or warehouse facilities (see below).

Warehouse Facilities

Warehouses are revolving structures and may be structured as a single-purpose facility or with rolling revolving periods. Fitch will analyse these structures similarly to structures with defined revolving periods by assuming that the portfolio will migrate towards the outer bounds allowed by the warehouse facility’s eligibility criteria and portfolio parameters.

Single-purpose warehouse facilities are similar to transactions with defined revolving periods, while warehouses with rolling revolving periods can transfer receivables out of the facility, such as to another SF transaction, potentially leaving a concentrated portfolio. Fitch expects structural features to mitigate this risk.

Maturity Risk

For all types of financial structures, Fitch will apply the cash flow criteria for the specific asset class in question where relevant. For example, the criteria may specify scenarios involving varying prepayment speeds where a slow prepayment speed stress is applied to determine if a shorter pay bond with a legal final maturity earlier than that of the underlying assets will be repaid in full at its maturity. Similar stresses would test the ability of structures to accumulate sufficient principal funds to be able to meet bullet repayments by their legal final maturity.

Fitch also assesses if the legal final maturity date provides sufficient time needed for loans to be worked out beyond the expected maturity date. Similarly, bonds that pay pro rata will be tested in accordance with asset class criteria to assess whether credit enhancement will remain sufficient in the later stages of a transaction when the portfolio has amortised significantly, such that issues of asset concentration or adverse selection may arise in the portfolio.

Counterparty Risk

As part of its assessment of financial structure, Fitch will analyse any counterparty dependencies — such as the provision of derivatives, bank accounts, or financial guarantees — as these represent credit exposures beyond the securitised asset pool.

Generally, SF transactions which are dependent on the credit quality of an underlying entity or guarantee provider are credit-linked to those entities (in the absence of any structural mitigants). For further details of Fitch's counterparty risk analysis, see *Structured Finance and Covered Bonds Counterparty Rating Criteria.*

Representations and Warranties

SF transactions typically contain representations and warranties relating to the underlying assets (including those regarding ownership and title to the assets), as well as the organisation and status of key transaction participants. SF transactions also typically include enforcement mechanisms that are available for the benefit of investors to address a breach of a representation or warranty. Fitch reviews the representations and warranties and enforcement mechanisms (RW&Es) contained within a transaction and will typically publish the RW&Es available to investors which were disclosed in the transaction's offering documents and that relate to the underlying asset pool. Fitch will also publish a description of how the transaction's RW&Es differ from those typically seen for that asset class. Any deviations will be highlighted and the rating approach in relation to any omissions which present credit implications will be described.

Purchased pools often have RW&Es from the seller that are weaker than those typically seen for that asset class. In this case, further comfort may be taken by Fitch through extended legal due diligence and third-party file reviews.

Investor Action

Fitch's rating analysis looks to legal final maturity. As such, Fitch assumes that investors will not exercise options or rights available to them that will cause a payment default or loss on a rated note, where Fitch's rating opinion expects that the rated note is capable of continuing to maturity without a payment default or loss arising. Examples include noteholder options to liquidate collateral or to receive alternative securities in settlement of the obligation, in lieu of cash. Similarly, where a note event of default occurs, if it is Fitch's rating opinion that the transaction would not suffer a default or loss in the event of the transaction continuing until maturity, then Fitch will assume in its analysis that rights to enforcement or acceleration will not be exercised.

Notwithstanding the above, there may be instances where investors vote to exercise an option to redeem all notes, which subsequently generates a loss on the rated par value of the notes.

Where the exercise of such options or rights is at the discretion of a senior class of noteholders over a subordinated class, Fitch will consider the potential impact of exercising such options or rights on the subordinated class when forming its rating opinion. Similarly, in the event that changes to the priority between noteholders would occur as a result of a note event of default and an acceleration of the notes, at this time Fitch will consider the potential impact of the change in priority in its rating analysis, where this could bring a relative advantage to a controlling class of noteholders over another class.

In addition, transactions where a note event of default has been triggered and remains in force may become subject to a rating cap, where this is indicative of potential future performance uncertainty or volatility for the transaction.

Operational Risk

The originator, servicer and CLO asset manager as transaction participants can affect the performance of the underlying assets and, ultimately, the SF transaction. Where applicable, Fitch's operational risk teams, or asset-specific rating analysts review the operational processes for each originator, servicer, or asset manager participating in a SF transaction rated by Fitch. Whether indicated by an internal score, opinion, or public rating, the assessment may lead to adjustments to a transaction's base case expected loss and credit enhancement levels, application of a rating cap, or cause Fitch to decline to rate a transaction. Where applicable, Fitch's originator, servicer, and asset manager review criteria are published as part of the respective asset sector criteria reports or as separate criteria.

In general, Fitch expects an originator/SF issuer to have sufficient operating experience in the relevant market and in originating the product comprising the asset pool.

Fitch assesses the risks associated with the originator's products, programs, and underwriting guidelines, including those risks embedded in less stringent and aggressive origination practices and controls, since these assets will have a greater propensity to underperform than those assets originated under more stringent guidelines and controls. The review looks to assess whether collateral from an originator is likely to perform in line with, better, or worse than collateral from other originators in its peer group in times of stress. Propensity for better performance (relative to expected performance for a portfolio with similar characteristics originated by a typical originator) may be indicated by the quality of origination controls and the use of best practices. The quality of the originator's practices and controls will also be of particular importance in revolving transactions, where receivables that are to be originated in the future will be sold into the transaction using principal repayments on the existing portfolio (see also *Revolving Periods* above).

For certain asset classes, Fitch will complete file reviews as part of the originator review process, in line with its sector criteria. The purpose of the review is to provide examples of the origination and underwriting processes in order for Fitch to better understand how the processes are performed and to cross-check data provided in the portfolio data files. Such file reviews are typically very limited in terms of scope and sample size. For example, a review may consist of Fitch selecting 10 loan accounts from a list of those expected to be included within the securitisation transaction. Fitch will then review the originator’s physical and/or electronic records of the selected accounts. Any inconsistencies identified (e.g. between paper and electronic files, or between the described and observed processes) would be discussed with the originator and may be taken into account in the rating analysis, depending upon Fitch’s opinion of the materiality of such inconsistencies.

Fitch's operational risk teams or rating analysts review the processes of each originator, servicer, or asset manager participating in a SF transaction rated by Fitch.

In general, Fitch expects an originator to have sufficient operating experience in the relevant market and in originating the product comprising the asset pool. Fitch also will expect the originator to provide historical performance data as well as historical loss severity and recovery data.

Servicer Reviews

The primary responsibility of the servicer is to collect and distribute payments from the underlying assets to the trustee for the benefit of the bondholders. In certain SF sectors, servicers have additional responsibilities such as advancing delinquent loan payments and negotiating loan workouts. Fitch’s servicer review process is designed to identify and evaluate the quality of a servicer's loan administration and default management processes, compliance with stated guidelines, operational stability and in jurisdictions where servicer continuity is less certain, financial stability, when needed for the rating analysis. The servicer review process assesses the company's strategy for handling assets in various jurisdictions and conditions, procedures to stay informed on current legislation, and methods of integrating these changes into its loan servicing processes. In addition, a servicer's internal control framework is of particular importance to Fitch as it demonstrates the servicer's commitment to sound operational business practices. When rating CLOs, Fitch reviews the asset manager to assess its operational ability to manage a CLO transaction, as explained in the *Global Rating Criteria for CLOs and Corporate CDOs*.

Surveillance

Once Fitch rates a SF transaction and if the ratings are not point in time, the transaction will be subject to on-going surveillance. Of the four key rating factors outlined in this report, asset quality, financial structure and operational risk often evolve over the term of a transaction. Asset isolation and legal structure in contrast, are usually stable and affected only by specific events.

With respect to asset quality, financial structure and operational risk, Fitch monitors rated transactions using asset performance and cash remittance information supplied by servicers and trustees and any other relevant information. The surveillance process involves a number of quantitative and qualitative functions to assess the performance of rated tranches, including monitoring pool-level performance indicators, comparing current credit enhancement levels against forecast or stressed assumptions, assessing the impact of market developments on the performance of transactions, and loan-level analysis.

Ratings are reviewed at least annually by a rating committee. If a rating action appears warranted for reasons including reported transaction performance, Fitch's asset performance outlook or the occurrence of a credit event, a committee review will be undertaken promptly. Rating actions for some transactions occur more frequently, particularly if performance of the underlying pool exhibits rapid deterioration.

Credit events are discrete developments that may affect the rating analysis of certain transactions. Examples of credit events include: a reduction in the rating of a counterparty; a change to the underlying legal framework; a material transaction document amendment; or any other event on a case-by-case basis thought to have a material credit impact. Upon Fitch observing or being notified of any such event, the agency will consider the extent to which the rating analysis may be impacted.

In respect of potentially material events, Fitch will hold credit discussions on the event in question. To the extent that the event is not expected to have an impact on ratings, Fitch may publish a non-rating action commentary (NRAC) with a description of the event, the relevant ratings and the rationale behind Fitch's analysis. If an event is expected to have an impact on ratings, then rating committees for the affected transactions will be convened to consider the extent of the rating impact. The resulting rating actions will be published in a Rating Action Commentary (RAC).

Under Fitch's surveillance analysis, notes that experience a very small payment default as the result of a large one-off expense for example may be considered non-material to the rating opinion (whether through a very small amount of interest deferral, or a principal loss that is not expected to recur). In Fitch's view, the recognition of such small amounts as a downgrade or default would not effectively reflect the substance of the notes' credit position where transactions have otherwise shown a strong credit profile throughout their lives. Such instances are expected to be infrequent and the circumstances will be specific to each transaction. As a general rule, such instances would not be expected to exceed one month's cash flows owing to the rated security. Fitch derives its base case loss expectations in consideration of the transaction's expected performance. If the transaction is not able to withstand Fitch's loss expectations, the agency will assess the evolution of asset quality, cash flow certainty and how much greater expected losses are compared to the transaction's current credit enhancement at each rating level, to determine which distressed rating to apply to a bond.

