ARC RATINGS

STRUCTURED FINANCE RATING CRITERIA

EUROPEAN NON-PERFORMING LOANS (NPLS) RATING CRITERIA

This is an update to the methodology previously published in September 2019.

There are no material changes and as such no rating impact.

October 2020

I. INTRODUCTION

ARC Ratings' ('ARC') European Non-Performing Loans ('NPLs') Rating Criteria (the 'Criteria') summarise how ARC assesses credit risks within NPL transactions across Europe. The approach looks to analyse both quantitative and qualitative factors including the transaction structure, recovery amounts, recovery timings, servicer performance, operational risk, counterparty risk and other factors as described below.

This report is an update to the version published in October 2019. There are no significant changes to the Criteria. Therefore there will be no rating impact on existing transactions. Going forward, all new transactions will be rated using these Criteria.

As transactions can vary significantly and each transaction is unique, in certain cases analysis may diverge from stated assumptions. For example, assumptions may vary between countries, between structure types etc. If Criteria assumptions are amended or supplemented these will be disclosed in individual transaction reports.

Where insufficient information is available or structural mechanisms are incompatible with these criteria, a rating cap may be applied, or ARC may decline to rate the transaction.

These Criteria address both unsecured and secured NPLs. Whilst the definition of NPLs varies between jurisdictions, ARC defines NPLs as loans that have defaulted in accordance with the originator's default definition.

II. RELATED RESEARCH

Each transaction will be accompanied by a transaction specific report that will disclose the specifics of the transaction and modifications to the Criteria, if any. These Criteria should be read in conjunction with ARC's 'Global Structured Finance Methodology' and 'Structured Finance Servicers Criteria', both updated in September 2020.

III. RATING APPROACH

ARC's rating approach is both quantitative and qualitative with final ratings accorded by a rating panel.

ARC will initiate its rating approach with a review of the underlying pool of assets, including an assessment of the granularity and concentration limits of the pool, together with a review of any business plan provided by the servicer as described further below.

ARC will perform a loan-by-loan analysis to estimate recovery amounts and recovery timing for the underlying assets and their respective cash flows. ARC's expectations of recovery amounts and recovery timings might be influenced by several factors including, but not limited to, the servicer's past performances, the servicer's portfolio business plan projections, the type of asset and/or underlying security and ARC's economic outlook of the country where the NPLs have been originated or where the assets and courts are geographically located.

The review of the servicer's business plan and of the servicer's historical performance are key exercises given the role that any servicer plays in the recovery process. For secured exposures, those backed by assets (e.g. residential property), ARC expects to receive from the servicer data based on completed sales of similar assets in the relevant jurisdiction. For unsecured exposures (i.e. those which do not materially benefit from collateral support) historical static recovery curves with similar clusters as presented in the business plan should be provided.

Given the frequently irregular pattern of cash-flows in NPL portfolios, ARC will perform a cashflow analysis, incorporating the findings from the above analysis, allowing ARC to determine whether there are appropriate liquidity measures in place to meet financing obligations. ARC will prepare its cash flow analysis to reflect all items in the transaction priority of payments (which should be clearly defined in the transaction documentation), specifically including transaction features such as obligations on financing and administrative and servicing fees.

In terms of the servicer review, ARC will review the servicer's experience, collection policies and procedures, its record of performance against past business plans, staff expertise as well as measures in place for servicing continuity.

All securitisation transactions rely to some extent on the performance of transaction parties and counterparties. These include account banks, swap counterparties, liquidity providers, etc. For more details on how these can affect transaction ratings, please refer to ARC's' Global Structured Finance Methodology.

IV. OPERATIONAL AND SERVICING RISK

A key factor of the rating analysis is the ability of the originator and/or servicer to perform their functions in respect of business strategy, work out of loans and servicing continuity. As part of its review, ARC will consider the impact of servicing and recovery strategy on past performance as well as the future ability of the servicer to service the portfolio of loans. As part of the rating analysis, ARC will carry out both an originator (in cases where the originator retains an interest in the portfolio) and a servicer review for each transaction (see Appendix B). The review provides a qualitative (and in some cases quantitative) input to the rating panel.

