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Rating European Non-Performing Loans Securitisations

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Scope and Limitations

DBRS evaluates both qualitative and quantitative factors when assigning ratings to European non-performing loans transactions. This methodology represents the current DBRS approach for rating non-performing loans transactions issued in Europe with non-performing loans originated in Europe. It describes the DBRS approach to analysis, which includes (1) a focus on the performance, experience and expertise of the servicer, (2) evaluation of the collateral pool, (3) utilisation of historical performance data, (4) analysis of the business plan and (5) cash flow modelling. This report also outlines the asset class and discusses the methods DBRS typically employs when assessing a transaction and assigning a rating. It is important to note that the methods described herein may not be applicable in all cases. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Introduction

DBRS expects that the issuance of notes backed by European non-performing loans (NPL) within the next few years in many European jurisdictions is likely to become a viable funding option to help clear the mounting volume of non-performing loans. DBRS expect the main drivers for issuance to be (1) demand from investment funds and hedge funds and (2) regulatory capital purposes.

This methodology summarises DBRS’s rating approach for European securitisation transactions backed by non-performing loans. This methodology has its conceptual foundations in the rating approach developed by DBRS for European consumer and commercial asset-backed securities (ABS) transactions. For our purposes, the ABS approach has been adapted to take into account the peculiarities of the asset class under discussion. If the pool under scrutiny contains a significant portion of secured loans, the methodology may complement the recovery rate and timing assumptions described in the Master European Residential Mortgage-Backed Securities Rating Methodology and related Jurisdictional Commentaries.

Executive Summary

As noted above, the DBRS European NPL methodology focuses on transactions where the underlying pool of receivables consists of non-performing loans. Although the concept of “non-performing loan” may vary (even considerably) from one jurisdiction to another, for the purposes of this methodology, DBRS has adopted an approach that affords the flexibility to include loans classified as defaulted according to varying types of originator default definitions. This methodology considers as “unsecured” those non-performing loans that do not (substantially) benefit from a solid collateral such as a first-ranking mortgage (e.g., consumer loans, credit cards, insolvency claims, small-ticket claims, current accounts) or for which no information has been provided with regard to such collateral. Under this methodology, “secured loan” is a loan under which the borrower has a pledge over residential assets and small commercial properties.

The criteria described below are most applicable to transactions where the underlying pool of receivables consists of one or more large, homogeneous and granular pool(s) of non-performing loans. Accordingly, DBRS generally expects to apply this rating methodology to NPL portfolios where individual obligors or loans do not represent a large proportion (i.e., not more than 1% to 2%) of the overall pool.

Under this methodology, DBRS reviews the following qualitative and quantitative factors when assigning and monitoring ratings for NPL transactions:

- Performance, experience and expertise of the servicer;
- Alignment of servicer incentives to noteholders’ interest;
- Quality of the proposed collateral pool;
- Historical information quality and level of detail;
- Operational capabilities and financial strength of the transaction parties;
- Transaction structure and proposed credit enhancement;
- Results of cash flow analysis; and
- Legal structure and opinions.

As a first step of its quantitative analysis, DBRS defines a projected base case for the receivable portfolio through an expected performance analysis (the “performance analysis”). In the second step of the quantitative analysis, the projected base case undergoes appropriate stress tests in order to assess whether, given a certain transaction structure and a certain level of credit enhancement, the probability of payment of principal and interest on the rated notes is consistent with the requested rating level (the “cash flow analysis”).

However, and unlike performing asset securitisations (where most debtors make regular payments pursuant to their loan agreements), the performance of an NPL pool is largely based on the servicer’s ability actively to work out the non-performing loans and, as a result, the recovery cash flows may be irregular and their timing difficult to determine. These features have considerable implications in DBRS’s NPL rating approach.