Transactions are reviewed using the latest remittance reports and any other relevant information available.

Sector-specific criteria reports do not usually address stress scenarios below ‘Bsf’. Instead, Fitch makes projections of expected future performance based on the current circumstances, without applying additional stress.

Distressed ratings of ‘CCCsf’ or lower indicate that default is a real possibility (‘CCCsf’); default of some kind appears probable (‘CCsf’); or default appears imminent or inevitable (‘Csf’).

In addition, Fitch will take into account the likely occurrence of a DDE and the security’s ability to meet its obligations in the near future. See *Appendix 3* for further details of Fitch’s approach in determining DDEs. Fitch will assess the default likelihood of distressed bonds in accordance with its ratings definitions. Bonds that have already defaulted or experienced an irreversible principal write-down will be rated ‘Dsf’. Further details of Fitch’s Rating Definitions are available on Fitch’s web site.

Specific surveillance criteria may be published by individual asset groups to explain the process for that group's surveillance and any methodological aspects that are specific to the surveillance of the rating. For example, specific surveillance criteria may address the process for downgrade rating action for sectors that have experienced stress, to explain how rating actions are taken.

Probability of Claim Ratings for Credit Default Swaps

Rather than expressing an opinion regarding the likelihood of default on the repayment of rated obligations, probability of claim ratings address the likelihood of a claim being made by a protection buyer under an unfunded credit default swap (CDS). Analysis involves assessing stressed loss expectations associated with a particular rating level, which allows a rating opinion to be assigned to the CDS based on its loss coverage attachment points.

The rating also addresses the likelihood of the swap premium being paid in respect of the period for which credit protection is provided. Ratings are assigned using the long-term rating scale to reflect the relative vulnerability of the CDS to a claim being made and the swap premium not being paid following the default of the protection buyer.

A probability of claim rating expresses an opinion exclusively on the probability of a claim being made and the likelihood of the swap premium being paid. In particular, it does not represent a counterparty rating on the CDS provider, or their financial capacity to meet a claim in the event that one is made.

CDS with Two-Stage Payments

CDS structures with two-stage payments by the protection seller are a relatively recent development. Under this type of structure, the protection seller would first have to fund a certain percentage of a defaulted exposure (the assumed loss under the documentation) when a credit event notice is served. In the second stage, the final claim under the CDS is determined by assessing the actual loss on the defaulted exposure (the final loss). If the final loss exceeds the assumed loss under the documentation, the protection seller will transfer additional funds to the protection buyer, or if the assumed loss under the documentation exceeds the final loss, the protection buyer will pay back the excess, plus interest, to the protection seller.

Fitch’s ratings for structures with two-stage payments address the likelihood of a final claim being made (ie payments at the end of the second stage) rather than a prefunding claim being made (ie payments at the end of the first stage).

For ratings of ‘AA-’ and higher, Fitch expects the assumed loss under the documentation to be significantly lower than the loss Fitch associates with the specific rating scenario. At other rating levels, where the loss Fitch associates with a specific rating scenario is lower than the assumed loss under the documentation (ie if in the specific rating scenario Fitch expects the protection buyer will have to make payments to the protection seller), the counterparty risk resulting from the protection buyer's payment obligations is analysed under Fitch's *Structured Finance and Covered Bonds Counterparty Rating Criteria*.

Rating Sensitivity Analysis

For each new rating, Fitch completes a rating sensitivity analysis. For public ratings, the analysis is published in the transaction presale and new issue reports. For each class of rated note, the analysis indicates the rating impact from the application of more stressful asset performance assumptions. For example, the sensitivity analysis may show that the rating of the Class A note would be expected to migrate to 'Asf' from 'AAAsf' if the base case default assumption is increased by 50%, and other factors are kept constant. For most transactions, the sensitivity analysis is based on model-implied ratings only and this is indicated in the relevant rating report. The sensitivity analysis parameters are selected according to the key performance parameters of the relevant asset class and will include at least three stress assumption scenarios.

Reasonable Investigation

In issuing and maintaining its ratings, Fitch relies on the factual information it receives from issuers and underwriters and from various third-party sources Fitch believes to be credible. As part of the rating process for transactions initially rated and reviews completed from 1 December 2010, Fitch conducted and conducts a reasonable investigation of the factual information relied upon by it. This includes seeking to obtain reasonable verification of that information from independent sources, to the extent such sources are available for a given security.

In case information cannot be verified to a satisfactory extent, Fitch will assess the materiality of the information to its rating analysis. If Fitch intends to rely on unverified information, and this information could materially affect the analytical outcome, Fitch will alter its assumptions or cap its ratings to reflect the increased uncertainty, or decline to rate (for a new rating) or withdraw existing ratings if Fitch believes the uncertainty cannot be appropriately reflected in the analysis.

Prior to 1 December 2010, Fitch did not typically conduct an investigation into the available information in the manner adopted thereafter. In particular, Fitch did not typically receive any verification of the information provided about the asset portfolio before the transaction closed. Nevertheless, as with all transactions under surveillance, Fitch has monitored the performance of the outstanding transactions that closed before 1 December 2010 and uses this extended track record to check that the information relied upon for its initial analysis was sufficiently reliable. If the monitoring highlights inconsistencies between the reported asset performance and the agency's expectations given the operating environment, Fitch undertakes a further review of the quality of the data provided and seeks explanations for any material inconsistencies.

Variations From Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Criteria Disclosures

In the initial rating report or rating agency commentary, Fitch expects to disclose the following items, along with any relevant items specified in applicable cross-sector and/or sector-specific criteria:

- if market-wide data, rather than originator-specific data, is relied upon in the transaction analysis, as per *Data Adequacy* above, and this use is not covered in the sector-specific criteria;
- the credit implications of deviations from representations and warranties and enforcement mechanisms typically seen for that asset class, as per *Representations and Warranties* above; and
- any variations to criteria, as mentioned in the section *Variations from Criteria* above.

In subsequent rating action commentary related to surveillance actions, Fitch expects to disclose the following, along with any relevant items specified in applicable cross-sector and/or sector-specific criteria:

- any variations to criteria.

Appendix 1

Special Purpose Vehicles in Structured Finance Transactions

Analysis of Bankruptcy-Remote SPVs

This appendix describes Fitch's expectations with respect to bankruptcy-remote SPVs used in SF transactions. The agency's analysis of the SPV is concerned primarily with the degree to which the assets have been isolated from the corporate credit risk of the originator and/or the SPV's owner and other affiliates. The means of achieving this may vary between jurisdictions, asset classes and structures, and references to SPVs herein should be understood to mean an insolvency-remote entity; such references should not be construed as having any accounting-related meaning.

Fitch's analysis will use the principles detailed below to determine the benefit a given SPV provides to a transaction. In following these principles, the analysis will consider the role each SPV plays in a given transaction — whether the SPV is the issuer, a borrower, an intermediate purchase company, or otherwise.

Key Points

The following are the key points of consideration with respect to Fitch's analysis of an SPV.

Bankruptcy Remoteness of the SPV

Including limited recourse and non-petition provisions; restrictions on activities to reduce the risk of new liabilities and creditors being created; and separateness covenants (see Formation of an SPV, Limitations on Activities and Limited Recourse and Non-Petition Provisions below).

Isolation of the Assets

Typically by way of a true sale to the SPV (see *Isolation of Financed Assets* below).

Clear Cash Flow Allocation

Transaction documents should establish clearly the priorities of noteholders and other transaction parties and should not be open to misinterpretation (see *Priority of Payments* below).

Operational Capacity

Responsibilities of the SPV's key operational counterparties, including the note and/or security trustee, should be clearly defined in the transaction documents (see Operational Capacity below).

Key Issues and Mitigants

Formation of an SPV

Type of Vehicle

Fitch considers transactions with SPVs in many different legal forms. The legal form of organisation is not necessarily a determining factor in Fitch's assessment of the degree of risk; whether it is a determining factor will be assessed through the review of the characteristics of the SPV in the context of the overall transaction structure, the impact of the legal and tax regimes in the relevant jurisdictions and the purpose and role of the SPV in the structured finance transaction (issuer, borrower, etc).

Operational History

A newly formed SPV created for a specific securitisation transaction will, by definition, not be encumbered by any previous operating history. A newly established SPV has the benefit of a limited and known operating history and few creditors and liabilities at the outset of the transaction. For this reason, a new vehicle may have a reduced insolvency risk. Therefore, the creditors involved in the proposed transaction can — by agreeing to limitations on their individual rights to take bankruptcy or recovery action against the SPV or its assets — largely define the degree of insolvency risk of the SPV (see *Limited Recourse and Non-Petition Provisions* under the *Mitigating Factors* heading, below). However, insolvency risk is also influenced by factors outside of the securitisation structure, such as the applicable legal regime and its interpretation, and cannot be exclusively defined by contractual arrangements amongst the creditors.

Existing SPVs may achieve the same objectives for the structured finance transaction as a newly formed SPV.

An SPV that is not newly formed may achieve the same benefits for the transaction as one that is newly formed, if adequate structural and contractual provisions have been put in place to reduce or eliminate any impact of legacy transactions on the vehicle. If an SPV is not newly formed, Fitch will typically request substantial supporting evidence for its suitability for use in a structured finance transaction. For SPVs that are not newly formed, relevant considerations include:

- information about the nature and extent of the SPV's historical business operations;
- the amount of actual and contingent liabilities and the identity of its existing and potential creditors (including any actual or contingent liabilities of the SPV that have arisen or may arise because of the group to which the SPV belongs);
- any material tax, litigation and/or other liabilities; and
- any information about the way in which the SPV has historically operated, which may mitigate any of the issues set out above.

