Methodology

Rating Funds Backed by Corporate Credit

FEBRUARY 2015
DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS’s extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.
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Scope and Limitations

The scope of this methodology is to consider the credit quality of Fund\(^1\) assets, and not to include considerations relating to Fund liabilities such as expected performance of a Fund due to market volatility, recoveries, yield, liquidity, foreign exchange, leverage, regulatory risks or other erosion of Fund holder return. DBRS also considers the Fund management and legal structure in assigning a rating. This methodology only applies to Funds that invest in corporate credits and does not apply to a Fund that could purchase structured finance securities, equities or other assets, including derivatives. 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

This publication outlines the DBRS methodology for assigning credit fund ratings to Funds that invest in corporate credits (assets). DBRS had previously requested comments on this methodology during the period 7 November 2014 to 9 December 2014. No comments were received.

This framework is applied in conjunction with a number of other DBRS publications, including:
- Legal Criteria for European Structured Finance Transactions;
- Legal Criteria for Canadian Structured Finance;
- Legal Criteria for U.S. Structured Finance;
- Rating Asset Management Companies;
- Operational Risk Assessment for European Structured Finance Servicers;
- Mapping Financial Institution Internal Ratings to DBRS Ratings for Global Structured Credit Transactions; and
- Derivative Criteria for European Structured Finance Transactions.

These methodologies can be found at [http://www.dbrs.com/about/methodologies/page/1/id/10056](http://www.dbrs.com/about/methodologies/page/1/id/10056).

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1. Funds under this Methodology are generally distinct legal entities, and a DBRS Rating is assigned to each entity.
The following diagram describes the process used to analyse funds backed by corporate credit:

1. DBRS performs an operational risk review of the Fund manager and reviews any significant Fund parties.

2. DBRS reviews legal aspects of the Fund to identify legal risks inherent in the documents and to ensure consistency with the appropriate DBRS legal criteria.

3. DBRS analyses the credit quality of the Fund assets and determines an expected default rate of the Fund.²

² Any change from the quantitative result of three or more rating notches is considered to be a material deviation.
Chapter 1 – Counterparty Analysis

OPERATIONAL RISK ASSESSMENT
DBRS’s operational risk assessment procedures for funds backed by corporate credit are designed to evaluate the quality of the parties that perform certain key roles in a transaction rated by DBRS. These roles include, but are not limited to:

• Ongoing management
• Administrative services
• Custodial services
• Accounting

While DBRS does not assign formal ratings to these processes, it does conduct operational risk reviews to determine if the key parties are acceptable, and then incorporates the results of the review into the rating and surveillance processes. In instances where it is determined that any of the key Fund participants are outside of DBRS guidelines, issuers may incorporate certain structural enhancements into a proposed transaction for DBRS to be able to rate the transaction. In the event that DBRS determines that a key Fund participant does not meet minimum standards and there are insufficient mitigating factors, it may decline to rate the Fund.

FUND MANAGER REVIEW
From the roles noted above, DBRS particularly focuses on the Fund manager’s abilities with regards to asset selection and ongoing management, including a review of:

• Prior default rate history of corporate credit in the manager’s previous funds;
• Credit selection and monitoring processes;
• Team experience and staffing levels;
• Internal controls and compliance for ensuring that a fund is investing within its criteria; and
• Frequency and quality of reporting to investors.

For more details, please refer to Appendix D. DBRS may decline to rate a Fund where the manager is unable to provide sufficient historical information or fails to meet certain criteria.
Chapter 2 – Asset Analysis

DBRS evaluates Fund assets based on credit assessments of the underlying corporate credits. If the manager is able to trade within the Fund, DBRS typically assesses the assets based on either the current composition or on a hypothetical pool constructed on the worst-case portfolio allowed by the Fund guidelines.

**DBRS Obligor Rating**
The individual assets of the Fund must have (i) a long-term rating (public or private) issued by DBRS, or, where such rating does not exist, (ii) a credit estimate issued by DBRS, (iii) a DBRS Internal Assessment and/or (iv) internal risk scores.