In establishing expectations for future performance of proposed asset pools to be securitised, DBRS places particular emphasis on the business plan prepared by the relevant servicer. Due to the crucial role of the servicer in the recovery process, its business plan tends to be considered the starting point of the pool’s performance analysis and is reviewed by DBRS. In particular, the business plan is analysed on the basis of the historical performance of the servicer itself with assets of a similar nature in the relevant jurisdiction. Consequently, the DBRS review and analysis of NPL transactions comprise an operational risk review of the servicer, including its track record and operating procedures and policies. The operational risk review and assessment provides insight into the manner in which these processes have had an impact on past performance and assists in establishing its current and future capacity to service the portfolio.

In addition, the irregular cash flow timing profile of NPLs may have a critical impact on the cash flow analysis, particularly when DBRS ratings address both the timeliness of interest payments and ultimate repayment of principal on the notes. In these circumstances, liquidity is an important structural feature of a transaction, which typically is reflected in cash reserves, a committed liquidity facility from a creditworthy counterparty(ies) and/or a servicer advancing mechanism.

Scope of Methodology

JURISDICTIONAL DIFFERENCES
The rating paradigm outlined in this report is intended, in principle, to apply to transactions evaluated across all European jurisdictions, as the present criteria focus on historical performance data to determine the projected base case and, therefore, typically reflect market specificities without the need to introduce jurisdiction-specific adjustments. However, as each European jurisdiction exhibits a different legal and regulatory framework, different market practices and product characteristics, DBRS considers the specificities of the relevant European jurisdictions as discussed in the DBRS Legal Criteria for European Structured Finance Transactions and separately analyses the impact of the underlying receivables regulatory framework.
COUNTERPARTY EXPOSURE

All securitisation transactions rely to some extent on the performance of third parties (account banks, swap counterparty, etc.). The present criteria do not address in any detail DBRS’s methodology for assessing counterparty risk. For a discussion on the DBRS methodology on swap counterparties, the reader is referred to the DBRS Derivative Criteria for European Structured Finance Transactions. For a discussion on the DBRS methodology on other counterparties, the reader is referred to the DBRS Legal Criteria for European Structured Finance Transactions. In addition, with regard to the servicer, the reader is referred to the Operational Risk Review Origination and Servicing section below, as well as DBRS Operational Risk Assessment for European Structured Finance Servicers.

Data Request

As part of the rating process, DBRS analyses a servicer’s historical performance data provided by the relevant sponsoring entity or the servicer and also looks to compare the servicer’s experience to the performance of the overall market. For consumer and small commercial NPL transactions where the assets are sufficiently granular, DBRS utilises this historical information to help assess future performance. Preferably, DBRS expects servicers to provide recovery information, as described below, that covers asset performance during a full economic cycle to enable DBRS to adjust its base case in light of the impact that macroeconomic factors\(^2\) may have on the recovery performance for the relevant type of collateral.

STATIC POOL DATA

DBRS’s recovery analysis focuses on static pool recovery data. Static pool analysis relies on historical recovery data from discrete groups of assets having the characteristics of the proposed asset pool to be securitised in terms of vintage, size, geographical distribution, receivables type, stage of legal procedure (if any) and recovery effort, out of court settlements, etc.

DBRS expects to receive (with respect to both closed and open files) five to seven years of performance history from a servicer to perform a rating analysis. DBRS may request the servicer to provide full servicer’s performance history also in respect of groups of assets which do not match the profile of the proposed asset pool to be securitised.

The servicer’s static recovery data should be presented in such a way that (1) assets are considered defaulted in a manner that is consistent with the defaulted profile of the pool to be securitised according to the transaction documentation, and (2) to ensure that cash flow stresses are constructed in a manner that properly addresses the collateral’s recovery profile.

POOL CHARACTERISTICS

When approached to rate a transaction backed by a pool of NPL assets, DBRS typically receives pool stratifications that provide a summary of the pool’s characteristics as they relate to variables such as type of asset, vintage, size, geographical distribution, stage of legal procedure (if any) and out of court settlements. In general, the characteristics of the underlying assets that comprise the static pool recovery sample should mirror the characteristics of the proposed pool as closely as possible. However, DBRS recognises that pools with similar characteristics can demonstrate significantly different performance. For this reason, it is important that servicers have the reporting capability to provide static pool performance data that can be stratified by various attributes such as type of asset, vintage, size, geographical distribution, stage of legal procedure (if any) and recovery effort, out of court settlements, etc. In cases where sufficient performance detail has been provided, DBRS can refine its recovery analysis by using the data to determine an accurate recovery estimate for each distinct sub-pool and then use this information to develop a weighted-average recovery expectation for the securitised pool based upon the relative contribution of each segment.