Fitch expects the SPV to have independent existence and to operate independently of the SPV's owner and any other affiliates.

Multi-Issuance SPVs

Sometimes a sponsor will prefer to use a multi-issuance (rather than a single issuance) vehicle. Where this is the case, Fitch will review the structure and documents to assess whether the multi-issuance SPV achieves materially the same protection for investors in its individual issuances as those investors could expect from investing in the same assets via a single issuance SPV. Certain issues Fitch will examine include the following.

- If there is effective legal segregation (or compartmentalisation) of particular pools of assets and cash flows for the group of transaction creditors of each series issuance, and if there is any risk of liabilities of one series (or compartment) attaching to the assets of another series (or compartment). This will include if any party involved in more than one series issuance of the same multi-issuer can set-off its liabilities in respect of one series (or compartment) against a different series (or compartment).

- How effectively the segregation of assets and liabilities has been entrenched in the structure to ensure that no existing series (or compartment) can be prejudiced or impaired by the terms of issuance of any other series (or compartment).
- How the structure allocates responsibility for third-party liabilities (eg tax and administration and advisor fees incurred by the multi-issuer SPV).
- Whether the structure provides for separate enforcement of security for individual note issuances and any impact this may have on other series (or compartments).
- The operational procedures established to separate the asset cash flows and to mitigate commingling risk in respect of different series issuances.

Some jurisdictions have passed specific legislation for the legal segregation of assets and liabilities, in respect of individual series issuances in a multi-issuance vehicle. In other jurisdictions, the legal segregation is effected by contract and/or trust law. In each instance, Fitch will review the effectiveness of the mechanisms used to achieve the legal segregation of assets and liabilities in respect of different series issuances in a structure. The relevant transaction documents are key to Fitch's review. Fitch also expects the transaction legal opinions to confirm the enforceability of the legal aspects of these mechanisms.

Separate Existence

Fitch will consider not only whether an SPV has an independent legal existence, but also whether the SPV has the ability to operate independently of the SPV's owner and any other affiliates. In some jurisdictions, matters such as management and shareholder control, maintenance of its own accounts, books and records and advisors, arms-length terms for its place of business, separateness of its assets and funds and ability to operate independently of the originator and owner are among the factors considered in this assessment. No single factor is in and of itself sufficient to determine whether the SPV has a separate existence. For example, the presence of independent management or directors does not guarantee that the SPV cannot become a bankrupt entity upon an insolvency filing of another related entity. Rather, Fitch will look for such an assessment to be supported by the full range of factors deemed relevant to support a separate existence in the relevant jurisdiction.

If the SPV cannot be considered to exist independently of all other parties — eg its parent or an affiliate — Fitch may decide that no instrument issued out of the SPV can be rated higher than the rating of the party on which the SPV is dependent.

"Orphaned" or Not

SPVs may be (and in Europe commonly are) "orphaned", that is, not legally or beneficially owned or controlled by the originator of the securitised assets nor any other enterprise with an interest in those assets or the SPV. In such cases, the beneficial ownership of the SPV will often be held on trust for a charity by the immediate legal owner, which will often be a professional company specialising in the management of such vehicles and which performs the management duties for a fee.

There may be commercial, tax, structural or legal reasons for an SPV not to be orphaned. This may be the case where there are one or more intermediate SPVs in a structure through which note issuance proceeds and/or asset cash flows pass. In this case, Fitch will review the safeguards and any aspects which may compromise the separation of the SPV from its parent or sponsor.

When the SPV is part of a group of companies, risks arising from the use of a non-orphaned SPV include exposure of the SPV to group tax or employee pension liabilities, or the risk in some jurisdictions that a court may order the consolidation of the SPV's assets with those of its parent entity in the parent's insolvency proceedings. To the extent that those risks exist in a particular jurisdiction, Fitch expects those risks to be addressed.

A non-orphaned SPV may achieve the same benefits as an orphaned SPV where relevant mitigants (such as noteholder control and strong separateness provisions) are present and respected.

Jurisdiction

The choice of jurisdiction for the SPV can be influenced by many factors, not all related to mitigation of the risk of insolvency.

Tax considerations in the form of both potential liabilities and potential benefits for the relevant SPV, or in relation to payments received on the underlying assets, can often be significant elements affecting the choice of jurisdiction by the transaction parties for the establishment of an SPV. Whether any SPV in the structure is exposed to tax liabilities in its jurisdiction of creation, or whether taxes will be imposed to reduce the cash flows or other income or proceeds available from the underlying assets, will have a consequential impact on the ability of an SPV issuer to service its rated debt.

Low or no tax jurisdictions are often chosen as the place to establish the SPV to mitigate the tax risk. However, in cases where it is nevertheless (for other reasons) beneficial to establish the SPV in a jurisdiction that exposes the SPV to potential tax liabilities, Fitch will expect to receive information about the nature and amount of the potential tax liabilities that may be imposed, how such liabilities are calculated, and any structural considerations that may neutralise or mitigate their impact. Fitch will assess the impact of any potential tax liability on the transaction as part of the cash flow analysis.

Limitations on Activities

Fitch expects restrictions to be in place in the transaction that will preserve the future independence of the SPV. It is also expected that these restrictions will limit the business the SPV may engage in to only what is necessary for it to perform its obligations under the transaction documents. This reduces the risk of new liabilities and creditors being created, which may impact adversely on the transaction or the solvency or bankruptcy remoteness of the SPV. Fitch expects these restrictions to be maintained for the duration of the transaction.

Depending on the laws of the relevant jurisdiction in which the SPV has been established, restrictions on the SPV’s business activities and transactions can be entrenched through the documents forming the SPV and/or through contractual restrictions in the transaction documents and, optimally, both. Fitch would expect such restrictions typically to include:

- prohibition of change of ownership;
- covenants to maintain a separate business existence;
- limited ability to amend the constitutional documents;
- restrictions on any asset dealings (beyond those necessary for the SPV to enter into and perform its obligations under the relevant structured finance transaction documents);
- narrowly defined objects and powers (to those necessary for the SPV to enter into and perform its obligations under the structured finance transaction documents);
- restricted powers of directors;
- no additional borrowings, finance raisings, guarantees, additional granting of security and the like (save in limited exceptional circumstances where debt is subordinated and the subordinated creditors have agreed to be subordinated to the existing structured financing);
- no operating business;
- no employees; and
- no commingling of assets with other parties.

Other limitations, in addition to the above, may be put in place for some structures. Fitch will always review the applicable limitations in their entirety.

Depending on the jurisdiction, other forms of legal comfort or mitigant may be present that preserve the independent ownership of the SPV (for example, where the ownership interest in the SPV is widely held).

Limited Recourse and Non-Petition Provisions

As all the transaction creditors involved in a potential structured finance transaction are known and identifiable (the noteholders, security trustee, liquidity providers, swap counterparty, and any other party contracting directly with the SPV), they can (subject to any applicable legal restrictions) agree contractually in the transaction documents to limit their (individual) legal rights to take insolvency or other recovery action against the SPV or its assets.

Structured finance transactions typically limit creditors' rights through limited recourse and non-petition provisions.

The limitations that the transaction creditors typically agree to at closing are set forth in the limited recourse and non-petition provisions in the SPV formation documents and/or transaction documents. In agreeing that their secured debts are limited recourse, the transaction creditors agree to have recourse only to the assets of the SPV for repayment of the amounts owed to them. Under the non-petition language, the transaction creditors waive their rights to sue the SPV individually and agree not to take any steps to "petition" a court to put the SPV into bankruptcy or other insolvency proceedings for non-payment of its debts to the creditor. In certain jurisdictions, an unlimited restriction on a creditor's right to take such action against the SPV may not be enforceable. In these instances, it is usual for creditors to agree a restriction that lasts for any applicable suspect period, plus a day after the issued debt is repaid.

Fitch expects transaction creditors to agree to limited recourse and non-petition covenants. In circumstances where a structure may not include limited recourse and/or non-petition covenants, or where there are restrictions on these covenants, Fitch will expect information as to the reasons for this (together with any structural mitigants). This will allow the agency to assess the risks to the SPV and consequently, whether the structured finance transaction can be said to benefit from limited recourse and non-petition covenants.

To further limit the risk that transaction creditors may (despite the existence of limited recourse and non-petition covenants) seek to take individual action to enforce repayment of their secured claims, structured finance transactions often use a security trustee, which holds and enforces the security on behalf of all the transaction creditors.

Priority of Payments

Having a known universe of transaction creditors means that these creditors can agree to clear priorities in respect of the repayment of their liabilities by allocating the cash flows and other proceeds from the assets, according to a predefined distribution (or waterfall). Fitch will examine these arrangements to confirm that they reduce uncertainty of outcome and establish effectively the priorities of the noteholders and other transaction parties, both before and after the occurrence of a default.

Fitch will also examine the arrangements for the priority of repayment to any third-party SPV creditors (such as tax authorities) that are not transaction parties and therefore may not be bound by the limited recourse and/or non-petition covenants, and also may be mandatorily preferred by law.

Isolation of Financed Assets

Fitch expects that structured finance transactions are structured to achieve such isolation and the agency will, as part of its analysis, undertake an assessment of the effectiveness of the proposed mechanisms to achieve this.

