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Introduction
The asset-backed securities market in the U.S. has evolved from the first equipment-lease and auto-loan deals issued in the mid-1980s to a dynamic market with a variety of consumer, commercial, operating, and nontraditional assets, and new asset classes and structures continue to emerge and develop. Despite the contractions that occurred in the structured-finance markets during the 2007 financial crisis and its aftermath, ABS securitizations play a vital role in the capital markets.

To respond to the market’s evolving needs, Morningstar Credit Ratings, LLC employs a principles-based approach to assigning and monitoring ratings on ABS. Morningstar’s multifaceted analytical framework typically incorporates the following seven areas of analysis common to ABS transactions: legal structure, asset quality, transaction structure, credit support, cash flow analysis, originator and servicer quality, and counterparty risk. The principles discussed in this methodology represent Morningstar’s overarching framework for assigning and monitoring ratings of U.S. ABS transactions.

Legal Structure
Morningstar typically begins its analysis by evaluating a transaction’s legal framework. We review the legal structure and opinions provided to us to confirm whether the cash flow generated by the securitized assets may be impaired and what factors could diminish the cash flow, such as the potential bankruptcy of the originator or other transaction parties, the trustee’s lack of a first-priority perfected security interest in the assets, and tax considerations.

Bankruptcy Considerations
One fundamental consideration is whether the transaction is bankruptcy-remote, and the level of bankruptcy remoteness will inform analysis of risk in the transaction. The purpose of bankruptcy remoteness is to isolate the securitized assets from the corporate credit risk of the originator so the cash flow generated by those assets is available to make timely interest and principal payments on the debt that the assets secure.

Morningstar analyzes bankruptcy remoteness from two perspectives. The first factor is whether a “true sale” exists, where the assets have been transferred from the originator to the special-purpose vehicle, either directly or indirectly, so that if the originator were to become the subject of an insolvency proceeding, the securitized assets would not be part of the originator’s bankruptcy estate. The second factor is whether “nonconsolidation” exists, whereby the originator and SPV are separate entities, so that if the originator were to become subject to an insolvency proceeding, the SPV’s assets and any proceeds would not be substantively consolidated with the bankruptcy estate of the originator.

Factors that support bankruptcy remoteness include the SPV’s limited purpose and business activities, the inclusion of an independent director on its board of directors, and limits on the SPV’s ability to incur debt or merge with other entities. Morningstar typically evaluates the transaction documents and structural elements of the transaction to make true sale and nonconsolidation determinations. To determine whether a transfer is a true sale, we usually
examine the following factors: whether the originator or the SPV bears the risk of loss on the transferred assets; whether the SPV has recourse to the originator for losses on the transferred assets; whether the SPV paid the originator fair consideration for the assets; whether the parties intend for the transfer to be a sale; and whether the originator has the obligation to repurchase the transferred assets. For loan originators/sellers that are not subject to the U.S. Bankruptcy Code, such as banking institutions, a first-priority perfected security interest may be sufficient to achieve legal isolation of the securitized assets.

Some of the factors that Morningstar may analyze to determine whether the originator and SPV could be substantively consolidated include the following: the degree to which the originator and its affiliates maintain a separate existence from the SPV; whether third parties would reasonably rely on the assets of the SPV to satisfy the obligations of the originator and vice versa; whether either party is accountable for the payment of the liabilities of the other; and whether either party guarantees the liabilities of the other.

Morningstar may receive legal opinions from the securitization transaction counsel that address the various transfers in the transaction and provide assurance that, in the event of the bankruptcy or insolvency of the originator/loan seller, the transfer of the securitized assets from the originator/loan seller to the SPV would not be part of the originator’s/loan seller’s bankruptcy estate, and that the SPV would not be substantively consolidated with the assets of the originator/loan seller.

Morningstar also typically receives a legal opinion that addresses the security interest in favor of the trustee. This is important in that the trustee must have a perfected security interest in the collateral in order to exercise legal rights to any liquidation proceeds from the collateral either as recoveries on defaulted receivables or as a source of principal repayment. The security interest opinion can provide assurance that the security interest has been validly created and that, based on a certificate provided by an officer of the servicer and actions described in the opinion, the necessary steps have been taken to attach and perfect the trustee’s security interest in the assets.