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\(^2\) Such as high unemployment levels or the court system burdened by an increasing volume of proceedings.
Operational Risk Review - Portfolio Sourcing and Servicing

**ORIGINATION REVIEW**

Due to the intrinsic characteristics of NPLs, in carrying out its performance analysis, DBRS mainly relies on the servicer’s recovery capabilities. Therefore, in contrast with performing assets securitisations, the DBRS European NPL methodology focuses on a few specific aspects of a proposed pool’s origination process and subsequent servicing that may have an impact on future recovery performance. Typically, these aspects have a legal, economic and factual connotation as they concern, in broad terms, the validity of the collateral (such as legal title, compliance with applicable consumer protection, data protection, usury laws and regulations, absence of set-off risk, etc.), its existence (i.e., the outstanding amount) and the quality and completeness of the asset documentation.\(^3\)

Generally, these types of concerns are addressed through representations and warranties (R&W) made by either the seller of the assets or a qualified third party (including the servicer). Considering that the seller of the non-performing loans may not necessarily be the actual originator of the original assets securitised, DBRS understands that some representations normally present in a performing loan securitisation may not be fully available. DBRS, as applicable, reviews these R&W and evaluates their strength on the basis of the applicable market practice, and it expects that effective indemnity or repurchase mechanisms are in place in case of misrepresentation or breach of warranties.

While DBRS recognises that NPL securitisations are constructed in a manner that strives to isolate the performance of the assets from the credit quality of the originator or the sponsor, the reputation of the R&W’s provider is an important qualitative factor in the DBRS assessment. Financially sound companies with diversified funding sources are more likely to be in a position to remedy breaches of representations made to the securitisation.

**SERVICER REVIEW**

Granular NPL transactions rely heavily upon the presence of the servicer to actively work out the defaulted assets and to generate the recoveries that will be applied towards repayment of the issued securities. For this reason, DBRS reviews the capabilities of the servicer, including its operational capabilities and financial strength, and assesses any servicing continuity risk. DBRS servicer review methodology is detailed in the *DBRS Operational Risk Assessment for European Structured Finance Servicers*.

In addition, the servicer is required to provide comprehensive data of its past performance regarding the management of defaulted loans. Track records would ideally contain a clear and accurate record of the following:

- Type of asset (consumer loans, insolvency claims, small-ticket claims, trade receivables, residential mortgages, etc.).
- Characteristics of the assets (such as vintage, size, location of the debtor, status of legal proceeding (if any) and stage of collection efforts at the time of the boarding, etc.).
- The timing for closing files (including the expected timing for unclosed files).
- For secured loans, key dates, where applicable, including default date, loan termination date, initiation of legal action, engagement of external counsel, court resolution date, expected date for final recovery, expected date for final distribution of proceeds (per court).
- The recoverable values for each of the loans as of the original business plan and the most recent, revised business plan.
- Details of the various workout strategies applied to the loan and re-default rates if applicable.
- Historical amounts collected.
- Purchase price (when applicable) and Gross Book Value/Net Book Value data.

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\(^3\) It is not uncommon to find in NPLs that paper files have been lost, misplaced or in poor conditions. These circumstances may have a significant impact on the recovery timing and on the servicer’s ability to recover the claim.
Asset Quality Review and Performance Analysis

ASSET CHARACTERISTICS
DBRS reviews the characteristics of the assets being securitised on an aggregate basis, considering pool stratifications. In a typical unsecured NPL transaction, DBRS does not consider it necessary to review the asset pool on a loan-by-loan basis, but reviews any individual obligors or assets that represent a large proportion of the pool (i.e., more than 1% to 2% thereof). Where a securitised pool is composed of distinct sub-pools that are themselves homogeneous but exhibit different recovery profiles, DBRS analyses each of the sub-pools separately. However, for secured sub-pools, DBRS will analyse the pool on a loan-by-loan basis in order evaluate the recovery value of the individual loans' underlying assets.