A DBRS Credit Estimate is a model-driven default probability. It is not a DBRS public rating. Credit Estimates are not actively monitored and typically expire one year after assignment. Further description of Credit Estimates is available on the DBRS website under Credit Estimates Global Policy. 3

A DBRS Internal Assessment is an opinion regarding the creditworthiness of an issuer or security based on public ratings issued and maintained by other Credit Rating Agencies that are registered in accordance with jurisdictional regulations and/or DBRS analysis/review that should not be equated to the depth of analysis/review conducted on public or private ratings. Further description of Internal Assessments is available on the DBRS website under Internal Assessments – Global Policy.

If at any time the DBRS rating, Credit Estimate or Internal Assessment cannot be determined as above, DBRS may use other forms of risk assessment at its disposal to determine them, which may include mapping the issuer’s internal risk scores. If none of the options mentioned above are applicable, then the exposure is generally assumed in the CCC category, which is also applied to assets where a DBRS opinion has been requested but not yet provided.

**ASSET TYPES RECEIVING ALTERNATIVE TREATMENT**

**Treatment of Defaulted and Distressed Assets**
Defaulted and non-performing assets are typically assumed to have the lowest possible rating from DBRS.

**Assets Experiencing Extended Delinquency**
In general, any asset that has defaulted on a scheduled payment – irrespective of waiver of such default – is considered defaulted for modelling purposes. In situations where an asset has not technically defaulted as per its contractual conditions but has deferred any payment for a year or longer, the asset is also treated as defaulted for modelling purposes.

**Variable Funding and Delayed Draw Instruments**
DBRS creates a worst-case scenario which may include full draws and funding of revolving and delayed-draw assets.

**Structured Finance, Equity Securities, Derivatives and Instruments that are Convertible, Exchangeable or Have Attached Warrants**
If such assets are in the pool, DBRS generally assigns a “C” default probability to structured finance assets, to equity securities or to any securities that may become equity within corporate credit funds. Debt securities with attached warrants would be similarly penalised on the non-debt portion of the security. In general, DBRS would expect to see a prohibition on the purchasing of such assets (including derivatives as investments).

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3. A description of the Credit Estimate model is not currently available on the DBRS website. DBRS expects to have such a document available before the publication of a final methodology.
Chapter 3 – Quantitative Analysis

DBRS uses a model to generate the expected default rate of the Fund assets. The following inputs are used for each asset:

- Individual asset and a unique identifier associated with its obligor.
- Amount of exposure (generally par value, although other valuations may be used).
- Tenor of exposure.
- DBRS obligor rating (derived as described in the DBRS Obligor Rating section).

The Expected Default Rate of the Fund assets is equal to the par-weighted-average (WA) Default Rate of those assets. The Default Rate of each asset is equal to its probability of default, derived from its DBRS Obligor Rating and corresponding to the relevant tenor.

The Expected Default Rate is compared with the comparable rating level in the Idealised Default Table (see Appendix C) for the WA life of the assets used. The WA lives between two columns are linearly interpolated to derive the applicable Idealised Default Rate for each rating level. The next Idealised Default Rate level below the Expected Default Rate of the assets is considered the model output for the rating. A description of the scale applicable to fund ratings can be found in Appendix A: DBRS Credit Fund Rating Definitions.

Chapter 4 – Legal Structure and Fund Documentation Review

DOCUMENTATION AND LEGAL RISKS
DBRS reviews the legal structure of a Fund to ensure consistency with the DBRS legal criteria for the appropriate jurisdiction and to match the investment limitations used in the modelling.

DBRS’s legal analysis of the administrative structure of the Fund would also typically include a review of various governing documents based on the jurisdiction of the Issuer, as well as various legal opinions. A major focus of the DBRS legal analysis would be fund separateness of the assets from both the portfolio manager and from other Funds under management.