ARC will assess more favourably, servicers with long track records and proven experience. Servicer expertise is key in the ability to work with delinquent borrowers as well as managing and disposing of assets. The return on assets is often directly linked to the ability of the servicer, this driven by a given servicer's experience and procedures. Local knowledge and local placement can also have a positive impact on the servicer's ability to collect on and manage assets; and to choose recovery options which can accelerate the recovery process or yield better results. ARC will examine the servicer's capabilities in part with a review of its financial position (including a review of annual financial statements), its staffing complement and systems.

As part of its servicer review, ARC will consider the extent of incentives offered to improve returns and how these are ranked in the waterfall relative to obligations to Noteholders. In particular, ARC will analyse the potential trade off between incentives to achieve earlier collections (e.g. via a non-judicial process) which might be lower in absolute terms but higher in net present value terms than following judicial proceedings. ARC will also determine whether the appointment of a back-up servicer at the outset of a transaction would be beneficial.

V. RECOVERY AMOUNT AND TIMING

ARC will formulate a base case scenario for the transaction based upon historical performance of the servicer and underlying assets. As a result, ARC will derive specific recovery assumptions, which culminate in the determination of haircuts - evidence - based reductions from expected gross recovery amounts - for both secured and unsecured portfolio segments.

ARC's secured exposures historical data analysis takes into account a whole range of information on the collateral managed by the servicer, including the most recent valuation amounts and dates, sale prices and dates of similar assets, location of the local court and the number of auctions typically held (where applicable). Further adjustments can be made to account for jurisdiction-specific historical evidence of market liquidity and may capture qualitative adjustments reflecting the nature of the collateral (e.g. residential assets as opposed to non-residential assets). Based upon the historical and forecast performance of the assets (if secured) and expected costs of work out and enforcement, ARC will calculate historical recovery timing curves which can then be adjusted to account for qualitative factors or portfolio-specific features (out-of-court settlements, borrowers' repayment plans etc.).

In forming its base case, ARC assesses the characteristics of the underlying properties, including time since repossession, to assess if further recoveries are achievable. ARC also takes into consideration whether the servicer's business plan expected collections already include stressed assumptions in relation to anticipated property value development or distressed sales discounts, or if they carry specific risks which could result in lower levels of expected recoveries.

For unsecured exposures, ARC usually analyses static recovery data provided by pool stratifications that relate to historic vintages. The focus of the analysis is typically on the loan ageing since the date of default, having observed that the higher the ageing of the default the lower the expected recovery.

ARC's loan by loan analysis will take account of the varying forms of security for secured receivables, which can include residential property, commercial property, guarantees, cash, rental income, and can include cash held in court in respect of an executed recovery but where release of funds is not immediate.

ARC might also consider the amount of NPLs in that particular market and sector, and whether the work-out of a large volume of such loans over the same time horizon as the securitisation could have an adverse impact on the expected recovery values and timing. In such cases further adjustments might be made to establish ARC's base case cash flow estimate for the portfolio.

As recovery processes and asset characteristics can differ across jurisdictions and different regions of the same country, ARC may apply country/region specific stresses or even assign a rating cap where necessary.

VI. LEGAL PROCEEDINGS

Typically, judicial proceedings and non-judicial proceedings in respect of collections will occur simultaneously. This will be analysed as part of the business plan and strategy analysis. In general terms, legal proceedings are likely to take longer to achieve, while non-judicial proceedings are likely to be quicker but given their compromise nature, might yield lower recoveries. As noted above, NPL transactions are reliant on the servicer's judgment to determine which will yield the better net present value. In certain jurisdictions, recoveries may be held in court for prolonged periods of time, but ARC may be able to give credit to cash held within the court system if it can easily be identified and ultimate recovery within a reasonable time-frame is assured. However, if a substantial amount of cash owing to the transaction is held within the court system this may result in a cap being imposed upon the transaction resulting from increased sovereign risk.

VII. LEGAL ANALYSIS

ARC's understanding of the specifics of the local insolvency framework for any NPL transaction is key to its ratings. It will seek legal opinions which support the assumptions made in the business plan around the method and timing of recoveries expected. ARC will also review all transaction documents to fully understand how these assumptions are formulated and applied.