BASE CASE RECOVERY DETERMINATION
In DBRS’s NPL rating approach, the two key drivers for establishing the base case recovery estimate for the proposed pool are:
• the expected recovery amount, i.e., the total amount expected to be recovered from the underlying portfolio that is available for payment of the relevant liabilities under the transaction structure;
• the expected recovery timing, i.e., the expected distribution of the recoveries along the timeline of the relevant NPL transaction.4

These two variables are a function of (1) the data and projections provided by the servicer in the portfolio business plan and (2) static pool performance data. Preferably, DBRS expects issuers to provide recovery information, as described below, covering asset performance in order to evaluate the impact that macroeconomic factors such as unemployment levels may have on collateral performance. In order to assess the expected recovery amount and timing set out in the business plan, the combination of these variables is achieved by comparing the recovery data and projections provided by the servicer in the portfolio business plan:
(a) firstly, to the historical performance of the servicer itself (the “servicer historical performance”), and
(b) secondly, to the historical performance of assets of a similar nature in the relevant jurisdiction (the “market historical performance”).5

DBRS recognises that the servicer may have the deepest knowledge of the NPL portfolio, particularly if the servicer was involved in the due diligence prior to the initial NPL portfolio sale and/or has been servicing the loans since inception. Therefore, DBRS begins its performance analysis from information set out in the business plan. Accordingly, as a first step in the performance analysis, DBRS engages in discussions with the servicer to understand the methodology used to prepare the portfolio business plan(s). During this phase, DBRS places particular emphasis on the following:
• servicer’s experience and expertise in the relevant jurisdiction and in the recovery of non-performing assets similar to those included in the securitised pool;
• servicer’s role in the due diligence process surrounding the sale of the NPLs including, if applicable, the preparation of original business plans;
• size of the collateral sample and the method utilised for its selection;
• assumptions on which the business plan is based (including in terms of non-judicial resolution strategy, i.e., discounted pay-offs (DPO), short term repayment plans and other types of settlements) and servicer’s track record of achieving results by implementing non-judicial resolution strategies;
• whether the servicer has working knowledge of the underlying portfolio or its knowledge is based on due diligence only;
• expected timing for the boarding (i.e., when the contractual obligations of servicing the assets are in place) of the portfolio (in the event that the portfolio is not already under the servicer’s management);

4. In NPL transactions, the timing of recoveries is as critical as the assumptions for recovery amounts. In the model, recovery timeline has the following two-prong ramifications: (i) the longer the period, the more carrying costs and interest expenses are incurred in the cash flow waterfall, and (ii) the more volatile the recovery cash flow is expected to be, the higher the liquidity risk to which the structure is exposed.
5. The market historical performance is established on the basis of information available in open sources (e.g., statistics on enforcement proceeding timing in various court districts provided by public authorities) or otherwise in the possession of DBRS.
type of servicing structure, including the servicer’s decision-making powers; and
the servicer’s use of external resources for managing the NPLs, including lawyers, debt collection companies and other third parties.

DBRS is aware of the risk of significantly relying on the servicer’s recovery expectations when the servicer is not independent from the issuer, the originator and/or the sponsor. In these circumstances, as well as where the operational review shows weaknesses in the areas listed above, the analysis assesses the data and information supplied by the servicer and the servicer historical performance, as well as market historical performance.

In addition, as a substantive part of the quality review of the portfolio business plan, DBRS considers whether the servicer is properly incentivised to act in a manner that balances the need for timeliness with the need to achieve the highest possible recovery, and whether DBRS can therefore expect that this is reflected in the business plan. In this perspective, DBRS reviews the transaction documents (particularly the servicing agreement) and especially the servicer’ replacement mechanisms based on under-performance, the structure and type of servicing fees and incentives and their senior ranking position within the transaction waterfall. DBRS views favourably a fee structure which aligns the interests of the servicer with the interests of the investors.