In reviewing documents and opinions, DBRS seeks to identify any features, ambiguities or inconsistencies that could result in the Fund assets performing in a manner at odds with the rating analysis. For portions of the documents open to interpretation, DBRS generally adopts the more conservative reading of the documentation.
Chapter 5 – Fund Surveillance

MONITORING
DBRS monitors a number of factors in Fund surveillance, including any limits that are observed in relation to those modelled in establishing the then-current rating. DBRS generally expects to receive a report outlining holdings in the Fund and their current ratings, as well as par and market values on at least a monthly basis.

For Funds that are no longer buying or selling assets, DBRS may rely on the previous review of the portfolio, adjusting for repayments at maturity, any changes in the pool asset ratings and defaults. For Funds that permit trading, DBRS generally models to the worst-case scenario of the manager’s most aggressive portfolio as allowed by Fund guidelines; if these limits have been surpassed, DBRS may assume the more punitive of the limit and the actual level.

The financial condition of counterparties is important to Fund asset performance. Disruptions at the fund manager or trustee level in a Fund can lead to neglect of the assets and may result in a failure to maintain these assets within Fund guidelines. DBRS monitors the health of Fund parties in light of potential implications for the structure.
Appendix A – DBRS Credit Fund Rating Definitions

All rating categories from AA-cf to CCC-cf also contain subcategories (high) and (low), indicating incremental differences in credit quality. A rating without a subcategory is in the middle of the category.

- **AAA-cf**: The fund portfolio is considered to be of the highest credit quality.
- **AA-cf**: The fund portfolio is considered to be of a high credit quality.
- **A-cf**: The fund portfolio is considered to be of a good credit quality.
- **BBB-cf**: The fund portfolio is considered to be of an adequate credit quality.
- **BB-cf**: The fund portfolio is considered to be of a speculative, non-investment grade credit quality.
- **B-cf**: The fund portfolio is considered to be of a highly speculative credit quality.
- **CCC-cf**: The fund portfolio is considered to be of a very highly speculative credit quality.

Please refer to www.dbrs.com for an explanation of our rating scales and rating policies.
Appendix B – DBRS Credit Fund Rating Examples

INVESTMENT-GRADE FUND

<table>
<thead>
<tr>
<th>Rating of Assets</th>
<th>Percentage</th>
<th>Tenor</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>40%</td>
<td>1 Year</td>
</tr>
<tr>
<td>AA</td>
<td>30%</td>
<td>1 Year</td>
</tr>
<tr>
<td>A</td>
<td>20%</td>
<td>1 Year</td>
</tr>
<tr>
<td>BBB</td>
<td>10%</td>
<td>1 Year</td>
</tr>
</tbody>
</table>

The expected default rate of the pool is 0.0437%, which is in between the A (high) and “A” levels. The lower of the ratings is the model result.

\[
40\% \times 0.0110\% + 30\% \times 0.0212\% + 20\% \times 0.0487\% + 10\% \times 0.2318\% = 0.0437\%
\]

A (high) 0.0419%
“A” 0.0487%
A (low) 0.0945%

Fund Model Rating: A-cf

NON-INVESTMENT-GRADE FUND

<table>
<thead>
<tr>
<th>Rating</th>
<th>Percentage</th>
<th>Tenor</th>
</tr>
</thead>
<tbody>
<tr>
<td>BB</td>
<td>45%</td>
<td>1 Year</td>
</tr>
<tr>
<td>B</td>
<td>50%</td>
<td>1 Year</td>
</tr>
<tr>
<td>Non-Performing/Defaulted Assets/Equity</td>
<td>5%</td>
<td>NA</td>
</tr>
</tbody>
</table>

\[
45\% \times 1.3627\% + 50\% \times 4.8503\% + 5\% \times 100.0\% = 8.0384\%
\]