The precise mechanisms may vary depending on the relevant jurisdiction and on the objectives of the transaction sponsor. Fitch has seen several isolation mechanisms. One established mechanism is by way of a sale of the underlying assets to the SPV (a true sale), the aim of which is to give effect to the transfer of title in a way that defeats as much as possible the ability of the originator (or any creditor of, or insolvency official appointed to, the originator) to overturn the sale and claw back the assets sold. How the transfer to an SPV of title to the assets is achieved will depend on the type of asset, its location, the law governing the asset and the law governing the sale.

Where the beneficial (or equitable) title, rather than the legal title of assets, is transferred at the outset of a transaction, Fitch will expect the structure to include appropriate perfection mechanisms to complete the transfer of legal title to the SPV at a point in time sufficiently prior to enforcement. This typically occurs in jurisdictions where the assets being transferred are in the form of a debt and the requirements under the applicable laws for an effective legal transfer to the SPV include notice in writing to the debtor or obligor. In these circumstances, the originator may not find it practical (or desirable) at the outset of the transaction to give the required notice to its underlying debtors to effect a legal transfer of the assets.

Alternatively, isolation of the assets is in some transactions achieved through an intermediate SPV acquiring the assets, which in turn is funded by a secured loan from another SPV (which in turn issues securities to finance the loan).

Fitch analyses the relevant documents to assess the extent to which the assets in the SPV have been isolated from other parties.

Whatever mechanism or structure is used, Fitch assesses the extent to which the assets have been isolated from the transferors and the SPV's controlling party. Fitch expects the transaction legal opinions to address the risks in the relevant jurisdiction(s) that an insolvency of the asset originator, or any other transferor, will result in the assets being clawed back into the insolvency estate of such entity.

Operational Capacity

Fitch expects the SPV to have sufficient support from operational counterparties, notably the note trustee and/or the security trustee, to enable it to operate on a day-to-day basis and particularly in a crisis. The agency expects the responsibilities of the operational counterparties to be clearly defined in the transaction documentation and the counterparties to have the powers to be able to effectively address issues that may arise, thereby minimising the risk of transaction disruption.

Other Potential Threats to the SPV

Unlike operating companies, SPVs are restricted by their formation and transaction documents and do not have the ability to borrow or raise capital to remedy cash flow shortfalls, or asset, security or transaction structural problems. For these reasons, Fitch does not expect the SPV to be vulnerable to a range of risks, including:

- re-characterisation of asset transfers;
- consolidation with its affiliates or service providers;
- tax obligations (including corporate tax, VAT, stamp duty or transfer taxes on realisation of collateral);
- pension liabilities (or other employee-related liabilities), tax liabilities or insolvency risk belonging to a group (usually that of the originator);
- thin capitalisation or other accounting-related risks;
- loss of priority of security interests of the noteholders;
- unavailability of expected liquidity in the transaction; and
- obligations or liabilities attaching to assets that may require capital expenditure (such as environmental risk).

Where such risks exist, Fitch examines any mitigating features to assess the impact of those mitigating features on the rating analysis.

Issues Not Addressed by the Rating

There will always remain certain issues that are difficult to analyse, such as the risk of a vexatious or nuisance challenge, the potential for a change in the legal or tax regime and fraud. Issues such as these are not addressed in Fitch's analysis of an SPV, or in its rating opinion. Clear pending changes in the legal or tax regime at the time of assigning a rating may be addressed on a case-by-case basis.

Issuer Default Ratings for SPVs

Fitch is sometimes requested to assign credit ratings to SPVs themselves: ie what would effectively be the equivalent of an Issuer Default Rating (IDR) for the SPV itself, as opposed to the issue ratings that are assigned to the securities that it issues.

Fitch does not assign credit ratings to SPVs in structured finance. This is because the SPV has no real economic substance of its own; its assets are segregated, it conducts no business other than its participation in the structured finance transaction and it is restricted from assuming liabilities other than the issuance of the notes that form part of the structured finance transaction (although subordinate debt may sometimes be permitted).

The SPV therefore has no senior unsecured liabilities of its own that any rating could address. The risks involved with an SPV consist primarily of whether it has been effectively legally constituted; therefore, there are no credit-related risks that a credit rating could address. A credit rating for the SPV itself would therefore have no meaning. For more details, please see *Appendix 4: Rating Caps and Limitations*.

Appendix 2: Repackaged Structured Finance Notes

Additional considerations apply to rating securities backed by single tranches, or small pools, of existing structured finance notes. These repackaged notes (or re-securitisations) can have a senior/subordinate or simply a pass-through structure.

A senior/subordinate structure involves the issuance of both new senior and subordinate notes backed by the underlying bond(s), thereby creating extra protection for the new senior bond compared with the underlying bonds themselves. On this basis, the new senior note can achieve a higher rating than that of the original repackaged security(s). Fitch will generally decline to rate the new most subordinated tranche of the newly repackaged transaction. If the agency decides to rate the subordinated tranche, it is likely to assign a rating below the existing rating of the note that is being repackaged.

In a pass-through structure, no additional subordination is created and the cash flows from the underlying security are simply passed through to the new notes issued by the new structure, In such a case, the rating of the repackaged note will be the same as that of the underlying security. Fitch's report *Single- and Multi-Name Credit Linked Notes Rating Criteria* details the analytical approach in the case of pass-through analysis.

Fitch will generally not rate repackaged securities where the performance of the underlying collateral is still highly uncertain or expected to be highly volatile. For example, in cases where the original notes are on Rating Watch Negative or Rating Outlook Negative, Fitch may either decline to rate the repackaged notes or apply additional stresses to compensate for potential volatility.

Ratings of Repackaged Senior Notes

Fitch will typically rate only a repackaging of senior notes. Unlike senior tranches, subordinate tranches may be cut-off from payments in the event of a default of the underlying transaction, in instances where senior noteholders, who control the choice of remedies, choose to divert cash flows from the subordinated notes.

Fitch may consider rating a repackaging of subordinated notes under sector-specific criteria or on a case-by-case basis dependent upon asset class, securities concerned, stability of performance and rating level. In such cases, the risks associated with the subordinate position of the notes that are being repackaged would have to be sufficiently mitigated, as determined by Fitch's analysis of the proposed structure. The agency's approach would be detailed in its rating communications.

In cases of the repackaging of a single or a small number of securities (typically, no more than five), Fitch will analyse underlying assets under the framework of relevant sector-specific criteria. In cases of the repackaging of multiple securities within a single special purpose vehicle (SPV), Fitch may complement or replace this look-through analysis with a portfolio-based analysis that assesses correlated default risk and concentrations in repackaged securities. Fitch's report *Global Rating Criteria for Structured Finance CDOs* details the analytical approach in the case of portfolio-based analysis.

Tranche Thickness

The thickness of a tranche relative to the original size of the portfolio (tranche thickness) and the seniority of the tranche are important determinants of the portfolio's expected loss. Fitch is unlikely to assign new ratings to repackagings of underlying thin tranches (as defined in the report *Global Rating Criteria for Structured Finance CDOs*) since they are significantly more vulnerable to changes in loss expectations and losses could easily eat through these tranches, resulting in zero recoveries.

Underlying thick tranches (usually the most senior class outstanding) will typically cover a multiple of Fitch's expected loss for the portfolio and will generally receive higher recoveries given default, than thin tranches. Since Fitch’s structured finance rating addresses only the likelihood of default, or the first dollar of loss, the rating of the underlying tranche will not distinguish between notes with a high or lower expectation of recovery after its default. By repackaging the original tranche into a senior and subordinate structure, the new senior note can be shielded from losses corresponding to a higher rating stress.

By contrast, thin tranches tend to have lower recoveries in the event of a default. They will cover a much lower multiple, or a fraction of Fitch’s expected losses for the portfolio. The default expectation for repackaged notes of a thin tranche is unlikely to vary significantly from that on the underlying note. However, further subdividing a thin tranche would exacerbate the already heightened sensitivity of the original underlying tranche to changes in loss expectations.

Derivatives from Underlying Transactions

Underlying structured finance transactions may embed various derivative contracts that aim to mitigate interest rate or foreign exchange risk. If an event of default occurs and the security over the collateral is enforced by the noteholders through collateral liquidation, the derivative contracts may be terminated. If these derivatives are out-of-the-money from the perspective of the underlying structured finance transaction, a lump sum termination payment is owed to the counterparty. This payment would typically rank senior in the waterfall and therefore would be made before any payments to the re-securitised senior notes. If there is a risk that the collateral securing underlying assets may be liquidated and/or derivative contacts terminated, resulting in a significant termination payment that ranks higher than payments to the noteholders of the re-securitised asset, Fitch is unlikely to rate such re-securitisation.

Potential Consideration of Price Paid

Fitch uses its published rating criteria to form an opinion on a security. However, when assigning new ratings to a repackaged security, the agency may also consider the price at which the SPV purchases the original security (especially if there is a substantial gap between Fitch's rating opinion regarding the likelihood of full principal return and the market price).

While these principles address repackaged structured finance transactions globally, individual sector groups may publish sector-specific criteria that augment or supersede these guidelines.

Appendix 3: Distressed Debt Exchange (DDE)

Within SF, the vast majority of defaults are accounted for by missed coupon or principal payments. However, as SF transactions globally have faced more challenging asset performance and potential payment defaults following the financial crisis, incidences of possible DDE situations have grown within the SF sector.

Fitch may determine that a DDE results when an issuer, in conjunction with noteholders, decides to restructure or exchange the rated notes in an effort to avert a probable payment default. By definition, the restructuring or exchange will cause a reduction in original economic terms from the noteholders' perspective, and to some extent will therefore be distressed in nature. Such a reduction may consist of a reduction in, or deferral of, contractual coupon payments to noteholders.

