STRUCTURED FINANCE RATING CRITERIA

GLOBAL STRUCTURED FINANCE SERVICERS 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.

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I. CRITERIA SUMMARY

This report details ARC Ratings, S.A. ("ARC")'s approach to awarding a servicer quality ("SQ") rating to servicers supporting structured finance transactions. ARC may require an originator or servicer to be rated as part of a structured finance transaction in order to ensure that securitised assets may be serviced efficiently and effectively. An assessment of origination and servicing practices to determine a servicer rating is particularly important for any transaction, all the more so for highly granular pools such as those backing Residential Mortgage Backed Securities. Preferably, this should be via an ARC SQ rating, to enhance our understanding of the capabilities and financial condition of the company. However, a rating from another recognised rating agency can also be relied upon and, in the case of experienced originators/servicers with high credit ratings, an unpublished operational review can suffice.

Although SQ ratings are country specific, ARC's rating approach and methodology is similar across all jurisdictions, ARC will not develop separate methodologies for each country where servicers are rated. However, the servicer environment may differ across countries due to local customs and laws, which may require modifications to the factors analysed in the rating process. In these cases, an addendum to the methodology detailing these changes on a country basis will be included.

II. INTRODUCTION

ARC's SQ rating approach separates a servicer's performance from the credit quality of the loans being serviced and the transaction of which they provide collateral, as well as other factors beyond the servicer's control. The rating approach will involve an intensive review of the servicer's business processes and procedures. The intention is to evaluate how effective a servicer is at preventing and managing and minimising delinquencies and defaults and maximizing recoveries when defaults do occur. The quality, stability and experience of a servicer (regardless of asset type) can have a direct impact on the asset portfolios quality and therefore the performance of the structured finance transaction.

The SQ rating considers the operational and financial stability of a servicer, as well as its ability to respond to changing market conditions. This assessment is based on a servicer's organizational structure and management strength, its financial profile, information technology and reporting capabilities, as well as its strategic goals. Although financial stability is assessed, this should not be regarded as a substitute for a credit rating.

ARC's SQ ratings typically cover three types of servicer (each of which is discussed later in this report):

1. Primary servicer – directly or indirectly responsible for servicing loans from origination to final settlement;

2. Special servicer – servicing delinquent or already defaulted loans; and
3. Standby/back-up servicer – a servicer that is contracted to be 'on call' and able to take over the primary servicer's role in the event that this servicer defaults for any reason.

III. NATURE AND IMPORTANCE OF SQ RATINGS

ARC's SQ ratings differ from ARC's credit ratings, which are opinions of the credit quality of a specific instrument or issuer. SQ ratings measure the quality of the servicing operations, not the probability of the servicer's financial default or ability to repay a fixed obligation. However, a servicer's financial stability and performance is taken into account in the SQ analysis, as explained under the Rating Criteria section of this report.

Although SQ ratings are by nature more qualitative than ARC's credit ratings, quantitative elements are considered through the analysis of the servicer's performance track record and financial condition.

IV. SERVICING TYPES

PRIMARY SERVICER

A primary servicer is an entity servicing its own assets as part of a securitisation, but also includes a specialised, third-party, servicer to whom this function has been outsourced. A primary servicer handles all aspects of servicing assets throughout their lifetime. In addition to processing payments and providing customer service, a primary servicer will also manage collections and the resolution of defaulted loans, as well as origination and credit processes.

Originators are typically the servicer in securitisations. Outsourcing of the servicing function to third parties has, however, gained momentum in recent years.

SPECIAL SERVICER

A special servicer is differentiated from a primary servicer in that not only are the assets serviced generally not originated by this company, but its serviced are limited to the management of assets that are not performing. A special servicer's core business is generally the servicing of already delinquent or defaulted assets, rather than day-to-day collections on performing assets. This role will be fulfilled in either an outsourcing relationship or through the acquisition of delinquent assets from other companies. These specialised servicers can also fulfil the role of a standby servicer.