Fund Model Rating: B (low)-cf

VARIED TENOR FUND

<table>
<thead>
<tr>
<th>Rating</th>
<th>Percentage</th>
<th>Tenor</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>10%</td>
<td>1 Year</td>
</tr>
<tr>
<td>AAA</td>
<td>20%</td>
<td>1.5 Years</td>
</tr>
<tr>
<td>AA</td>
<td>40%</td>
<td>1 Year</td>
</tr>
<tr>
<td>A</td>
<td>20%</td>
<td>2.5 Years</td>
</tr>
<tr>
<td>BBB</td>
<td>10%</td>
<td>1 Year</td>
</tr>
</tbody>
</table>

\[
10\% \times 0.0110\% + 20\% \times (0.0110\% + 0.5 \times (0.0264\% - 0.0110\%)) + 40\% \times 0.0212\% + 20\% \times (0.1287\% + 0.5 \times (0.2419\% - 0.1287\%)) + 10\% \times 0.2318\% = 0.0736\%
\]

WA Tenor: 1.4 Years
Fund Model Rating: A-cf
### Appendix C – Tables Relating to Quantitative Analysis

#### Table 1: DBRS Idealised Default Table

<table>
<thead>
<tr>
<th>Rating (cf)</th>
<th>Tenor (Years)</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td></td>
<td>0.0110%</td>
<td>0.0264%</td>
<td>0.0460%</td>
<td>0.0699%</td>
<td>0.0987%</td>
<td>0.1330%</td>
<td>0.1736%</td>
<td>0.2212%</td>
<td>0.2765%</td>
<td>0.3405%</td>
</tr>
<tr>
<td>AA (high)</td>
<td></td>
<td>0.0161%</td>
<td>0.0390%</td>
<td>0.0691%</td>
<td>0.1071%</td>
<td>0.1539%</td>
<td>0.2107%</td>
<td>0.2784%</td>
<td>0.3580%</td>
<td>0.4501%</td>
<td>0.5554%</td>
</tr>
<tr>
<td>AA</td>
<td></td>
<td>0.0212%</td>
<td>0.0517%</td>
<td>0.0922%</td>
<td>0.1442%</td>
<td>0.2091%</td>
<td>0.2883%</td>
<td>0.3832%</td>
<td>0.4948%</td>
<td>0.6237%</td>
<td>0.7703%</td>
</tr>
<tr>
<td>AA (low)</td>
<td></td>
<td>0.0281%</td>
<td>0.0709%</td>
<td>0.1297%</td>
<td>0.2055%</td>
<td>0.2994%</td>
<td>0.4123%</td>
<td>0.5445%</td>
<td>0.6962%</td>
<td>0.8672%</td>
<td>1.0571%</td>
</tr>
<tr>
<td>A (high)</td>
<td></td>
<td>0.0419%</td>
<td>0.1095%</td>
<td>0.2045%</td>
<td>0.3280%</td>
<td>0.4801%</td>
<td>0.6602%</td>
<td>0.8671%</td>
<td>1.0991%</td>
<td>1.3543%</td>
<td>1.6306%</td>
</tr>
<tr>
<td>A</td>
<td></td>
<td>0.0487%</td>
<td>0.1287%</td>
<td>0.2419%</td>
<td>0.3893%</td>
<td>0.5704%</td>
<td>0.7841%</td>
<td>1.0283%</td>
<td>1.3005%</td>
<td>1.5978%</td>
<td>1.9173%</td>
</tr>
<tr>
<td>A (low)</td>
<td></td>
<td>0.0945%</td>
<td>0.2420%</td>
<td>0.4391%</td>
<td>0.6815%</td>
<td>0.9643%</td>
<td>1.2825%</td>
<td>1.6309%</td>
<td>2.0045%</td>
<td>2.3990%</td>
<td>2.8101%</td>
</tr>
<tr>
<td>BBB (high)</td>
<td></td>
<td>0.1860%</td>
<td>0.4685%</td>
<td>0.8333%</td>
<td>1.2659%</td>
<td>1.7521%</td>
<td>2.2792%</td>
<td>2.8359%</td>
<td>3.4126%</td>
<td>4.0013%</td>
<td>4.5956%</td>
</tr>
<tr>
<td>BBB</td>
<td></td>
<td>0.2318%</td>
<td>0.5818%</td>
<td>1.0305%</td>
<td>1.5581%</td>
<td>2.1460%</td>
<td>2.7776%</td>
<td>3.4384%</td>
<td>4.1166%</td>
<td>4.8024%</td>