Determining DDE

A DDE will be determined on the merits of the individual case, but may include a change of interest payment terms from timely to deferred, an extension of the rated notes' legal maturity, a reduction in structural protection that leads to a reduction in economic terms, or a tender offer involving an exchange on terms that are significantly worse than the original contractual terms. An element of subjectivity will remain in most cases.

When considering whether a transaction or class of notes should be classified as having experienced a DDE, Fitch would expect both of the following to apply: the relevant noteholders will suffer a material reduction in economic terms compared with existing contractual terms; and the restructuring or exchange will avert a probable payment default on the underlying notes.

Fitch will make the determination of a DDE event and any adjustments to its ratings based on the agency's assessment of each specific case and at its sole discretion. Fitch determines whether a restructuring or exchange is distressed in nature by reviewing the entirety of the proposal, the motivation for the proposal, and its economic impact on the holders of each class of rated notes, based on the information disclosed to Fitch.[1]

Material Reduction in Economic Terms

If, in Fitch's opinion, the proposed economic terms of a restructuring are significantly worse than the original contractual terms, or an exchange results in the investor receiving anything other than an equal amount of notes on similar terms, then there is a strong presumption that the restructuring or exchange, as the case may be, should be considered a DDE.

Fitch defines a material reduction in economic terms in an SF transaction as a restructuring or exchange proposal that results in holders of a security receiving revised terms that, taken overall, materially impair the economic position of the noteholders compared with the previous terms. It includes – but is not restricted to – any one of the following, or a combination thereof:

- reduction in principal balance;
- reduction in coupon;

[1] Fitch cannot guarantee that all relevant information is disclosed by the transaction parties, especially in the case of exchange or tender offers. Fitch expects that each issuer that has agreed to participate in the rating process, or its agents, will promptly supply to Fitch all information relevant to evaluating the ratings on such issuer or the relevant securities, including, without limitation, all material changes in any information previously provided, potential material events and the issuer's overall financial condition, which may require communication of non-public information to Fitch. Fitch expects all such information to be timely, accurate and complete in all respects. This will include any information requested regarding tender or exchange offers made. Where Fitch cannot obtain sufficient information to form an opinion, the rating will be withdrawn at the agency's sole discretion.

- deferral of coupon payments, or payment-in-kind, on a note rated for timely payment of coupon;
- maturity extension;
- reduction in structural protection to holders of rated notes (eg, removal of a protective trigger or termination event) leading to a negative economic impact; and
- contractual or structural reduction in the seniority of the note (the agency may determine that some changes eg, an increase in the amount of senior fees following servicer replacement, may not be regarded as material enough to constitute a DDE).

However, this does not mean that the restructuring or exchange is not in the noteholders' best interests. It may be the logical (or only) choice in the circumstances; however, the restructuring or exchange itself is, in Fitch's view, an acknowledgement of credit impairment. In determining whether investors have suffered a material reduction in economic terms, consideration may be given to whether the notes were purchased at a discount to par.

Generally, DDEs in SF transactions involve one or more of the above. If there are no mitigating factors, the presence of any one of the above examples may be sufficient for Fitch to determine that a material reduction in economic terms has occurred.[2] Fitch will determine during its committee process the materiality of any of the above referenced examples and factor this into its rating decision.

Although mitigating factors, such as an increase in coupon, may be present in DDEs, Fitch expects these will often not fully compensate for the impact of the DDE on affected noteholders. A rating committee will consider the restructuring or exchange in its entirety and determine whether a DDE has occurred.

Fitch's analysis may conclude that a DDE has occurred for some but not all classes of notes issued by a particular issuer. The decision will depend, amongst other factors, on the materiality of the change and the economic impact on each class of rated notes.

Default Risk

The second element required in determining that an event should be considered a DDE is whether the event will avert a probable payment default on the notes. If the notes must pay interest on a timely basis, and it is clear to Fitch that the issuer does not have sufficient funds to make upcoming interest payments in future periods, then payment default under the notes is clearly imminent. In such a case, an exchange that changes the note terms to allow for interest deferral would very likely be classified as a DDE, as the notes would otherwise default without the exchange.

In other circumstances, a DDE may be more difficult to assess. Factors commonly associated with DDEs that may assist Fitch with this assessment include the following.

- Ratings have deteriorated since the original issuance, for example, where notes that were originally rated at investment-grade level have significantly deteriorated, so that ratings have been materially downgraded.
- Collateral performance has deteriorated significantly, for example where the performance of the underlying collateral has significantly deteriorated compared with original expectations, or when compared with securitisations of similar collateral (for example, where delinquency rates have significantly increased and pre-payment rates have reduced).

[2] Fitch rates securities issues according to their contractual terms and conditions. Although mark-to-market values of securities may provide some indication regarding the nature of the exchange, such values themselves do not exclusively enter into Fitch's determination of whether investors have suffered a "material reduction in economic terms."

- Supporting counterparties are distressed, for example where one or more of the parties to the original transaction (for example, a swap provider) have defaulted or are in a high level of distress.
- Secondary market prices are substantially discounted, for example where mark-to-market values (MTM) have been declining and are distressed, or are low in comparison to securities of a similar type. As noted above, depressed MTMs are not necessarily indicative of credit problems with the notes themselves, for example where MTMs are depressed generally due to restricted liquidity in the market. However, where individual notes are valued substantially below otherwise comparable instruments in their peer group, this may be an indication of distressed performance.

These are only potential indications and it is possible that Fitch may make a DDE determination in the absence of one or more of the above. Conversely, Fitch may not consider a DDE to have occurred, even if one or more of the above are present.

Rating Implications

Pre-Execution

When Fitch is informed of a proposed restructuring or exchange for the notes, which the agency determines to be a potential DDE, the credit rating of the notes affected may be placed on Rating Watch Negative. Once the details of the formal exchange offer or restructuring proposal have been finalised and communicated to Fitch, the affected notes may be lowered to ‘Csf’, indicating imminent default.

On Execution

If the DDE executes successfully, the note rating is lowered to ‘Dsf’. This reflects Fitch’s view that a DDE has occurred and communicates to the market at large that the agency regards the DDE as a default.

Post-Execution

Immediately after the effective date of the DDE, the note rating is raised from ‘Dsf’ and re-rated to a level reflecting the structure as it exists after the DDE. Any new note issued, or existing notes restructured in a DDE, will be rated purely on the transaction’s credit profile after the restructuring or exchange, coupled with any structural and/or legal considerations related to the specific issuance.

As a result of the exchange, new notes, which replace the previous notes that are extinguished, may be issued. In these instances, the newly issued notes are assigned a new rating on the effective date of the DDE. Conversely, the rating of the extinguished notes, having been lowered to ‘Dsf’ on the effective date of the DDE (as described above), is withdrawn.

Old notes that remain outstanding, but with restructured terms and conditions, are re-rated to reflect the agency’s opinion regarding the new credit profile of the notes, after the DDE has been executed. The fact that any note issue was a product of a DDE is not relevant to the current rating.

Appendix 4: Rating Caps and Limitations

Fitch Ratings may view certain characteristics of SF transactions to be incompatible with certain rating categories. Fitch's ratings may therefore be subject to a rating cap. Limitations may be such that it is not possible to rate the notes. This section discusses factors that influence the application of caps. It does not define highly prescriptive and granular rules that apply in all circumstances, due to the variations in SF asset classes. Specific rating caps in an asset class or market sector will be specified in the related sector-specific criteria reports where applied. Where specific caps are applicable based on sector-specific criteria, the sector-specific criteria take precedence over the criteria published in this report.

This section provides a high level framework of the principles Fitch's SF analysts will apply to assess transactions. In certain cases, transactions will not achieve high investment-grade categories (ratings at 'AA' or higher) on principle, regardless of the degree of credit protection or structural mitigation around the notes. Rating caps may be imposed at any rating level, depending on a sector or transaction's individual circumstances.

Rating cap considerations may apply to both national and international scale ratings. However, cap levels for national scale ratings will consider the specific circumstances of the individual country and its national rating scale, which differ in nature to the international rating scale. Cap considerations may be less relevant for national ratings (for example, data availability across all sectors in the country may represent a systemic issue where the national scale applies). Nonetheless, instances that would fundamentally prevent any rating would apply equally to national scale ratings.

A transaction that does not meet all of the elements described in this criteria report may still be rated, if Fitch determines that such transaction is compatible with the purpose and intent of Fitch's ratings and where Fitch believes it has sufficient information to form a credit opinion.

Key Points

Portfolio and Data Quality: Caps will be considered when there is insufficient originator and/or marketwide data, or if the portfolio quality is poor (particularly if combined with extreme portfolio concentration).

Asset Concentration and Performance Volatility: Caps will be considered if a transaction is fully or materially dependent on the performance of a single industry, a small geographic region or very few obligors, especially if these are combined with low credit quality and historically volatile performance.

Legal Terms and Conditions: The transaction's terms and conditions can include elements, such as deferability, note events of default, or a conditional reduction of interest or principal, that Fitch considers incompatible with the integrity of certain ratings.

Excessive Market Value Exposure: Caps are dependent on the degree and type of market value exposure, as well as the liquidity or market value risk of the underlying assets.

Sovereign Dependency: Fitch believes that it is not possible to entirely eliminate the risk that sovereign credit issues will affect the performance of a SF transaction, potentially resulting in sovereign risk-driven rating caps in certain circumstances.

Third-Party Dependency: Ratings may be constrained by the credit quality of third parties if the transaction performance depends, to a substantial degree, on their continued performance.

Incentives of Transaction Parties: Caps will be considered in cases of substantial misalignments of interest or incentives of important transaction parties.

Portfolio and Data Quality

Under *Data Adequacy* above, Fitch explains the data it expects to receive and relies on for its transaction analysis.