In addition, Morningstar may receive a legal opinion addressing the SPV’s tax liability. A liability can arise from a tax on the income of the SPV or a tax on the transfer of the assets. Any tax liability incurred by the SPV could erode cash flow that is available for making interest and principal payments on the securities. Morningstar expects that the form of SPV used will not result in any tax leakage from the transaction structure or, if taxes are incurred, Morningstar can quantify the tax amount so that we can factor it into the cash flow analysis.

If Morningstar does not receive from securitization transaction counsel any opinion that is typically provided for an ABS transaction, we may apply stresses in our analysis to capture or measure the related risks.

Finally, Morningstar may take into account any legal issues that pertain to specific asset classes and may affect the trust’s legal rights to asset proceeds. For example, Morningstar may take into account Bankruptcy Code Section 365, which pertains to leases, and Section 1110, which pertains to aircraft and vessels.
Representations and Warranties

Typically, ABS originators provide investors with representations and warranties regarding the assets that are securitized in a transaction, as well as enforcement mechanisms, which require a breach of a representation or warranty to be remedied when the breach materially and adversely affects the value of the assets or the interests of the investors. Morningstar may analyze the risks to the transaction and how each transaction provides for determining whether a breach has occurred, the available remedies, and the specific procedures to enforce those remedies.

Appropriate remedies may include reimbursement to the securitization trust for breaches that have occurred. Typically, transactions require that in the event of a breach of representations or warranties, receivables either will be repurchased or replaced with receivables that meet the eligibility criteria. The term of the repurchase obligation for any specific representation or warranty is usually reviewed on a deal-by-deal basis. The repurchase price is often defined as the par price on the unpaid principal balance plus accrued interest and any penalties the trust may have incurred as a result of a breach of the representations or warranties.

Asset Quality

The ABS sector is collateralized by a variety of consumer, commercial, and operating asset classes. Morningstar typically analyzes the credit quality of the securitized assets to derive a base-case loss expectation, reflecting the probable performance of an asset pool, as well as losses under stress scenarios based on the rating level, but may use other approaches to measure credit quality when appropriate.

The focal point in Morningstar’s credit risk analysis may differ depending on whether the asset pool is static or revolving and on whether the securitization involves financial, operating, or corporate assets. In transactions for which the underlying pool is static, the analytical focus is typically on the collateral characteristics, transaction structure, and servicer quality to assess whether the asset pool will pay timely interest and principal by the legal final maturity date. Revolving pools, for which additional assets are added to the collateral pool throughout, or through a portion of, the life of the deal, introduce an element of uncertainty in that the risk profile of the pool may shift. Deals backed by revolving pools incur the risk that the originator may lower its underwriting standards and that there will be deterioration in performance.

Factors that mitigate this risk may be the originator’s long and consistent underwriting track record and representation that additional receivables will not be adversely selected. In addition, transactions that have a prefunding or revolving period typically have eligibility criteria specifying the characteristics of the additional receivables. If a transferred receivable does not meet the eligibility criteria when it is transferred to the SPV, the originator may be required to either repurchase the receivable at face value or substitute an eligible receivable of equivalent value.

Most transactions permit only eligible assets to be included in the securitization and will include a list of eligibility criteria. Eligibility criteria vary by asset class but usually include that
the asset is not delinquent or defaulted, that the obligor is not insolvent, and that the originator has the ability to transfer the asset.

Eligibility criteria often include the following requirements:

- The assets are freely assignable with or without notice to the obligor.
- The assets have not been extended or restructured.
- The assets have been originated according to the originator’s underwriting guidelines.
- The originator holds legal title to the assets.
- The obligors are not in default.
- Obligor concentration limits do not exceed certain specified limits.

Morningstar may apply the same analytical framework in rating ABS transactions whether the underlying assets are financial, operating, or corporate assets, and in all transactions where such analysis is relevant, may review the quality of an originator’s/loan seller’s servicing and collections as it impacts the level of defaults and recoveries. However, Morningstar typically places a greater emphasis on the originator’s/servicer’s capabilities in certain transactions where continuous, forward-looking servicing and the servicer’s financial viability are of paramount importance to transaction performance. Two examples of transactions involving financial assets where this could be the case are subprime auto transactions, where even a minor disruption or deterioration in servicing could severely affect loan performance, and timeshare transactions, where maintenance of timeshare properties and effective inventory control are crucial to loan performance.