VIII. HEDGING

While ARC expects appropriate hedging mechanisms to be put in place on structure finance transactions, it recognises that NPL transactions typically have inherent interest-rate mismatches as recovery cashflows do not increase in line with Euribor (or other floating rate indices) because they are uncertain in size and timing. Accordingly, for floating rate note structures where such hedging is not in place additional interest rate stresses may be applied.

IX. LIQUIDITY

Another consequence of the uncertainty of recovery proceeds is the need for appropriate liquidity mechanisms to be in place. ARC expects such reserves to cover servicer disruption as well as periods of zero recoveries. Liquidity may be provided in the form of reserves or a committed liquidity facility. For NPL transactions liquidity may amortise in line with the underlying NPL portfolio, subject to triggers which might be in place to limit amortisation.

X. STRUCTURAL MECHANISMS

Within its analysis, ARC will also analyse other transaction structural mechanisms such as performance triggers which limit the risk to noteholders of deterioration of the portfolio. These are expected to be adequately monitored and with any breaches enforced on a timely basis. Performance triggers may result in deferring interest to junior notes or switching from pro rata to sequential paydown of tranches.

NPL transactions are not expected to have revolving periods. Also, given volatility and uncertainty of cashflows they are typically expected to have a sequential pay down rather than pro rata structures.

In respect of servicer fees, it is common for NPL transactions to allow some level of payment to the servicer at a senior level in the waterfall with the balance paid at a junior level. ARC will look favourably on transactions that have servicer remuneration which is biased towards the lower end of the priority of payments, and also transactions which cap the amount of servicer remuneration until all rated notes are repaid.

XI. PERFORMANCE MONITORING

ARC should receive transaction reports on the respective reporting dates to assess recovery amounts, timing and work out costs in relation to the base cases set upon transaction outset and the original business plan. ARC will also monitor trigger levels to ensure no breaches have occurred in line with limits set within the transaction documentation. Periodically ARC will expect to receive updated loan-by-loan information. ARC will aim to meet with the originator/servicer at least annually to discuss any updates to the servicing processes and business plan / strategy.

XII. RATING MODIFIERS

An Indicative Rating - evidenced by the suffix (ind) – is a rating assigned by ARC to an issuer or an instrument (most commonly structured or project finance debt issues) when the assignment of a final rating is dependent upon the fulfilment of specific contingencies. Any material deviation in the fulfilment of these contingencies from the assumptions underlying the Indicative Rating can have a material impact on the final rating accorded, which accordingly may be fundamentally different to the initial Indicative Rating. Moreover, ARC reserves the right not to issue a final rating. Potential investors are advised to bear this in mind when considering any indicative rating.

As with all other structured finance ratings, NPL ratings are required to include the suffix (sf) following the rating assigned.

XIII. DISCLAIMER

Note that ARC is not a legal, tax or financial adviser and will only provide a credit opinion of the rated securities. For example, a rating does not cover a potential change in the applicable laws nor can it be regarded as an audit. Moreover, ARC is not a party to the transaction documents, nor does it provide legal, tax or structuring advice.

APPENDIX A: DATA REQUIREMENTS

ARC expects to receive sufficient data to analyse the transaction, including by way of example a Servicer Business plan, a loan-by-loan and property-by-property (if applicable) data tape, Servicer historical performance data (both for secured and unsecured exposures where applicable) and a Servicer Business Plan Methodology.

ARC can provide a transaction-specific list of data requirements prior to commencement of its analysis in the form of a spreadsheet for ease of completion.

The information list will include at least the following:

- Loan-by-loan information
  - Servicer Name
  - Originator
  - Loan ID
  - Borrower Legal status (Corporate/individual)
  - Gross book value ('GBV') at cut-off date
  - Loan Default Date
  - Position Type (Secured/unsecured)
  - Type of Procedure (i.e. Foreclosure, bankruptcy, out of court settlement)
  - Bankruptcy (Y/N)

- Legal Procedure Status (Initial Stage, CTU, auction, distribution)
- Court
- Asset Type
- Gross Mortgage Amount
- Current and past lien position and amount ranking senior, if any, with maturity date(s)
- Additionally, if there were previously senior ranking claims, amounts and dates they matured
- Last Auction Reserve Price
- Property Sale Amount
- Next Auction Value
- Initial Collection Amount (if any)
- Cash in Court (if any)

