Structured Finance Rating Methodology

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Global Asset Backed Commercial Paper (ABCP) Criteria

This is an update to the methodology previously published in February 2017.
There are no material changes and as such no rating impact.

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I. INTRODUCTION

ARC Ratings' ("ARC") Global Asset Backed Commercial Paper (ABCP) Criteria (the "Criteria") lays down the fundamental considerations for any ABCP transaction rated by ARC. There are a number of different types of ABCP programme structures and support mechanisms, which are detailed in this report. ABCP is rated by analysing (i) the conduit and transaction structure, (ii) capabilities of the sponsor and administrator as well as an analysis of the sponsor's investment guidelines, (iii) support mechanisms and (iv) an analysis of the underlying collateral. ABCP programmes are accorded a short term rating, which reflects the short term exposure to default of the rated entity and its capacity to meet its financial obligations within a 12 month period. ABCP is short term debt, issued on a discount or interest- bearing basis, with a maturity not exceeding 364 days. ABCP ratings accorded by ARC are in respect of full and timely repayment of both principal and interest. ARC's analysis addresses the principal risks to ABCP investors (cash flow timing mismatches, the credit risk of the underlying collateral and seller or servicer risks) and the mitigation of these risks through credit enhancement, liquidity facilities, investment guidelines, issuance tests and triggers. ARC's analysis for fully supported ABCP programmes is focused on the programme structure, support mechanisms and support providers since timely and full repayment of the ABCP is assured by liquidity / credit support that provides full protection against credit losses on the underlying portfolio. For partially supported ABCP programmes, an analysis of the underlying portfolio and transaction, as well as the programme structure and support mechanism, is carried out to ensure the underlying collateral is commensurate with the rating of the CP issued.

An ABCP programme is typically structured as a bankruptcy-remote SPV that issues commercial paper ("CP"). The proceeds of such issuance are used to finance interests in various assets / securities via a traditional asset purchase or a secured loan. ABCP programmes, in general, issue short term liabilities to fund long term assets with structural mechanics to cover potential repayment shortfalls caused by timing mismatches. Typically the pools of assets are revolving, with no scheduled amortisation. An ABCP programme typically funds multiple and varied asset types creating a diversified portfolio.

The Criteria applies globally, however, specific transactions may give cause to additional observations or deviations which will be disclosed in the transaction rating reports.

II. RELATED RESEARCH

Each transaction will be accompanied by a transaction specific report that will disclose any additional observations or modifications to the Criteria. This Criteria should be read in conjunction with ARC's published 'Global Structured Finance Criteria – Updated September 2017 and available at www.arcratings.com.

III. PROGRAMME STRUCTURES

There are a number of different ABCP programme structures, being multi-seller, securities backed, single-seller and hybrid. The programme structure is defined by the assets financed.

MULTI-SELLER PROGRAMMES

Multi-seller programmes are the most common type of ABCP programme. This structure has the flexibility to purchase multiple assets from many different and varied sellers. The programme sponsor typically uses the programme to provide an alternative financing solution to its clients. It should be noted that for multi-seller conduits, assets are typically not rated on a stand-alone basis but are structured to be commensurate with the rating of the ABCP.

SECURITIES BACKED PROGRAMMES

Securities backed programmes invest in securities such as mortgage-backed securities, other asset-backed securities or corporate loans / securities which are rated. The proceeds of the CP issuance are used for such investment.

SINGLE-SELLER PROGRAMMES

Single-seller programmes are established where the sponsor is the sole originator of the financed assets and uses the programme as an alternative source of funding for its business activities.

HYBRID PROGRAMMES

Hybrid programmes are very common and are programmes that have the ability to finance both multi-seller type assets and rated securities. These programmes have the maximum flexibility for both the sponsor and for providing financing to their clients.

IV. SUPPORT MECHANISMS

A key part of the analysis is the support provided to the ABCP programme. As part of its analysis ARC will review the support mechanisms provided as well as the entities providing such support. Support is typically provided to ABCP programmes via credit enhancement and liquidity.

The type of rating analysis is determined by whether an ABCP programme is partially or fully supported. A programme that has support mechanisms that provide full protection against credit losses on the underlying portfolio are deemed to be fully supported. Where exposure to credit risk remains on the underlying portfolio these are deemed to be partially supported programmes.