In addition, the ongoing viability of the originator/servicer is critical to the performance of operating and corporate asset transactions in general. In operating asset securitizations, such as rental-car fleets, aircraft lease, equipment lease and railcar lease, where the transaction relies on future cash flows generated from sales, service contracts, or franchise fees, and in corporate asset transactions, such as whole business securitizations, where all or part of a company’s operating assets are securitized, the originator’s/seller’s ongoing performance and viability are important to the transaction. Any deterioration in the servicer’s financial condition may impair its ability to perform crucial functions, such as remarketing and re-leasing, or to continue to operate the business. Deal performance and financial trigger events usually are built into the transaction structure to protect investors and often are tied to delinquency levels, loss levels, the originator’s/servicer’s credit rating, bankruptcy or insolvency events, debt service coverage ratios, payment defaults and the remaining level of credit support.

Deriving a Loss Expectation
Morningstar evaluates the collateral characteristics of an asset pool to ascertain the credit quality of the underlying obligors and receivables. Our analysis may include comparing the pool characteristics to those of the issuer’s managed portfolio and prior similar securitizations or historical performance of similar assets to gauge whether the issuer’s historical portfolio and prior securitization performance or historical track record of similar assets are good indicators of performance for the proposed transaction pool. Among the collateral characteristics that Morningstar may analyze are obligor FICO scores and an originator’s internal obligor credit scores, credit ratings of corporate obligors, original and remaining loan term, the amount of...
seasoning, loan type, coupons, down payment/loan-to-value ratios, and geographic concentrations.

Morningstar’s approach for deriving expected losses for a given transaction depends on the type of asset class and granularity of the asset pool. For a diversified asset pool that has limited geographic, obligor, and industry concentrations, we typically evaluate historical default and net loss data to derive an expected loss estimate. This may entail developing a loss curve by analyzing an originator’s historical static pool data and the cumulative loss-to-liquidation rate, which we may evaluate to project losses on pools that have not experienced their full loss cycle. Morningstar may adjust our expected loss estimate by taking into account certain qualitative factors. If, for example, an originator has loosened its underwriting standards but that change is not yet reflected in the performance data, Morningstar may increase the base-case loss estimate and/or the stress multiple. In addition to changes in origination standards, among the other factors, Morningstar may consider collateral seasoning, adverse pool selection, performance trends, and changes in servicing practices.

For concentrated pools with only several large obligors, which is the case in dealer floorplan transactions for example, historical default data is less meaningful, and the creditworthiness of the obligors may become the focal point of review. Typically, these asset pools consist of a few investment-grade obligors, may have large geographic or industry concentrations and only minimal expected credit losses. Morningstar’s approach in rating these transactions may be to default several of the large obligor concentrations within the pool to derive an expected loss and credit-support requirement. The number of obligors to be defaulted would likely depend on the rating level.

**Transaction Structure**

Morningstar’s evaluation of a transaction’s structural features typically centers on payment priorities, trigger events and remedies for those triggers, servicer termination events, events of default, and/or early-amortization triggers for revolving transactions.

Morningstar typically analyzes the payment mechanics for each transaction by reviewing transaction documentation and cash flow modeling output to understand how the cash flows generated by the asset pool are allocated to pay interest and principal to investors as well as transaction expenses to service providers. Transaction fees that are senior to interest and principal payments are typically accounted for in cash flow modeling for a transaction. However, extraordinary expenses may be carved out of the ratings.

A transaction’s principal allocation is crucial because it may result in credit enhancement growing or shrinking in relation to the outstanding pool balance. Typically, ABS payment structures are pro rata pay, sequential pay, or bullet maturities. In a pro rata payment structure, interest and principal collections are paid proportionately to each tranche based on the tranche’s outstanding balance. This allows the subordinate tranche to amortize while the senior tranche is outstanding. In pro rata pay deals, therefore, the timing of losses significantly impacts transaction cash flows. If the subordinate tranche amortizes before losses occur, then there may not be enough credit support available to cover future losses. Morningstar’s analysis
of pro rata pay transactions will typically include cash flow scenarios that incorporate back-ended losses to test the transaction’s ability to withstand amortizing credit support.