Fitch expects to receive loan-by-loan data to perform its analysis for certain types of SF transactions. If specific loan-by-loan information is not available, significant market-wide data and other feedback from the originator may often provide proxy information.

While the length of time may be extensive, data may only cover a period of benign economic circumstances and may therefore be insufficient to develop robust assumptions. Such data for a long benign period allow limited insight into how performance may unfold during the downturn part of the cycle, especially since a sustained extended upcycle could itself be indicative of a “bubble.” A lengthy benign period can mean a subsequent sustained and lengthy down-cycle as performance reverts toward the long-term trend.

Fitch also considers how product types have evolved over the period for which data has been provided with very long-dated assets. If product features have changed significantly, then data provided regarding assets that originated 20 or more years ago (and in some cases even a shorter period) may no longer provide sufficient insight as to how assets might perform in the future and, hence, become less relevant. Qualitative adjustments may be sufficient to address limited changes in product features, such that a rating cap may not apply. However, multiple layers of product change giving rise to several layers of additional risk would be more likely to lead to a rating cap unless there was supplementary data available to assess how such product evolution might influence future performance.

The relevance of historical data to ratings analysis may be a particular issue for transactions with “tail-end” market value risk *(see Excessive Market Value Exposure section, page 11)*. This may be a function of a fundamental systemic shift whereby historical performance patterns may suddenly change, rendering risk assessments based on historical data (including observed mean and dispersion values) less predictive. The modelling framework will be subject to additional scrutiny in these circumstances, with a particular focus on how short-term liquidity stresses could affect the transaction.

If an originator is not capable of producing historical performance data in line with the aforementioned description for the assets targeted for securitisation, the transaction proposal is unlikely to be rated by Fitch unless strong mitigants, such as relevant market-wide data, are available. In asset classes where the originator-specific underwriting criteria are expected to have a limited influence on the credit quality of the portfolio (eg syndicated loans or commercial property loans), available market data are expected to be more relevant than specific originator data.

Rating caps based on portfolio quality or attributes may also apply only to portions of a portfolio. In such a case, the transaction may still be eligible for ratings in the highest categories. Fitch’s analysis may attribute 100% loss to the portion of the portfolio subject to a rating cap in determining the extent of credit protection that Fitch would expect to support rating levels above the cap.

Some transactions backed entirely by a portfolio of a certain type of assets may see a rating cap imposed where, for example, those assets have a particular attribute or emanate from a volatile sector of the market. However, there may be instances where a transaction is backed only by a proportion of such assets rather than the entire portfolio. In such a case, the transaction may still be eligible for ratings in the highest categories if, in Fitch’s analysis, the relevant portion of the portfolio would effectively get no credit and would be expected to result in a total loss in rating scenarios above the level where a rating cap would ordinarily be expected to apply to such assets.

The asset class-specific criteria reports provide a detailed description on the type and extent of data expected for each asset class that is in line with the above principles.

Possible Mitigating Factors

If available originator data do not fully meet the aforementioned standards, representative proxy data can be considered to supplement otherwise inadequate historical originator performance data (either in terms of length of time or direct relevance) and the rating of a transaction. In addition to considering other sources of data, Fitch may also take into account any relevant information or industry perspective from other analytical groups within Fitch.

The proxy data may be data of other originators active in the same market or general industry-level data (in each case, the receivables that are the subject of the data should be similar in nature in terms of profile, as well as underwriting, origination and servicing standards). In limited cases, it might also include data available from different jurisdictions for similar asset classes, where the jurisdiction-specific aspects of the data can be addressed via reasonable adjustments.

If the jurisdiction where the receivables are originated has a significantly different legal and political regime compared to other jurisdictions where proxy data might be available, then it is unlikely that data from these jurisdictions can qualify as a proxy due to its limited relevance. In such cases, Fitch is unlikely to assign a rating.

For those ratings that proceed subject to a rating cap, based on limited data supplemented with proxy information, default, and loss severity assumptions will be higher than might usually be the case for the rating categories concerned if more extensive data were available. This reflects penalties applied in the analysis to mitigate increased uncertainty regarding the data used to derive rating assumptions, which will result in higher base case assumptions and/or higher stress levels and higher credit enhancement than would be the case with more data.

In the event that there is only limited deficiency of historical data and/or proxy data available as described, it may be possible to rate a transaction without a rating cap. This limitation would be mitigated through applying significantly higher asset stresses to reach higher investment-grade categories. Such an approach can be taken either at a criteria level if significant wider market information is available or at a transaction-specific level.

Asset Concentration and Performance Volatility

Asset concentration concerns arise, for example, where the performance of a transaction is fully or materially dependent on a single industry, a small geographic region or very few obligors, especially if these are combined with a low credit quality. Transactions that are initially granular may become concentrated over time as they season and amortize. In such instances, a rating cap may apply. Fitch expects such risks to be addressed through structural mitigants such as credit enhancement floors in new transactions.

Industry Concentration

In case of industry concentration, Fitch would analyse the type of industry (or the small number of connected industries as the case may be) and analyse whether such industry is characterized by very volatile asset performance, few players, or a large degree of uncertainty (for example, through the obsolescence of key technology). If such considerations are prevalent, a rating cap is likely to apply.

Examples where such an industry concentration rating cap may apply include, but are not limited to: (a) a securitisation of junior commercial property loans (B-notes), particularly if in a single or related jurisdictions or regions; (b) a securitisation of shipping loans, particularly if strongly dependent on volatile spot freight rates; and (c) a securitisation backed by future cash flows from legal settlements owing from tobacco companies to U.S. states (tobacco settlement ABS).

However, standard granular SF transactions are not considered to fall into the single industry category. Specific segments of the consumer finance market like auto and credit card loans or the commercial real estate market are characterized by markets with adequate performance data, such that robust analytical assumptions may be developed. While these sectors may be exposed to cyclical behaviour, Fitch typically does not apply a rating cap because of the relatively low degree of uncertainty associated with the robust performance data. Consumer finance transactions are also exposed to a large granular pool of obligors where an opinion can be formed on collective behaviour in stressed scenarios. Similarly, a securitisation of a diversified portfolio of high- yield corporate obligations would also not be considered to be subject to the single industry exposure. While the lower credit quality assets are subject to higher performance volatility provided these transactions demonstrate significant industry and obligor diversification (thus sufficient overall stability), in Fitch's view a rating cap may not apply.

Despite this, rating caps may be applicable in certain asset classes where a transaction is concentrated in a sector or subsector in which historical performance has been volatile or unpredictable in the past. These may include transactions backed by non-traditional or riskier credit quality assets combined with more aggressive underwriting practices and/or other risk factors. It may also include transactions concentrated in particular vintages originated in peak conditions where historical performance has been poor and highly volatile. When analysing securities backed by such subsectors, Fitch may consider applying rating caps as determined by the relevant sector-specific criteria. Caps may apply for the whole subsector or industry or for individual transactions with details described in associated rating communication.

Prefunding and Revolving Periods

Additionally, transactions that have long prefunding or revolving periods or where the prefunding amounts are considered significant may not be rateable or may be subject to a cap on the maximum achievable rating. These structural features expose noteholders to additional risks with respect to a longer risk horizon. In particular, there is an increased risk of being subject to negative evolution in the credit profile of a collateral portfolio, particularly in the run up to the peak of a cycle, with the risk of increased losses during a subsequent downturn.

Geographic Concentration

Similarly, if significant geographic concentration is present, a rating cap may also apply. For example, this can be the case if an RMBS transaction is mainly backed by mortgages of secondary or holiday homes located in a region or an island dominated by tourism. Fitch believes such a transaction may be subject to performance volatility that is inconsistent with 'AAAsf' ratings. Determination of whether a rating cap will apply will depend on a specific analysis of the economic profile of the region concerned. Less acute geographic concentrations can be addressed by specific analytical adjustments that would be described in related criteria or transaction-specific reports.

Obligor and Asset Concentration

Rating caps can also be applicable if a significant asset or obligor concentration is present in a transaction portfolio. However, this also depends on the asset class, type of obligor or asset concentration, and the asset credit quality. For example, the securitisation of a single high-quality New York commercial property is unlikely to be subject to a rating cap due to the expected high- quality liquidity and re-sale value of the underlying property. On the other hand, a transaction backed by unsecured debt from a small pool of 'BBB' rated corporate obligors is unlikely to achieve a rating above 'Asf', as opposed to more granular transactions.

Asset or obligor concentration risk may arise in transactions that are initially granular but experience increased small pool or loan count concentration over time. Increased tail- end credit enhancement targets may be one way of mitigating this risk as transactions season and amortize. Fitch will apply rating caps for transactions that could experience such loan count concentration and where the transactions lack any type of structural mitigants to offset potentially increased performance volatility as the pool size declines.

Legal Terms and Conditions

Fitch generally assigns ratings to SF instruments that address the likelihood of receiving payments in accordance with the terms and conditions on which the investor makes his investment, i.e. in accordance with the terms and conditions of the transaction documents.

Nevertheless, a transaction's terms and conditions can include elements that Fitch considers incompatible with high investment-grade ratings, particularly at the 'AAAsf' level, which would result in ratings being capped or limited. Some elements may be incompatible with any rating being assigned. Examples include, but are not limited to, those described in the subsections below.

Deferability of Notes

Fitch's SF ratings address the likelihood of receiving payments in accordance with the terms and conditions on which the investor makes its investment. This means that, for principal repayment, a Fitch rating addresses the repayment by the legal final maturity of the note in accordance with Fitch's rating definitions (unless there is a pre-defined principal repayment schedule that would represent an event of default if not met).