<td>5.4884%</td>
</tr>
<tr>
<td>BBB (low)</td>
<td></td>
<td>0.3732%</td>
<td>0.8912%</td>
<td>1.5142%</td>
<td>2.2099%</td>
<td>2.9528%</td>
<td>3.7230%</td>
<td>4.5053%</td>
<td>5.2884%</td>
<td>6.0636%</td>
<td>6.8252%</td>
</tr>
<tr>
<td>BB (high)</td>
<td></td>
<td>1.0800%</td>
<td>2.4384%</td>
<td>3.9327%</td>
<td>5.4686%</td>
<td>6.9863%</td>
<td>8.4500%</td>
<td>9.8400%</td>
<td>11.1473%</td>
<td>12.3697%</td>
<td>13.5091%</td>
</tr>
<tr>
<td>BB</td>
<td></td>
<td>1.3627%</td>
<td>3.0573%</td>
<td>4.9001%</td>
<td>6.7721%</td>
<td>8.5997%</td>
<td>10.3408%</td>
<td>11.9738%</td>
<td>13.4908%</td>
<td>14.8921%</td>
<td>16.1826%</td>
</tr>
<tr>
<td>BB (low)</td>
<td></td>
<td>2.2346%</td>
<td>4.7297%</td>
<td>7.2541%</td>
<td>9.6836%</td>
<td>11.9572%</td>
<td>14.0507%</td>
<td>15.9604%</td>
<td>17.6938%</td>
<td>19.2641%</td>
<td>20.6863%</td>
</tr>
<tr>
<td>B (high)</td>
<td></td>
<td>3.6297%</td>
<td>7.4056%</td>
<td>11.0204%</td>
<td>14.3419%</td>
<td>17.3292%</td>
<td>19.9866%</td>
<td>22.3389%</td>
<td>24.4186%</td>
<td>26.2592%</td>
<td>27.8922%</td>
</tr>
<tr>
<td>B</td>
<td></td>
<td>4.8503%</td>
<td>9.7471%</td>
<td>14.3160%</td>
<td>18.4179%</td>
<td>22.0296%</td>
<td>25.1805%</td>
<td>27.9201%</td>
<td>30.3028%</td>
<td>32.3799%</td>
<td>34.1974%</td>
</tr>
<tr>
<td>B (low)</td>
<td></td>
<td>10.0776%</td>
<td>21.6690%</td>
<td>23.5135%</td>
<td>28.1371%</td>
<td>31.8670%</td>
<td>34.9314%</td>
<td>37.4891%</td>
<td>39.6528%</td>
<td>41.5044%</td>
<td>43.1047%</td>
</tr>
<tr>
<td>CCC (high)</td>
<td></td>
<td>18.7898%</td>
<td>30.8505%</td>
<td>38.8426%</td>
<td>44.3357%</td>
<td>48.2625%</td>
<td>51.1831%</td>
<td>53.4376%</td>
<td>55.2363%</td>
<td>56.7119%</td>
<td>57.9502%</td>
</tr>
<tr>
<td>CCC</td>
<td></td>
<td>22.2746%</td>
<td>36.1264%</td>
<td>44.9743%</td>
<td>50.8151%</td>
<td>54.8208%</td>
<td>57.6837%</td>
<td>59.8169%</td>
<td>61.4696%</td>
<td>62.7949%</td>
<td>63.8884%</td>
</tr>
<tr>
<td>CCC (low)</td>
<td></td>
<td>61.1373%</td>
<td>68.0632%</td>
<td>72.4872%</td>
<td>75.4076%</td>
<td>77.4104%</td>
<td>78.8419%</td>
<td>79.9085%</td>
<td>80.7348%</td>
<td>81.3974%</td>
<td>81.9442%</td>
</tr>
<tr>
<td>C</td>
<td></td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
<td>100.000%</td>
</tr>
</tbody>
</table>
Appendix D – DBRS Fund Manager Review Outline

DBRS’s operational risk assessment procedures are designed to evaluate the quality of the parties that manage the Fund. While DBRS does not assign formal ratings to these parties, it does conduct operational risk reviews and incorporates the results into its rating and surveillance processes. In the event that DBRS determines that a manager is unacceptable, it may refuse to rate the transaction.