In a sequential pay structure, the most senior tranche is paid in full before the mezzanine and subordinate tranches. In addition, sequential pay bonds may be repaid based on the stated maturity dates of the tranches, in which the earliest maturing bond is paid the amount of its tranche’s share of principal collections until its balance is reduced to zero. Because sequential structures retain rather than amortize credit support, the timing of losses may not significantly affect cash flows, but the reduction of excess spread may reduce total credit support as explained in the Credit Support section.

In some transactions, bonds that initially are paid in accordance with a pro rata payment structure will convert to a sequential pay structure once a performance or credit-driven trigger event occurs. For example, timeshare loan securitizations that are senior/subordinated usually have pro rata pay structures. Many of these transactions include triggers that convert the pro rata pay structure to sequential pay and provide for the trapping of excess spread. Typically, the conversion to sequential pay occurs upon the breach of pool performance triggers based on the average delinquency level and average default level for the prior three due periods exceeding a certain percentage and on the cumulative default level exceeding a certain percentage.

Transaction structures with bullet maturities repay principal on a scheduled payment date. Throughout the revolving period, interest, which may be deferrable, is due on the bonds on each payment date but principal collections on the collateral are invested in newly generated receivables. The revolving period is for a predetermined length of time and may be followed by an accumulation period, which is set to allow for sufficient principal to accumulate by the scheduled payment date; a controlled amortization period, which repays principal in equal scheduled payments; or a full turbo period, during which most or all principal that comes into the transaction pays down the notes. ABS transactions that have revolving periods/bullet maturities usually are backed by revolving assets, such as dealer floorplan loans, rental-car receivables, and credit-card receivables, but may also be backed by other assets such as loans to corporate obligors and short-term unsecured consumer loans.

Credit Support
Morningstar reviews the composition of the credit support in a transaction and the structural provisions that pertain to it. The level of credit support is an important consideration in ABS transactions because it protects investors from losses on the underlying assets and enables the ratings on the bonds to exceed the originator’s credit rating. Generally, Morningstar assesses whether the proposed credit support in a transaction is sufficient to withstand losses on the asset pool at a stress level that is in line with the desired rating on the bonds.

Morningstar will typically first determine base-case gross and net cumulative loss levels by evaluating historical performance data. We may make adjustments to the base-case estimate when the historical data is limited or questionable and also may take into account the potential impact of economic conditions on asset performance. Morningstar will typically then stress losses by a multiple of the base case depending on the rating level. Typically, Morningstar establishes stress multiples at each rating level and applies these multiples to the base case. In determining stress multiples to apply in a particular transaction, we may take into account
several factors, including the historic volatility of losses in the applicable sector and in the originator’s portfolio, the findings of the operational risk assessment, and industry trends.

The form of credit support used in ABS transactions has evolved over time from the use of letters of credit from commercial banks in the early days of the ABS market to the use of internal credit enhancement that usually consists of a combination of subordination, excess spread, reserve funds, and/or overcollateralization.

**Subordination**
In transactions that have senior and subordinated classes, losses on the asset pool are allocated in reverse sequential order beginning with the most junior tranche. Protection for the junior tranche is usually provided by overcollateralization, excess spread, or a cash reserve fund that is tapped first to cover losses. Typically, protection available for the most senior tranches consists of the credit enhancement available to the junior tranche as well as the subordination that the junior tranche provides.

**Excess Spread**
Excess spread refers to the revenue remaining at the end of each payment date after all required payments to the bonds have been made and is equal to the difference between the net weighted average coupon on the assets and the funding cost of the rated bonds (weighted average note rate plus expenses). Depending on the transaction terms, excess spread may be used each payment period to pay principal to bondholders in an amount up to the outstanding realized losses and delinquent amounts for the asset pool.