Fitch will not assign 'AAAsf' or 'AAsf' ratings to notes that it expects would defer interest under stress scenarios associated with those ratings, even if permitted under the terms of the documents. Fitch will only assign 'Asf' or 'BBBsf' category ratings for bonds projected to incur deferrals in an expected case scenario (which in the absence of a published "expected case scenario" will refer to a 'Bsf' scenario) if the following conditions are met.

- Deferrals are permitted under the terms of the documents.
- Deferrals must be fully recovered under the terms of the documents well in advance of the legal final maturity in the rating scenario associated with the rating assigned to the note.
- The deferral period is not deemed excessive.
- Noteholders are viewed as being in a substantially similar economic position as if deferral had not occurred.
- Noteholders are given clear indications that deferrals may occur (e.g. notes are titled "deferrable notes" or deferral is outlined as a key risk factor of the notes in the offering documents).

Fitch will review cash flow results or similar analysis to assess the likelihood and frequency of interest deferrals in expected and stress scenario cases. In each case, Fitch will explain in its rating communication if the rated notes can, according to the notes' terms, defer or capitalize interest, if, according to the rating analysis, deferral is expected to occur and whether ratings have been capped as a result.

Certain Note Event of Defaults

Certain transactions may underperform in relation to Fitch's initial expectations, resulting in the occurrence of a note event of default. However, despite this, the note event of default may not be expected to result in any change to the allocation of transaction cash flows nor result in any interest or principal loss to the security, according to Fitch's current expectations, provided the transaction continues to maturity. While such events may not affect Fitch's credit analysis, nevertheless they are usually indicative of some form of performance stress.

In such circumstances, higher investment-grade ratings will generally not be achievable in cases where a transaction may have entered a note event of default due to the breach of a trigger but is otherwise performing within Fitch's current expectations. Such note event of default triggers are often linked to overcollateralization or coverage ratio tests that are prevalent, for example, in SF CDO transactions. Note events of default may continue to be unremedied for the life of the transaction if no enforcement action is taken by the majority of the controlling class.

Conditional Reduction of Interest and/or Principal

Fitch has been approached with transactions where the terms and conditions specify the reduction of an interest distribution and/or the reduction of principal proceeds, subject to certain credit events (for example, the reduction in an interest rate coupon if a sovereign credit defaults — thereby embedding credit risk within the definition of the interest coupon — or reducing the principal repayment if an equity or commodity index falls below a certain level). In such cases, when assigning SF ratings, Fitch would depart from the principle of rating to the documents and will also consider the likelihood of such a conditional event occurring in combination with other structural arrangements.

This is because, in such circumstances, a credit rating opinion delivered on the form of the transaction as described in the transaction documents would not effectively express an opinion on the substance of the entire credit profile of the transaction when considered as a whole (i.e. Fitch would apply the principle of "substance over form" in such cases). This could result in a rating cap or make a transaction not rateable at all.

In instances where receipt of an interest coupon (or part of an interest coupon) is conditional on credit risk (for example, the earlier example of the reduction of a coupon on the default of a sovereign credit), Fitch's rating will address the credit risk embedded in the interest coupon as well as the return of principal. This is because a credit opinion can be formed regarding the likelihood of the conditional reduction in the interest coupon. Therefore, the rating would be capped or limited by the credit position of the sovereign credit if lower than that of the entity that has the obligation to make interest and principal payments.

Fitch would not rate a SF note where the interest rate coupon or principal is market linked through dependence on the performance of a market or credit index (for example, an equity index such as iTraxx).

For clarification, this does not apply (and rating caps are not applicable) if interest distribution amounts are variable because payments are based on a margin over a floating interest rate index (such as LIBOR) or inflation indices.

Generally, Fitch would be more concerned about a conditional reduction of principal payments than interest payments, although either can, in Fitch's view, lead to a rating cap or make a note not rateable.

Net weighted average coupon (WAC) caps (net WAC caps), which cap the interest due on certain tranches to the level of the WA interest rate owed on all assets, are an example of a conditional reduction of payments, eg the interest distributions can be reduced, capped, or deferred in adverse interest rate or prepayment scenarios, but not as a result of credit-related issues (although the payments could result from established loan servicing strandards, such as distressed loan modifications in US RMBS and US CMBS). Where securitisation markets have evolved with net WAC caps or similar features as an established market standard (eg in US RMBS and US CMBS), Fitch believes that the limitations of these features are widely accepted and well understood by market participants, including investors.

In such cases, Fitch's rating opinion does not address the likelihood of receipt of any interest cash flows that might exceed the net WAC cap or similar features, nor would such features be a cause for a rating to be capped. Fitch would expect the consequences of these features to be clearly explained in transaction documentation, and Fitch would expect that these features would not give rise to any conditional reduction in payments as a result of credit-related issues, such as reduced asset revenues owing to obligor default.

In contrast, in securitisation markets or sectors where net WAC caps or similar features have not been used, where Fitch believes the concept is not familiar to market participants and where Fitch believes the prospect for inconsistencies between ratings in the sector could arise, Fitch will test for receipt of liability-side cash flows gross of the conditional reduction (eg in excess of the net WAC cap) in its rating analysis, or consider applying rating caps to notes subject to a net WAC cap.

Principal-Only Ratings and Principal-Protected Notes

Occasionally, Fitch assigns ratings that only address the ultimate payment of the principal at or before the maturity and do not include an opinion on the ongoing or ultimate payment of any interest distribution. This will typically be the case where no coupon is specified (e.g. zero-coupon notes). Fitch will not assign principal-only ratings where an interest coupon for a note exists.

For principal-protected notes, the principal is typically protected by a pledged asset or benefits from the guarantee of the sponsoring bank. Such protection would typically be limited to the creditworthiness of the guarantor and terms of the guarantee. Additionally, Fitch can consider applying rating caps to certain principal-protected notes where the transaction structure is deemed too complex. Any such limitation of the rating will be specified in Fitch's rating communication.

Step-Up Interest Coupons

SF transactions sometimes include arrangements for a step-up interest coupon, or increased interest margin, which is intended to provide an incentive for the originator or equity tranche holder to exercise an early prepayment option at a "clean-up" call for the transaction. Usually such step-up coupons are part of the defined coupon and are paid pari passu with the given note class and their non-payment on senior notes would cause a payment default. In its analysis, Fitch will assume that the clean-up call is not exercised and, therefore, the note coupon will step up and the step-up interest amounts are addressed in Fitch's analysis.

In contrast, Fitch may be approached with transaction structures where the step-up coupon would be paid subordinate in a transaction waterfall (i.e. junior to the lowest-rated note) and where the non-payment of the step-up coupon would not cause an event of default for the transaction, according to the transaction documentation. In such instances, Fitch will consider not addressing the subordinated step-up interest payments in its rating opinion, depending on the circumstances.

Fitch will expect to exclude such cash flows from its rating analysis where securitisation markets or sectors have evolved with this subordinated feature being an established market convention, where Fitch believes investors do not expect to receive such cash flows and where there has been clear and prominent disclosure in transaction documentation as to their subordinated nature and exclusion from events of default. In such instances, Fitch believes investors will have greater use for a rating opinion that only addresses the interest and principal cash flows that they actually expect to receive. Any such limitation of the rating will be clearly specified in the relevant sector-specific criteria and in Fitch's rating communication.

Practical Application — Fitch will consider not assigning ratings where there is a greater potential for the rating to be misinterpreted, misused, or misrepresented. Therefore, ratings assigned to interest-only (IO) securities will be directly linked to the credit risk of the referenced tranche or tranches:

- IOs that reference a single tranche will be rated at the same level as the referenced tranche;
- IOs that reference multiple tranches will be rated at the level of the lowest referenced tranche whose payable interest has an impact on the IO payments; and
- IOs that only reference: (i) tranches whose payable interest has no impact on the IO payments; (ii) non-rated tranches; or (iii) the entire pool balance will not be assigned ratings by Fitch.

In contrast, where such a feature has not been used in a particular subsector where Fitch believes disclosure is unclear or where the prospect for investor misunderstanding is high, Fitch could choose to include the step-up coupon in its rating opinion so as to allow for consistency in the basis for ratings across that subsector. Where step-up coupons are included in the rating opinion, they will be included in Fitch's cash flow analysis. In cases where a step-up coupon is paid subordinate in a transaction waterfall, the rating will be limited by the reduced likelihood of receiving this payment at the subordinate level. This can lead to a rating cap consistent with the payment of the subordinate payment, or make such notes not rateable.

Additionally, Fitch will not assign interest-only ratings where principal cash flows exist.

Ratings with Limited Credit Value

Previously, Fitch has been asked to assign ratings that are non-traditional or have no or limited credit substance due to the defined terms and conditions of the notes concerned. Examples are mortgage early redemption certificates, where investors will receive distributions only to the extent that early redemption payments are received by the special purpose vehicle (SPV). The rating can only address the mechanics of whether the distribution of funds from early redemption will happen but not express any form of credit opinion as to the extent of such redemptions. Such notes would only be subject to rating action resulting from issues related to the defined terms and conditions rather than any real credit opinion. Therefore, such a rating would be of limited value from a credit perspective and will not be assigned at any rating category.

As a general guide, if Fitch cannot envision scenarios where a note's ratings may be subject to rating actions due to credit issues, it is very likely that the rating would be considered to lack any real substance. In such situations, no Fitch rating will be assigned.

IDRs for SPVs

Fitch will not assign ratings to SPVs used in SF due to their lack of stand-alone commercial substance. The ratings of SF transactions relate to the obligations of the SPV issuer and do not address the SPV issuer itself, which is generally not an operating company. Any issuer default rating (IDR) that would be assigned to an SPV would be inconsistent with Fitch's IDR definitions and criteria and, as described in the previous section, would lack any credit substance.