For fully supported programmes the analysis focuses solely on the programme structure and support mechanisms. The support providers are considered to be taking the full credit risk on the underlying assets and as such an analysis of the underlying portfolio / transaction is not deemed necessary. For partially supported programmes, an analysis of the underlying portfolio / transaction, as well as the programme's structure and support mechanism, is carried out.

For any type of ABCP programme repayment is ultimately reliant upon the underlying institution providing the support, whether partially or fully supported. Therefore a rating dependency exists in respect of the institution providing support to the programme and ABCP rating.

LIQUIDITY SUPPORT

Adequate liquidity support is a key driver to ARC's rating analysis as the rating addresses the timely payment of principal and interest. ABCP programmes rely upon rolling over of CP, i.e. issuing new CP to repay maturing CP, with an element of collection from the underlying assets. Therefore should there be a market disruption or an issuer event this may impact on the ability to rollover CP. Also the liquidity facility can be utilised to cover timing delays particularly in respect of timing mismatches between collections on long term assets and short term payments due on the CP.

Typically ABCP programmes have a minimum 100% liquidity support from an external source. Liquidity may be provided on a transaction specific or programme wide basis. For multi-seller conduits, liquidity is normally provided to each individual transaction on a transaction-specific basis. For securities backed programmes it is typically provided at a programme wide level. Liquidity should always be available to an ABCP programme on a same day basis, given its purpose to cover timing delays. In partially supported ABCP programmes, the liquidity support does not cover cash shortages caused by credit losses on the underlying portfolio and credit enhancement is relied upon to play this role, however its aim is to cover timing delays and mismatches.

Liquidity support is generally provided by a liquidity loan agreement ("LLA") or a liquidity asset purchase agreement ("LAPA"), either of which should be provided on a committed basis. Often liquidity will cover other risk within the ABCP programme, such as seller/servicer risk, legal risks, market value risk amongst others.

In some programmes internal liquidity support may be provided which reduces the need for 100% external liquidity support. This is usually achieved by match funding the maturities of the assets with the maturities of the ABCP. In this circumstance the assets should have maturity dates either on or prior to the maturity dates of the ABCP. It is also possible for liquidity to be provided by total return swaps or repurchase agreements ("REPOs"). For a REPO to be considered the repurchase date should be on or before the maturity date of the CP.

However liquidity is provided, it should be an unconditional commitment that is renewable on an annual basis. No CP should be issued after the maturity date of the liquidity facility. This will be considered when analysing the conditions precedent to issuing CP within the documentation.

ARC's analysis will look to when liquidity can be drawn and for what purpose. The liquidity support should not be diverted away from the payment of CP. If the liquidity proceeds are subject to the waterfall ARC will expect anything ranking senior to the CP to also be covered by the liquidity commitment or an additional facility to be in place to cover senior ranking items. ARC will also consider the rating of the liquidity provider. Given the rating dependency, the rating of the ABCP will not be higher than the rating of the liquidity provider and any potential downgrade of the liquidity provider may also trigger a downgrade of the rating of the CP if remedial action is not taken to address the downgrade of the liquidity provider.

LIQUIDITY BORROWING BASE

The liquidity borrowing base is key to the rating analysis. The liquidity borrowing base calculates the amount of liquidity that can be drawn. The borrowing base is intended to equate to an amount at least equal to the outstanding CP less defaulted assets. For fully supported conduits the borrowing base should be able to repay CP in full without any deduction for credit losses. Therefore the definition of default is crucial as the definition results in a deduction from the liquidity borrowing base. Funding outs are typically restricted to bankruptcy or insolvency of the conduit and hence, the importance of establishing the conduit as a bankruptcy-remote entity. This may not always refer to written off assets but may refer to severely delinquent assets. ARC through its analysis will expect as few deductions to liquidity as possible.

Liquidity 'Outs', i.e. instances where liquidity cannot be drawn, should be very limited. These should include:

- Insolvency of the SPV;
- Illegality i.e. it becomes illegal to provide such a facility;
- Funded amounts in excess of the commitment level;
- Default of credit enhancement provider; and
- Downgrade of a security below a predefined rating level.