Factors that affect the availability of excess spread include the timing of defaults or losses, the rate of principal repayment on the asset pool, and interest-rate movements. Typically, available excess spread will be released at the bottom of the payment waterfall to the seller or other holder of the residual interest if no losses are realized in a given payment period. Transactions that trap unused excess spread in a reserve fund for use in future payment periods or that use all excess spread to repay principal until the notes are fully repaid maximize the benefit of excess spread. A fast principal repayment rate will reduce the monthly excess spread that is available in current and future payment periods. Excess spread also may decline because of weighted average coupon compression, in which the interest collected on the assets declines because the higher coupon receivables repay or default at a faster rate than do lower coupon receivables. Excess spread also will decline if the note rate on the bonds rises faster than the asset pool’s net weighted average coupon.

**Reserve Funds**
Cash reserve funds often serve as credit support in ABS transactions. A reserve may be fully funded at closing or funded with excess spread each month until it reaches a targeted amount. Typically, once the reserve fund reaches the targeted amount, unused excess spread is released from the deal.

**Overcollateralization**
Overcollateralization, another frequently used form of credit support in ABS transactions, may be created at closing when the dollar amount of the rated securities is lower than the amount of the asset pool securing the transaction. Overcollateralization also is created in transactions
in which excess spread is used to repay principal, which accelerates the principal paydown of the bonds. The resulting overcollateralization is available to cover losses that are not covered by excess spread. Typically, transactions have a target overcollateralization amount that is a specified percentage of the pool balance. Therefore, if the asset pool does not perform as expected or assets are liquidated due to an event of default, additional assets will be available to meet the SPV’s obligations. Once the target is reached, any unused excess spread in a payment period will be released.

**Cash Flow Analysis**

Morningstar often performs cash flow analysis to test the transaction structure and sufficiency of credit support. We may apply various stresses specific to each rating level to determine whether the asset pool generates sufficient cash flow to make timely interest and principal payment on the rated securities by the transaction’s legal final maturity date. Additionally, Morningstar typically evaluates potential leakage of excess spread from the structure that may reduce the likelihood of meeting investor payments when due. Generally, the stress assumptions we make pertain to the magnitude of losses, front-loading and back-loading the timing of defaults and losses, recoveries on losses, timing of recoveries, prepayments, interest-rate stresses, and factors specific to each asset class.

In transactions where Morningstar seeks to derive an expected loss rate for an operating company’s portfolio, as is the case in rental car, whole business, and film securitizations for example, or in certain lease transactions, we may use a Monte Carlo simulation modeling approach to derive an expected loss by randomly generating future performance based on a broad data set of historical performance. We then model the cash flows to a confidence level consistent with the desired rating.

In modeling the cash flows in a container lease ABS transaction, for example, we may run several thousand scenarios to determine whether the sum of lease payments, container sale proceeds, and available credit support is sufficient to make payments to investors when due. The cash flow simulations reflect the payment allocation mechanisms in the transaction, including early amortization and other performance triggers. Among the factors that we simulate in each of the scenarios based on an assumed probability distribution are the utilization rate, the lessee default rate, lease rates, the residual values of the containers, storage costs for off-lease containers and operating expenses (repair, maintenance, relocation) and the probability of a manager default, which is based on the manager’s credit profile. The distribution may be derived from issuer-specific historical data. To determine the transaction rating, Morningstar also may consider certain qualitative factors, such as the type of containers in the asset pool, the expected change in pool characteristics over time, and the capabilities of the manager and the back-up servicer.

**Originator and Servicer Quality**

For issuers whose transactions Morningstar is rating for the first time, we may review the originator/servicer of the securitized assets to assess loan origination, underwriting and servicing capabilities. ABS ratings analysts, with input from members of Morningstar’s operational risk assessment group, as needed, will often evaluate the capabilities of originators and servicers. This review can uncover risks embedded in the transaction because of origination and servicing practices, as well as the direction of portfolio performance going
forward. If a third-party due-diligence firm has conducted an operational audit of a given originator or servicer, Morningstar may review the third-party firm’s findings. For certain transactions, Morningstar’s operational risk assessment group may conduct a formal assessment and provide a ranking as part of the overall ratings process. For a detailed description of Morningstar’s Operational Risk Assessment methodology, please see “Operational Risk Assessments Methodology & Process for Residential & Consumer-Finance Servicers & Vendors” dated October 2016 on our website, www.morningstarcreditratings.com.