Analysis
The analysis is carried out through comparative analysis of (1) the data set out in the portfolio business plan, (2) the servicer’s past historical performance of the types of pools (by asset class, vintage, size, geographical distribution, stage of legal procedure (if any), out-of-court settlements, etc.) and (3) the historical data relating to the overall market (to the extent available and relevant) considered in the business plan, in order to gauge past volatility in recovery values and project volatility ranges for future performance.

Based on the servicer’s performance data (as adjusted to take into account vintage volatility to factor in minimum portfolio returns consistent with the expected performance at the targeted rating level), the data set out in the business plan and the data in possession of DBRS as to the typical performance of assets of a similar class in the relevant jurisdiction, DBRS develops for each pool or sub-pools of collateral (if divided into more discrete categories) a servicer’s historical recovery timing curve based on both servicer performance data and market recovery timings.

By extrapolating existing cohort returns and applying a volatility stress, DBRS derives an expected return of the proposed portfolio and, by taking into account the findings of the servicer’s operational review, analyses the consistency of the portfolio business plan. Where inconsistencies appear, DBRS enters into discussions with the servicer to establish whether there are factual reasons justifying deviation (including, in particular, in case of expected over-performance if compared to the historical trends of the servicer and the relevant market expectations).

Explanations from the servicer need to be substantiated by an analysis of the relevant pool, information about the servicer’s recovery process (including testing which proves consistent and tangible improvements in collection strategies and techniques) and other objective factors (including non-controversial macro-economic trends within the relevant economic cycle). The aim of such analysis is to calibrate the business plan with the historical performance provided by the servicer. If the explanations are not considered sufficient to justify a higher recovery level than the one indicated by the historical recovery timing curves, DBRS does not give credit to these additional factors when determining the base case recovery projection.

This approach assumes that the attributes of the proposed pool to be securitised are highly similar to the pools for which performance data are available. For cases where this assumption cannot be verified or such performance data is unavailable, DBRS may consider using performance data from third parties available for similar assets (selected on the basis of proximity) within the same or similar jurisdiction as a proxy and may further discount projections due to limitations from the servicer’s data.
VALUATION OF INITIAL POOL
To the extent available, DBRS reviews the purchase or transfer price that the issuer paid for the securitised pool and/or documents that indicate the market value of the pool in order to verify that it is consistent with the projected return on the securitised assets.

JURISDICTION-SPECIFIC CONSIDERATIONS
Asset characteristics, recovery procedures and results vary across European jurisdictions, primarily as a result of the different legal and regulatory frameworks, as well as differing market practices. The different frameworks result in different rights for creditors, which can reduce or delay collections, as well as different optimal work-out strategies for impaired assets. DBRS reviews the particular environment applicable to each type of asset, recovery strategy and jurisdiction with the originator and the servicer in order to assess appropriately the risks inherent in the asset class and recovery strategy and to interpret historical performance data accordingly. This DBRS European NPL methodology focuses on historical performance data relevant to the asset class, the servicer and the jurisdiction (including region, if relevant) under consideration and, unless changes to jurisdictional debt collection procedures are contemplated, therefore typically reflects these factors without the need to introduce jurisdiction-specific adjustments beyond those reflected in such performance.

Transaction Financial Structure

PRIORITY OF PAYMENTS
On a regular basis, recoveries on the assets are aggregated and then distributed to noteholders based upon the priority of payments (the “waterfall”) established in the transaction documents. Unlike performing asset securitisations (where principal and interest collections may be accounted for separately and then subjected to separate payment waterfalls), in NPL transactions, recoveries are normally aggregated to create a single pool of total available funds that are then subject to a payment waterfall.

The allocation of interest and principal payments among noteholders is typically sequential. Recoveries first pay for recurring transaction expense items like trustee or transaction management fees, after which noteholders receive interest and principal. Considering the importance of fees and expenses in the cash flows of NPL transactions, DBRS will try to assess the volatility of such costs in its analysis.

In a sequential pay structure, funds are first applied to the most senior class of notes until it is fully repaid and then directed to the next class of notes in the waterfall. Losses in excess of credit enhancement provided by the reserve account and over-collateralisation are absorbed by the lowest-rated tranche. Once the lowest-rated tranche is written down, the losses are absorbed by the second lowest-rated tranche in the structure.