STANDBY / BACK-UP SERVICER

The rating approach for a primary or standby servicer is similar, other than the fact that usually the standby servicer's ability to service and collect in a particular transaction cannot be assessed at the initial ratings stage, although ARC might expect to see evidence of its capabilities before assigning a credit rating to the transaction, for example where the primary servicer is rated below investment grade or if it is unrated.

The requirement for a standby servicer ensures continuity in servicing throughout the life of the transaction, with the back-up servicer stepping in should the initial servicer default or contract termination. The exact nature of the back-up requirement will depend on the nature of the transaction and assets being serviced. ARC will assess the capacity of the standby servicer to assume the primary role within a short period.

V. RATING CRITERIA

ARC's SQ ratings are based on a formal review of the servicer. Generally, the initial report will be detailed, covering the incorporation and history of the company since inception, its shareholders, operations, strategy, financial performance, in addition to the asset administration and servicing function.

The source of the information is the servicer itself. In general, ARC expects a servicer to have been in operation and actively servicing assets for a minimum of 12 months before an SQ rating will be assigned.

An initial servicer review will commence with an examination of the corporate structure, including:

- Incorporation and history;
- Ownership structure;
- Operational structure and strategy; and
- Corporate governance.

These factors are generally only covered in depth in the initial analysis and report. Follow up reviews would typically only address significant changes, particularly where these may have an impact on the rating accorded.

ARC analytical approach for SQ rating is based on five key analytical areas as follows:

1. Management and staff;
2. Systems and controls;
3. Debtor administration;
4. Arrears management; and

5. Financial performance.

Each area is separately considered by the analyst and given a score of between 1 and 5, with one being the best. The total SQ score will be the sum of each area's score, divided by 5. The final SQ score will then be translated into an overall SQ rating, based on the table below.

Servicer Rating	Description	Score
SQ1	Strong	1
SQ2	Above Average	2
SQ3	Average	3
SQ4	Below Average	4
SQ5	Weak	5

The aggregate score, as well as the score for each area, will then be discussed by the SQ rating panel, which will consider adjustments, either per area or the overall evaluation. The SQ rating panel will then vote on the final SQ rating.

A "+" or "-" may be added to the SQ rating to show their relative standing within their own rating categories (except in the case of SQ1, where "+" is not applicable).

Each of the five analytical areas is discussed in more detail below.

MANAGEMENT AND STAFF

One of the most important aspects of the SQ rating process is the assessment of the capability and performance of servicer's management. ARC's assessment of management includes the evaluation of the quality, level of oversight and support it provides to all of the servicer's activities. In this process, ARC focuses on the ability of the Board and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products.

ARC examines the corporate structure and various divisions and subdivisions within the organisation, determining the level of complexity and depth of the organisation's management and operational systems, and whether the accuracy, timeliness and effectiveness of the management information and risk monitoring systems are appropriate for the servicer's size, complexity and risk profile. The adequacy of internal audits and other controls to promote effective operations, reliable financial and regulatory reporting, safeguarding of assets and ability to ensure compliance with laws, regulations and internal policies are also assessed. As part of this process, appropriate system back-up and disaster recovery procedures are also reviewed.

The experience and depth of management, their track record, ability to manage through stressful periods, as well as the ability to manage new business lines and the presence of clear and established management succession plans are also evaluated.

Staffing plans are assessed in terms of workload and volume, and potential increases in these. This is material in terms of standby servicers, where a sizeable book of assets can be acquired at reasonably short notice. ARC expects the standby servicer to be able to take over seamlessly when required and within a specified timeframe. ARC will also look for active examples the standby servicer can provide of this occurring or how they aim to achieve this. This becomes of particular importance where the firm acts as a standby servicer for several transactions. Although unlikely, transactions that default in similar time frames could place the standby servicer under considerable pressure. ARC would typically prefer to see standby servicer mandates secured from a variety of sources, thus avoiding concentration risk.