DBRS typically begins the initial Fund manager review process by sending an agenda to the company that outlines the topics to be covered during the review and includes a list of documents to be provided, such as organisational charts, financial statements and performance statistics (sample below). A date is usually then scheduled to either conduct an on-site visit of the company or to have a call. During the on-site review and/or call, DBRS normally meets with senior management to discuss the operations, tour the facilities and review system demonstrations, as appropriate. The on-site review typically takes one to two days, depending on the complexity of the Fund. DBRS assesses the information gathered through the review process, along with its surveillance data and industry statistics, to determine if the Fund manager is acceptable. In instances where DBRS determines that they are below average, issuers may incorporate certain structural enhancements into a proposed transaction in order for DBRS to be able to rate the transaction.

DBRS conducts periodic reviews of the Fund manager as part of the ongoing monitoring of outstanding transactions or in cases when unexpected events warrant, such as the sale of the operation or a bankruptcy filing. The reviews are intended to update DBRS on any changes that have taken place since the last operational risk review and highlight any material changes to the operation or its management. The review may be accomplished through a conference call, meeting with senior management or by an on-site visit. The type of review needed is typically determined based on the length of time since the last on-site review, the performance of the rated transactions and the materiality of any changes within the organisation. Any findings from the update review may be incorporated into the surveillance process in addition to being included in the analysis for new transactions.

FIRM OVERVIEW

• Company History
  – Current & long-term business plans
• Financial Condition
• Ownership Structure
• Organisational Structure
  – Including clear organisational chart, showing every employee involved in management, titles and reporting lines
• Key personnel experience
  – Including biographies showing credentials and experience
  – Including a list of all analysts and the assets they cover
• Portfolio size
• Sample marketing material (if applicable)
• Assets under management
  – Investment vehicles
  – Investor profiles
  – Asset types
  – Strategies
  – Securitisations under management (if any)
• Regulators
  – Agencies
  – Governing law
• Material Litigation (past, present, expected)
• Ever terminated for cause?
• Internal/external audit results

SELECTION PROCESS
• Description of the asset selection process
  – Who is responsible for origination?
  – Sourcing & origination
  – General selection philosophy & guidelines
  – Investment evaluation criteria
  – Investment committee
  – Example of a selection process, with accompanying documents
• Valuation Process
  – Description of methodologies
  – Example of each valuation method
  – Example of any valuation deviation
• Monitoring
  – Who is responsible for ongoing monitoring?
  – Frequency of monitoring
  – Performance history
  – Legal – in house or external?
  – Example of a credit where material losses occurred
  – Example of a large deviation in credit valuation
  – Example of a credit with an extended distribution schedule
• Analyst compensation structure

SYSTEMS & OPERATIONS
• Description of the computer systems in place:
  – Origination, cash flow, monitoring/servicing and management systems
    • Off the shelf
    • Proprietary
    – Strengths and weaknesses
    – Capacity limits
• Data management
  – How do you ensure that financial statements are received on a timely basis?
  – What emergency backup systems are in place and where are they located?
  – Disaster recovery plans and the results of the last test
  – Storage and access (i.e., company intranet, shared drive, hard copy, etc.)
  – Future initiatives
• Key transaction support
  – Accounting support
  – Valuation services (if any)
  – Legal support
  – Compliance support
  – Other services
• Compliance & Auditing
  – Policies
  – Internal and external audit results
• Cash flow management
  – Loan facilities
  – Timing management
PERFORMANCE DATA
• Fund management philosophy & style
• Please provide a performance summary history for all credit or similar Funds, including periodic performance reports of portfolios
• Audited performance summary to include, if applicable:
  – Trading history
  – Internal Rates of Return over time