DBRS views favourably NPL transactions where no interest may be paid on subordinated notes until the higher ranking class of notes has been repaid in full.

LIQUIDITY
The irregular cash flow timing profile of NPLs may have a critical impact on the cash flow analysis, particularly when DBRS ratings are intended to address both the timely payment of periodic interest and ultimate repayment of principal on the notes. The higher the volatility of cash flow, the greater the need for cash reserves or a committed liquidity facility from creditworthy counterparties.

6. The servicer’s management fees (which are expected to constitute only a portion of the servicer’s remuneration) and recovery expenses (i.e., legal fees, enforcement costs and taxes, etc.) are normally paid in priority to noteholders.
7. Another structure is pro rata principal allocation. In these structures, principal amortisation funds are allocated to maintain constant credit enhancement levels (created by a constant ratio of tranches as at sale) so that all tranches pay down in unison. These structures typically contain performance triggers to lock out subordinated tranches under certain stress conditions, so to redirect payments to senior tranches.
The level of liquidity is generally a function of the envisaged rating level and the volatility shown in the past recovery behaviour of the servicer and the relevant market. To this respect, the inclusion of performing assets may improve cash flow stability.

In order to bridge cash flow timing mismatches, interest reserves or interest liquidity facilities may also cover the risk of payment delays occurring with a collection underperformance compared to the business plan. In general, DBRS expects such liquidity source to be able to cover interest payments to make up for a collection delay of up to six months, compared to the base case recovery schedule.

As opposed to prefunded cash reserves, the use of liquidity facilities and interest reserves funded through collections does not generally provide credit enhancement to the notes, but only liquidity support.

**TRANSACTION RATING THRESHOLDS OR TRIGGERS**

Depending upon the structure of a transaction, performance thresholds or triggers can mitigate risk in a deteriorating economy and poor collateral performance. The performance triggers are designed to provide for an increase in credit enhancement levels beyond what is initially included in the transaction, thereby enabling the transaction to withstand a lower-than-expected recovery performance. DBRS does not dictate the transaction triggers to be included in a particular structure; however, DBRS assesses the extent to which any additional credit enhancement may be built into a transaction as part of its overall assessment of the transaction structure and cash flow scenarios. In NPL securitisations, possible transaction performance triggers include levels of actual recovery compared to the portfolio business plan.

**TRANSACTION PROVISIONS – SERVICERS**

Given the dominant role of the servicer securing cash flow from already defaulted and distressed borrowers, the servicer’s experience, expertise and financial strength and on the probability and consequences of servicer failure and ensuing collection disruption are significant analytical considerations.

DBRS views positively transactions with servicers that can demonstrate a long-term track record. DBRS also considers their ability to adapt their collection strategies to a changing economic, legal and operational environment. DBRS views positively servicer agreements that allow for an appropriate level of flexibility in assessing the best recovery course of action and determining strategy, while complying with the appropriate regulatory guidelines.

The servicing agreement is expected to contain provisions that allow the trustee or transaction manager to appoint a replacement servicer on behalf of the noteholders if the original servicer is unable or unwilling to perform its duties or if the servicer defaults on its material obligations. DBRS considers the type of backup servicing arrangement and, if there is a designated replacement in the original deal structure, the amount of preparation and operational diligence undertaken by the backup servicer resulting in the “warm” or “hot” backup classification. DBRS values positively the presence of a third party, as well as any funds which would facilitate a smooth transition in case a replacement servicer is needed.

**Fees for Servicers and Backup Servicer**

DBRS views the alignment of servicer incentives as an essential part of its rating strength. DBRS may choose not to rate transactions that lack appropriate incentives for the servicers to recover the pool loans in a balance of timeliness and total value. Generally, DBRS views negatively base servicing fees that are disproportionately larger than expected baseline administrative and operational servicing costs. DBRS considers whether the same incentives exist in the servicer’s remuneration of employees.