We often begin a Morningstar operational review by requesting information from the originator or servicer that may include, as applicable, company history, management biographies, financial statements, origination policies, underwriting criteria, servicing infrastructure and collections policies, and historical performance data, including managed portfolio, static pool, and recovery data.

After we receive the requested information, Morningstar may conduct meetings with management to gain a better understanding of the issuer’s business model, strategic plan, financial condition, and operational capabilities. Morningstar’s review of origination operations is aimed at understanding the issuer’s lending channels, programs, marketing practices, underwriting policies, funding and documentation processes, and the quality of origination controls. Morningstar’s review of servicing operations will typically evaluate the quality of loan administration and default management processes, the technology that supports collections, compliance with guidelines and procedures, and operational stability.

**Counterparty Credit Risk**

Counterparty credit risk is an important consideration in rating ABS transactions. Typically, ABS transactions depend on the credit quality of counterparties, including providers of bank accounts, derivatives, and financial guarantees.

With respect to derivatives, interest-rate swaps and caps are often embedded in ABS transactions to tailor the cash flows of the underlying asset pool to better match those of the securities. Mismatches may occur in situations when the underlying loans are floating rate and the securities are fixed rate, and vice versa. To mitigate the risk that with interest-rate fluctuations, the interest generated from the asset pool is less than the required interest payments on the securities, the SPV will enter into an interest-rate swap and/or cap agreement and then use the payments it receives under the swap to pay the interest on the securities.

In analyzing interest-rate swaps/caps, Morningstar may model cash inflows and outflows in the waterfall and their impact on the desired target rating and will review the swap/cap documentation, such as International Swaps and Derivatives Association schedules and confirmations, including certifications and legal opinions to determine whether the hedges are properly authorized and executed.

Morningstar will typically determine the suitability of bank account, hedge and financial guarantee counterparties on a case-by-case basis. To the extent available, we will consider the Morningstar credit rating of the counterparty in its assessment. We also may consider the credit ratings of other rating agencies in assessing the credit quality of counterparties.
In Morningstar’s view, provisions requiring the original counterparty to a transaction to replace itself or appoint a guarantor at its own cost by a specific date should the counterparty’s rating be downgraded below a certain level are an effective way to mitigate counterparty credit risk. In addition, provisions that require the counterparty to post collateral after a trigger event are effective risk mitigants in that they secure counterparty obligations or replacement costs in advance.

**Monitoring of Performance**

Ongoing monitoring of the performance of outstanding transactions is an essential part of Morningstar’s ratings process. Once an ABS transaction is rated by Morningstar, we will periodically review and update the letter ratings if we have been contracted to do so. Morningstar usually expects to receive servicer reports monthly, which provide updated information concerning collateral performance, available credit support, and the paydown of the securities. In monitoring ABS transactions, Morningstar analyzes transaction performance in accordance with the methodology articulated in this report as well as any changes to the methodology made during the life of the securitization. Additionally, as a deal seasons, actual deal-specific data and performance becomes increasingly important in surveilling a rating.

In general, Morningstar’s surveillance involves quantitative and qualitative analysis that includes reviewing transaction performance relative to initial expectations, the likelihood that performance triggers will be breached, and information obtained from any ongoing operational reviews. In addition, Morningstar will endeavor to remain informed of and evaluate industry developments and emerging trends that may affect a rated transaction’s performance. Morningstar’s monitoring is asset-specific and tailored to the type of transactions we rate. For example, in dealer floorplan transactions where typically there is no or minimal loss in the life of the transaction, Morningstar would typically review the monthly charge-off rate but focus on more relevant performance metrics, including the monthly payment rate and level of excess spread in the deal. In addition, Morningstar would typically monitor the financial condition and performance of the manufacturer, dealers, and servicer given their viability is critical to transaction performance as well as trends in the used-car market and auto industry in general.

From time to time, Morningstar’s criteria committee will review ABS securitization methodology and models. We will apply any changes to the methodology or models to both initial and surveillance ratings for ABS securities, as applicable. The criteria committee will determine whether we retroactively apply such changes to the methodology or models, and we will make public the changes along with the notice of the update.