ARC compares staff turnover at the servicer to the national average for similar firms (if reliable data is available), with the higher rated entities usually displaying turnover levels that are below the average. Staff turnover among call centre staff is generally higher than for other functions, due to the high pressure and monotony of the job. The existence of adequate training programmes in the servicing industry is therefore paramount, and the highest rated entities typically display comprehensive and leading programmes for recruiting and retaining staff.

The analysis includes also a review of the qualifications and experience of all senior staff and Board members. Senior staff should have significant experience and be appropriately qualified for their respective roles, particularly in the key areas of asset administration, collections, credit and arrears management. Stability among senior management is also an important factor; in the event of concentration of skills in a small group of key individuals, or key man risk, ARC would expect to see adequate succession planning for their replacement if necessary.

SYSTEMS AND CONTROLS

Technology provides the backbone for any servicing company. A disaster recovery plan is essential to ensure minimum interruption of operations if a system shuts down. Systems should be sufficiently scalable to accommodate additional clients, particularly where standby mandates are in place.

ARC will consider a potential stress scenario with the default of the primary servicer of the largest portfolio where the servicing company is on standby. Sufficient capacity should be demonstrated to effectively absorb and manage this portfolio. Servicers with a track record of acquiring and successfully running down poorly performing books will be viewed favourably.

A servicer's ability to provide clear, accurate and timely management reports on servicing performance is very important. Inaccurate or late reports may indicate a servicing problem or unforeseen difficulties with collateral. Unclear or over-complicated reports make it difficult to track a transaction's performance. Performance metrics are measured against industry best practice.

DEBTOR ADMINISTRATION

The primary role of the servicer is to collect payments and prevent performing loans from going into arrears. ARC's analysis focuses on the day-to-day servicing operations necessary to support this function and capacity to deal with an increase in problem collections (i.e. delinquent loans).

The effectiveness of a servicer's default management practices is a key determinant in the ultimate performance of any portfolio. By the time an asset reaches greater than 90 days in arrears, a servicer must determine whether the borrower has both the ability and desire to pay. Highly rated servicers will have extensive workout and disposal expertise, thorough legal and collateral knowledge, and a proven track record in loss mitigation.

ARREARS MANAGEMENT

It can be difficult to determine the actual factors responsible for good or bad performances, since good performance could mean that the quality of the underlying borrowers is strong, rather than reflecting the ability of the servicer. This increases the emphasis on a qualitative approach as well as a focus upon the credit and origination process.

ARC's analysis of the performance of a servicer can be distorted due to the acquisition of poorly performing portfolios. Some servicers assessed by ARC, due to their specialised skill in collecting assets, also acquire poorly performing loan books at a discount. Since the delinquency rates are typically high at take-up, this initially distorts the performance analysis. It does, however, allow ARC to better analyse the servicer's performance in collecting on these "distressed" books over time, which is a good proxy for the potential position should the company be called to fulfil a standby servicer role.

FINANCIAL PERFORMANCE AND OUTLOOK

Although the SQ analysis is not focused on the ability of the servicer to service its own debt, the servicer's financial profile and profitability impacts its ability to retain key staff, maintain adequate systems, and fulfil its role in third party collections.

The overall score of this section is based on the analysis of the company's historical earnings quality, cash flows, capitalisation and gearing levels and future prospects. If a credit rating does exist it would be considered in our financial performance analysis.

VI. PERFORMANCE MONITORING

All SQ ratings, where public, will be made available on ARC's website at www.arcratings.com. All servicer ratings are reviewed at a minimum on an annual basis or as events warrant.

VII. QUALIFICATION

It should be noted 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.

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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A servicer quality rating provides an opinion on the quality of the servicing and, if appropriate, origination practices of the servicer. A servicer quality rating is not a credit rating and uses a specific rating scale.

Ratings do not constitute a recommendation or offer or solicitation to buy or sell any investments that may be mentioned, and are only one of the factors that investors may wish to consider. The use of any rating is entirely at the user's own risk.

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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