- Collateral Information
  - Servicer Name
  - Loan ID
  - Asset ID
  - Unit ID
  - Asset Type (i.e. Residential, commercial, etc.)
  - Updated Property Valuation
  - Updated Property Valuation Date
  - Valuation Type (i.e. Desktop, drive-by, etc.)
  - Asset Geographical Location
  - Work Out Strategy
  - Any Cost Related to Strategy (i.e. Repairs, refurbishment)
  - Income (e.g. Lease payments)
  - Independent Valuations (if property) – ARC will determine the precise number/percentage of portfolio to be covered

APPENDIX B: ORIGINATOR/SERVICER REVIEW AGENDA

Below is a sample of information that ARC might need to run its operational risk analysis:

- Company and Management
  - Company history, ownership, and operating experience
  - Financial condition/profitability
  - Ability to provide representations and warranties
  - Management experience
  - Staffing, training, and retention rates
  - Portfolio size and composition
  - Vintage loss performance and trends to date
  - Average servicing fees
- Controls and Compliance
  - Internal and external audit procedures and results
  - Corporate litigation (past, present, and expected)
  - Controls for managing potential conflicts of interest associated with ABS transaction parties
  - Approach to fraud detection
- Loan Administration
  - New loan boarding process
  - Procedures for checking booking accuracy and data integrity
  - Cash management procedures and controls
- Customer Service
  - Procedures and times for responding to customer inquiries
  - Strategy and technology
  - Call volume and average time to answer
- Collections
  - Collection strategies
  - Procedures for distressed accounts

- Describe process for assessing customer's ability and willingness to pay
- Use of external collection agencies

- Loss Mitigation
    - Significant changes (past or planned) regarding workout strategies and/or timelines
    - Repayment plan, modification, and forbearance plan procedures
- Bankruptcy/Insolvency
    - Bankruptcy procedures and technology
    - Number of loans in bankruptcy
    - Percentage of loans performing under the bankruptcy plan
    - Attorney selection process
- Enforcement/Foreclosure
    - Foreclosure process and initiation
    - Average time to repossess a property
    - Auction process, frequency, and performance
    - Percentage of assets sold privately or through lender/servicer-assisted sale and auction
- Possession Management
    - Average monthly repossession portfolio (number of loans and value)
    - Property evaluation (condition and value) procedures
    - Property management procedures
    - Liquidation methods, marketing plan, and strategy for disposition (e.g., auctions, renting, etc.)
    - Process for filing and recovering borrower deficiency/shortfalls
    - Recovery rates and timelines (by region)
- Investor Reporting
    - Procedures for dissemination of reports to investors and trustees
    - Average number of investors remitted to on a monthly or quarterly basis in the last 12 months

  - Average balance of monthly remittances in the last 12 months
  - Number of late remittances in the last 12 months
  - Details on whether and how long accounts are commingled
- Technology
  - Core servicing system strengths and weaknesses
  - Disaster recovery/business continuity plans and success of last test
  - Frequency of full-system backup
- Servicer (specific, additional)
  - Procedures for servicer's due diligence on the asset pool
  - Servicer boarding process, focusing on timing
  - Servicing structuring:
    - Decision making structure and line responsibility
    - Servicer incentive structure and performance management
    - Outsourcing
    - Historical data, benchmarking

DISCLAIMERS

ARC Ratings, S.A. is registered as a Credit Rating Agency with the European Securities and Markets Authority (ESMA), within the scope of the Regulation (EC) Nº 1060/2009 of the European Parliament and of the Council, of 16 September, and recognised as External Credit Assessment Institution (ECAI).

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Credit Ratings assigned by ARC Ratings are independent and forward-looking opinions on the capacity and willingness of an entity or the capacity of a transaction to make all required interest and principal payments on a given obligation in a timely manner interest and principal. The meaning of each rating category is explained in www.arcratings.com. ARC's credit ratings are based on ARC's published rating criteria.

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In the rating process, ARC Ratings adopts procedures and methodologies aimed at ensuring transparency, credibility and independence, and also that rating classifications are not influenced by conflicts of interest.

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