Lack of Transaction Economic Substance

It is Fitch's practice not to rate transactions that exist, in the agency's view, solely for tax and/or accounting considerations without serving any fundamental economic purpose. While tax and/or financial reporting considerations are often one of a number of motivating factors for issuers of SF transactions, such considerations will generally be complementary to a principal economic motivation. In the event that there appears to be no economic substance to the structures, apart from tax-avoidance schemes or accounting window-dressing, Fitch will not rate the transaction. While the agency may have no reason to believe such transactions are illegal in any way, such structures are not compatible with the purpose and intent of Fitch's ratings.

Excessive Market Value Exposure

SF transactions with material exposure to market value risk are specifically addressed in Fitch's criteria report *Rating Closed-End Funds and Market Value Structures*. In line with this criteria report, a rating cap can be applied, for example, for portfolios comprised of less liquid securities; the rating cap would be set at the 'A' category *(*see the criteria report available on Fitch's web site www.fitchratings.com for more detail*)*.

In addition, a rating cap may be applied to transaction structures that: (a) rely on a servicer's ability to achieve a loan workout or to liquidate collateral in an orderly fashion in the most stressed environments and/or a very limited time horizon (eg as a transaction approaches its legal final maturity date); (b) include assets with limited trading, pricing, and liquidity history; or (c) include assets with knock-out market value triggers in which the breach of a pre-specified trigger (albeit usually set far from current market levels) will result in a default of the transaction with often nominal recoveries.

In Fitch's view, these examples demonstrate a level of "tail end" risk (or risk of extreme events) that — particularly with respect to market price movements — is deemed to be incompatible with high investment-grade ratings. As a result, the ratings are capped as a matter of principle. No level of data, credit protection, or other mitigants will achieve ratings higher than the cap. Unlike asset performance data, historical data with respect to market price movements may provide less insight into the future path of such price movements.

The rating cap is largely driven by the limitations of effectively assessing the liquidation prospects in the tail-risk scenarios. For certain assets, forced liquidation prices in most severe scenarios may be so low such that no credit could be given to them in such an environment.

Sovereign Dependency

Sovereign governments and their agents can affect the operating environment for private entities and SF transactions in many ways. While the securitisation industry has developed a number of techniques to mitigate these effects, Fitch believes it is ultimately not possible to entirely eliminate the risk that sovereign credit matters will affect the performance of an SF transaction. A high level of sovereign default risk raises the prospect of extreme events occurring in a country and reduces the certainty of performance projections for SF assets. For this reason, a rating cap will be applied in certain circumstances. Fitch's *Criteria for Country Risk in Global Structured Finance and Covered Bonds* addresses sovereign risk in both developed and emerging markets, as well as transactions with multi-jurisdictional structures.

Legal Uncertainties

Rating caps can also be applicable where there are concerns regarding the robustness of the legal framework affecting a particular asset class or a particular jurisdiction. One means of assessing this is to examine the extent and materiality of reservations, qualifications, and assumptions in legal opinions, which may weaken the views expressed therein. Whether any rating cap is applicable — and at what rating level — will be influenced by the likelihood of the legal event, subject to reservations or qualifications. Where insufficient comfort can be obtained regarding salient legal issues, it is unlikely that Fitch will assign a rating at any level.

Third-Party Dependency

One of the basic principles of SF is to achieve the maximum structural “isolation” of a transaction’s performance from the idiosyncratic credit or operational exposure of the counterparties involved. In other words, the aim is that any credit deterioration or default of transaction counterparties does not have a material negative effect on the performance of the SF transaction itself. The intended result is that SF transaction performance reflects primarily that of the underlying collateral and is isolated from the specific risks that affect corporate counterparties.

However, there are situations where the SF transaction performance can depend to a substantial degree on the continued performance of a third party (e.g. the originator, seller, servicer, derivative counterparty or others). This can result in material credit exposure to that counterparty or provide operational dependency if the counterparty performs crucial functions that may not be replaceable and are crucial to the transaction performance. An example would be the case where a significant percentage of the pool comprises employee loans tied to one originator.

In such instances, the rating can be capped at the level relative to the relevant counterparty or at a certain level above the originators’ rating, depending on the considerations below. The list of such counterparties can be extensive but includes those discussed below.

Servicer

Fitch may consider a rating cap in transactions where continuation of the asset servicing is doubtful post default of the servicer because (a) the legal documentation does not provide for adequate backup servicing provisions (b) the jurisdiction lacks a well-developed servicer market for the assets at hand and/or (c) the legal regime is not considered supportive in case of servicer insolvency. This is particularly relevant for, but not limited to, servicers with a non-investment-grade IDR or unrated entities.

A rating cap may not be applicable if Fitch believes the transaction can withstand a liquidity shock in the event of a sudden default of the servicer or when concerns surrounding continuation of servicing are sufficiently mitigated at the transaction and/or jurisdiction level. In some cases, this may include additional liquidity to continue payment of the notes during the transitional period. The existence of a backup or standby servicing agreement at transaction closing may also mitigate the need for a rating cap, whereby the type of standby agreement and operational and credit quality of such backup entities would be considered.

For more detail, refer to the section, *Servicer Continuity Risk in Structured Finance,* in the report *Structured Finance and Covered Bonds Counterparty Rating Criteria*.

Originator

Generally, SF transaction performance aims to be detached from the performance of originators. However, in Fitch’s view, this may not always be achieved and may have rating implications. For example, where the true sale or a clear segregation of the assets cannot be achieved or where there is no clear legal comfort that such asset segregation is effective, the rating of the SF securities, in the absence of other mitigants, will be capped at the rating of the originator.

Ratings caps can also apply where there is a material reliance on the ongoing operations of the originator or aggregator. This is the case in future flow transactions, which securitise the cash flow originating from a specific business line of a bank or company that produces goods or services for (foreign) obligors. Fitch assesses the risk through a going concern assessment score (GCA) that allows for a rating between zero and six notches above the local currency IDR of the originator *(*for more details, refer to *Future Flow Securitization Rating Criteria*).

This will also apply to revolving structures where there are doubts about the originator maintaining the same quality of origination standards or ensuring data integrity.

Derivative Exposure and Other Counterparties

In Fitch's view, it is not possible to fully "structure away" counterparty risk for SF transactions. However, it is possible to employ structural mitigants that allow for this risk to be minimized. Fitch has published counterparty criteria for SF transactions that express the agency's opinion as to the minimum arrangements it believes are necessary to achieve the maximum degree of isolation from a counterparty. In these instances, Fitch will consider the SF ratings to be sufficiently remote from the ratings of the key transaction counterparties. In the absence of such arrangements, a rating cap will be applied.

Fitch applies rating caps for third-party dependency in certain instances:

Servicers — when assets are complex to service.

Originators — when doubts exist about the asset segregation.

Derivative or Account Providers — for ineligibility, lack of appropriate remedial actions or excessive dependency.

Notwithstanding these arrangements, Fitch also identifies instances where reliance on a counterparty can be so excessive that normal structural mitigants may not be sufficient to overcome the counterparty dependency, as it would become the dominant factor in the rating analysis. This may include hedging arrangements that seek to significantly increase the distributions to the SPV as a means of providing additional credit enhancement for highly rated tranches. Other examples would be account bank structures where large sums are held with a single institution over a long term and security arrangements protecting against the bank's default are not satisfactory. In such cases, a rating cap at the rating of the counterparty will apply, due to the excessive counterparty dependency.

Fitch's counterparty criteria framework is predicated on the expectation that counterparties will implement remedial actions upon becoming ineligible. However, where upon breach of eligibility thresholds, transaction parties choose either to amend or not follow documentation, Fitch may revise its expectations for the affected transactions. In such instances, the ratings may become subject to a rating cap. The application of the rating cap will depend on the materiality of the counterparty exposure, the counterparty's credit profile, any specific mitigating factors and Fitch's expectations of future remedial action

For material counterparty exposures where Fitch observes a lack of commitment to implement future remedial actions, the note ratings may be capped at the IDR of the relevant counterparty. Alternatively, where a restructuring or amendment undermines a transaction's integrity more fundamentally, Fitch may choose to withdraw ratings on the basis that a robust rating opinion cannot be maintained.

For more details, refer to *Structured Finance and Covered Bonds Counterparty Rating Criteria* and *Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum*.

Incentives of Transaction Parties

Ideally, the incentives of transaction parties are aligned with the interests of the noteholders. However, this is not always the case and some misalignments of interests or incentives can be so material that a rating cap would apply or ratings not achievable at any rating level. For example, especially for originators that are in some form of financial distress (as may be indicated by a low rating), an analysis of the incentive structure of the originator and any counterparty dependency is needed.

This is particularly the case in revolving or managed transactions where the collateral may significantly change over time and originators or managers may have the incentive to sell or substitute low quality assets into the portfolio to maintain short-term funding to the company. While eligibility criteria typically provide some protection against this, they usually do not fully address a material misalignment of interests. Depending on transaction-specific arrangements to address such concerns, a rating cap may apply or the transaction may not be rateable. Fitch notes that many regulators have introduced requirements for originators to retain an interest in the notes sold to investors in certain circumstances. Such provisions may provide a mitigating factor to incentive issues where they arise.

Issuers may also sometimes look to include provisions in transactions that allow for optionality on the part of the originator or other counterparties. How transaction counterparties may behave when exercising such optionality provisions is a consideration when assigning ratings to SF transactions. Where a specific action of a counterparty (other than the investor[s]) could lead to a significant note impairment, Fitch would not be able to rate the transaction at any level. Examples for this situation would be: (a) the option of an originator to call the transaction notes (or repurchase all the assets) at a price that could lead to a loss of either interest or principal for the noteholders or (b) the ability to redeem notes at any level chosen by the originator, thereby potentially altering the credit protection position across the structure

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