DBRS assesses whether fees for a replacement servicer are sufficient to complete the recovery process initiated by the original servicer. Consideration is also given to the amount of transition expenses provided for in the transaction documents.

DBRS views positively the participation of the servicer in the transaction capital structure in a subordinated and minority position to the rated notes.

8. Liquidity lines, for example, once drawn to cover shortfalls that may have an impact on the timely payment of interest on the rated notes, are repaid to the liquidity provider at the top of the waterfall.

9. For a more detailed discussion on the assessment of the servicer and backup servicer, refer to the DBRS Operational Risk Assessment for European Structured Finance Servicers.
Credit Enhancement

DBRS evaluates both the amount and the form of credit enhancement in the transaction in its ratings as part of the cash flow analysis discussed in the following section. The appropriate form and amount of credit enhancement depends upon a number of factors, including the overall amount and timing of recoveries and potential disruptions in collections, which that may result from a transfer of servicing. Credit enhancement in NPL deals may be provided through a combination of subordination, a reserve fund and over-collateralisation.

DBRS does not determine credit enhancement levels or transaction structures, but rather evaluates the level of protection provided by the proposed credit enhancement, given the existing transaction structure, the payment waterfall and triggers.

SUBORDINATION
Subordination is created by tranching the notes of the transaction and assigning lower priority of payments to subordinated classes of notes. Subordination is akin to over-collateralisation (see below), except that the subordinate notes usually pay interest, thereby decreasing the amount of available funds to cover potential recovery shortfalls.10

RESERVE FUND
Reserve funds provide liquidity to address periodic recovery shortfalls from the pool of NPLs. Such accounts may be funded at issuance and/or filled by trapping funds to a pre-specified amount after paying interest on the senior notes and before funds are allocated to other payments. Reserve funds are typically held in a cash deposit account or in short-term securities with little default risk.

Reserve accounts typically earn less than the coupons on the notes, leaving the “negative carry” to be borne by the junior noteholders. Reserve account floors can be used to provide back-end protection for noteholders.

OVER-COLLATERALISATION
Over-collateralisation consists of the amount by which the collateral amount exceeds the total amount of securities issued. Additional collateral amounts will be considered in the original evaluation of the aggregate collateral performance.

Cash Flow Analysis

DBRS evaluates cash flow model results to assess the sufficiency of the pool’s cash flow against proposed credit enhancement (evaluated by stress tests) within the transaction at the requested rating levels.

The inputs of the cash flow analysis most commonly include the following:
Recoveries: The base case projected recovery level after applying a portfolio specific stress and the stress-case recovery levels of the pool (see section Cash Flow Model and Performance Haircuts, below), and their implications for each tranche requested rating.
• Recovery Curve Timing: In addition to considering historical performances, the impact of the recovery timeline on the model is assessed using a dynamic scenario analysis where different stresses are applied to the time to recovery. The scenario analysis allows DBRS to observe the best-case and worst-case outcomes in terms of recovery time, cash flow degradation and ultimate principal recovery, and how these outcomes affect the reserves, waterfall and principal and interest payments to the outstanding

10. When interest on subordinated notes comes after repayment of principal on senior notes (which, as noted above, is normally the case in NPL transactions), then subordination provides protection against recovery shortfalls.
notes.

- **Recovery Delays due to Failure of the Servicer**: Modelling scenarios incorporate delays in receiving recoveries that could occur due to either ineffective servicing or a servicing transition.

- **Liquidity**: Available liquidity (in the form of interest reserve, liquidity facilities, etc.) to meet temporary shortfalls of recoveries which may result in non-payment of interest on the notes. Due to the uncertain timing of the collections, DBRS will model a six-month delay in cash flows at inception in order to stress the transaction resilience to delayed collections.

- **Interest Rate or Foreign Currency Swaps**: When no derivative agreement is in place, the cash flow modelling assumes interest rate or foreign currency stresses as described in DBRS’s *Unified Interest Rate Model for European Securitisations*.

- **Impacts of all of the above against Transaction Priority of Payments and Triggers**.