CREDIT ENHANCEMENT

ABCP programmes are structured with credit enhancement either at the transaction level, programme level or a combination of both. Credit enhancement protects against losses on the programme's underlying asset portfolio, or in a fully supported programme, it can be utilised at the programme level to provide full support.

TRANSACTION-SPECIFIC CREDIT ENHANCEMENT

Transaction-specific credit enhancement protects against losses for a specific transaction and is not fungible across multiple transactions. Where both transaction-specific and programme-wide credit enhancement exist, transaction--specific credit enhancement acts as the first loss protection with the programme-wide credit enhancement acting as the second loss protection.

Transaction-specific credit enhancement is sized to address the credit risks of the underlying asset to which it applies. It will typically be provided as over-collateralization, a reserve or guarantee. For partially supported ABCP conduits transaction-specific credit enhancement is a key driver to the rating analysis. ARC will review the credit enhancement provided to ensure it is sufficient to support the underlying assets and therefore ensure the asset is deemed to be commensurate with the rating of the ABCP to be issued.

PROGRAMME-WIDE CREDIT ENHANCEMENT ("PWE")

PWE typically provides a second layer of loss protection where losses exceed the transaction-specific credit enhancement. It provides further protection against asset default and potential third-party liquidity defaults. PWE is typically provided by subordinated debt, letters of credit, irrevocable loan facilities or guarantees. For a multi-seller programme the size of the PWE will be a fixed amount ranging between 5% - 15% of the commitment amount or the amount of outstanding ABCP. For securities backed programmes, PWE will be dynamic and fluctuate in size based upon the underlying portfolio composition. ARC will use a matrix approach, as detailed below, to determine the PWE considered appropriate for securities-backed programmes within its analysis. For securities backed programmes investing in highly rated securities PWE may not be necessary as it is inherent within the rating of the underlying security.

Rating of the Lowest Rated Security (excluding securities rated below BBB-(sf))	Securities Coverage	Floor % Applied to the Portfolio
AA-(sf) or above	0	0%
A+(sf)	Cover 100% of the value of the largest A+(sf) security	1%
A(sf) to BBB+(sf)	Cover 100% of the value of the three largest A+(sf) or lower rated securities	3%
BBB(sf) to BBB-(sf)	Cover 100% of the value of the four largest A+(sf) or lower rated securities	4%
Where securities are rated below BBB-(sf), PWE is expected to cover 100% of the value of the securities.		

V. ASSET ANALYSIS

For partially supported programmes ARC will analyse each individual transaction to ensure its credit quality is commensurate with the rating of the CP to be issued. ARC will apply the appropriate asset criteria in analysing the transactions. Risks that are covered by the liquidity facility will be excluded from the analysis. ARC will determine if the transaction-specific credit enhancement and structural mechanisms are sufficient to reduce credit risk associated with the transaction. ARC will also consider the short-term nature of the risk and support provided as well as review the legal documentation.

To reduce the risk of portfolio deterioration, ABCP programmes typically include stop-issuance or wind-down triggers. If a trigger is hit it prohibits the programme from issuing further CP and in some cases can trigger a liquidation of the asset portfolio. These triggers may be set at either the transaction or programme level and can assist in mitigating the depletion of credit enhancement.

Transaction-specific triggers may include, amongst others:

- Insolvency of a sponsor / administrator.
- Depletion of credit enhancement below a certain amount.
- Breach of covenants, representations or warranties.
- Material adverse change in the sponsor's ability to perform its duties.
- Deterioration of a programme's assets below predefined performance triggers.

Programme-wide triggers may include, amongst others:

- Failure to repay maturing CP or liquidity advances when due, unrectified for a certain number of days.
- Programme documents cease to be in full force and effect.
- Draws on PWE above a predefined amount.
- Breach of covenant, representations or warranties.

Within its analysis ARC will also consider Conditions Precedent to CP Issuance. These are the checks made by the administrator prior to issuing CP. These should include, amongst others:

- No event of default has occurred.
- Credit enhancement is available.
- CP does not exceed the liquidity commitment amount or expiry date.
- CP does not exceed the predefined tenor.
- Asset / liability test has been met.
- No performance triggers have been breached.

VI. SPONSOR AND ADMINISTRATOR REVIEW

As part of the rating process, ARC analysts will visit the sponsor and administrator to meet with key personnel and management involved in the programme. Normally, the sponsor is also the administrator of the programme. ARC expects the sponsor / administrator to provide a presentation that addresses, amongst others, the aspects listed in Appendix A. ARC may also carry out an on-site review of originators of partially supported transactions, as it would for a term transaction. For existing transactions a review is expected to be carried out on an annual basis to assess changes to policies and procedures. In addition to the originator / servicer review, an independent audit opinion on the underlying collateral / portfolio is required for each transaction, except in cases where the collateral is fully insured by an external insurance counterparty. ARC may request an additional audit opinion where it is felt the auditor has a conflict of interest or is not a highly recognised audit firm. In instances where an audit opinion is not provided, ARC will do a file review on a random selection of files relating to the underlying collateral.

VII. LEGAL CONSIDERATIONS

ARC expects to receive all final transaction documents as well as a full set of programme documents in order to ensure the programme and subsequent transactions are structured as presented. ARC also expects to receive a legal opinion which addresses:

- That a true-sale of assets has occurred.
- Bankruptcy remoteness of the SPV.
- The activities of the SPV comply with all the requirements of the relevant legislation.
- The transaction structure and documentation is legal, valid and binding.

ARC may request independent external counsel to review the legal opinion.

VIII. PERFORMANCE MONITORING

On-going monitoring of the performance of the programme and the underlying transactions is key to the rating process and maintaining current ratings. ARC expects sufficient performance information to be provided on a monthly / quarterly basis.

Upon each reporting period ARC will review the performance information provided to ensure the credit quality of the underlying portfolios has not deteriorated and remains commensurate with the rating of the CP issued. Surveillance rating panels are held annually at a minimum or as events warrant. Negative performance of the underlying portfolio may trigger potential rating action. For public transactions ARC will publish a performance report on an annual basis at a minimum or as events warrant.

IX. QUALIFICATION

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:
ORIGINATOR / SERVICER REVIEW AGENDA POINTS

AN OVERVIEW OF THE BUSINESS

- History;
- Organisational structure;
- Recent material developments and competition;
- Market share statistics;
- Financial performance and funding profile prospects for the future;
- Competitive environment; and
- Experience and qualifications of senior management.

AN OVERVIEW OF THE ADMINISTRATION AND OPERATIONS

- An overview of the underwriting department and origination channels as well as an overview of the credit department;
- Experience of credit personnel and procedures for granting new credit limits;
- Credit and investment policy, client selection;
- Due diligence process;
- Reporting and compliance process;
- Operations manual review;
- Investor relations;
- IT systems, disaster recovery and file maintenance;
- Performance monitoring systems; and
- CP funding process.

AN OVERVIEW OF THE ADMINISTRATION AND PORTFOLIO

- List of current transactions;
- Transactions funded over the past 12 months;
- Transactions terminated over the past 12 months;
- Current industry and seller breakdown; and
- Transaction pipeline.

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Prior to the assignment or revision of a rating ARC Ratings provides to the entity whose financial commitments are being rated the documents that substantiate the rating to be attributed (the Preliminary Rating Report). This entity is thus given the opportunity to clarify or correct factual details, thus allowing the rating assigned to be as accurate as possible. The comments made by the entity whose financial commitments are being rated are taken into account by ARC Ratings in the assignment of the rating.

ARC Ratings historical default rates are published in the European Securities and Markets Authority Central Repository (CEREP) which can be accessed in the website cerep.esma.europa.eu/cerep-web/. ARC Ratings default rate is the probability of lack of full and timely payment of capital or interest or of the occurrence of any event that explicitly indicates that the future full and timely payment of those commitments will not occur (e.g., in case of insolvency).

Ratings do not constitute a recommendation to buy or sell, but only one of the factors to be weighted by investors.

Throughout the entire period during which ratings are valid, ARC Ratings monitors the issuer's performance on a constant basis, and may even bring forward the date of the review unless stated as point in time. Hence, prior to an investor using a rating, ARC Ratings recommends that it be confirmed, namely by consulting the list of public ratings available at the website www.arcratings.com.

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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 situations of conflict of interests. Any exceptions to these principles are disclosed by ARC Ratings together with the rating of the financial commitment in question.