For the purposes of the cash flow analysis of an NPL transaction, DBRS requests that the transaction structure be clearly defined, including:

- Coupons of the proposed notes.
- Reserves and reserve structure.
- Administrative fees (if any).
- Servicer base and incentive fees (if any) and an estimate of the other recovery costs.\(^\text{11}\)
- Waterfall rules and priority of payments.

**Cash Flow Model and Performance Haircuts**

After having determined the base-case expected recoveries and taking into account any other available recovery information, DBRS reviews cash flows generated from the pool used to cover the transaction’s priority of payments (the waterfall), rating thresholds or triggers, to assess the adequacy of the proposed credit enhancement for each proposed tranche. DBRS applies stresses to the cash flow from the pool at increasingly conservative levels for higher ratings.

Adjustments are first built into the base case to capture risks that DBRS anticipates are typically present in all rating scenarios:

- Inherent variability in the behaviour of already distressed and defaulted borrowers;
- Limitations in data, which depend largely on the self-reporting and third-party verifications of performance of bespoke business practices by the originator;
- Uncertainty in economic forecasts and declining repayment capacity of such obligors from the lower range of such forecasts;
- Risk of deterioration of the efficiency of servicer operations, or servicer failure; and
- Other variables that may produce losses or delays, as may be relevant to the jurisdiction.

In practice, these baseline adjustments include a volatility stress to historical performance across the business cycle.

Against this baseline, various stresses (often referred to as “haircuts”) are scaled to emulate the pool’s cash flow under increasingly low-probability, high-impact negative events, largely deepening economic deterioration and risks in regulatory practices.

The key stress in DBRS’s NPL analysis is the haircut of expected collections as a percentage of initial pool value at transfer, as shown below. These haircut ranges are indicative and the final number will be based on the precise ratio of SD/Mean and Time Horizon.

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\(^{11}\) This estimate is particularly important where recovery expenses (i.e., legal fees, enforcement costs and taxes, etc.) are not included in the servicing fees. DBRS reviews the assumptions and data on which the recovery expenses estimate indicated in the servicer’s portfolio business plan is based, by analysing them on the basis of historical data provided by the servicer and information available in this respect on public sources and by stressing expenditure levels to incorporate risks of future increase due to external factors (e.g., changes in law). DBRS critically reviews the procedure put in place by the servicer to monitor on an ongoing basis the level of expenses incurred during the recovery process.
## Ratio: SD/Mean

<table>
<thead>
<tr>
<th>Rating</th>
<th>Horizon</th>
<th>Approximated Haircut Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>0.75</td>
</tr>
<tr>
<td>A (low)</td>
<td>3</td>
<td>88.00%</td>
</tr>
<tr>
<td>A (low)</td>
<td>3</td>
<td>86.00%</td>
</tr>
<tr>
<td>BBB (high)</td>
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<td>83.50%</td>
</tr>
<tr>
<td>BBB</td>
<td>3</td>
<td>82.50%</td>
</tr>
<tr>
<td>BBB (low)</td>
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<td>80.50%</td>
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<tr>
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<td>73.50%</td>
</tr>
<tr>
<td>BB</td>
<td>3</td>
<td>71.25%</td>
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<tr>
<td>B</td>
<td>3</td>
<td>55.25%</td>
</tr>
<tr>
<td>B (low)</td>
<td>3</td>
<td>42.00%</td>
</tr>
</tbody>
</table>

Recovery timing is also stressed to reflect the assumed longer recovery periods consistent with the higher rating scenarios after applying the haircut above to the base case recovery curve.

### Surveillance

Once DBRS assigns a rating on a European NPL securitisation, the surveillance process begins and is continued for as long as DBRS maintains a rating on the notes.

DBRS expects the collateral-level performance to be much more volatile than regular performing loans and measures whether cash flow may be deteriorating faster than assumed at issuance.

In cases where ongoing information is no longer deemed reliable or of sufficient quality, and DBRS is unable to properly monitor the transaction, DBRS may discontinue the existing rating(s).

### Additional Considerations

**Unconventional Asset Types**

For assets for which DBRS cannot form opinions about key assumptions of recovery timing and recoverable value because of a lack of well-supported historical and current empirical data, no recovery value would be assigned.