MOODY'S
INVESTORS SERVICE

REQUEST
FOR COMMENT

General Principles for Assessing Environmental, Social and Governance Risks: Proposed Methodology Update – Structured Finance Appendix

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Summary

In this Request for Comment, we propose to update the *General Principles for Assessing Environmental, Social and Governance Risks Methodology* with the addition of an appendix that would provide more detailed information on the principal considerations for assigning environmental (E), social (S) and governance (G) issuer profile scores (IPSs) and credit impact scores (CISs) to structured finance transactions. The proposed framework covers all structured finance asset classes and covered bonds (collectively, structured finance transactions), which are categorized under the private sector in our environmental and social sector scores.

The key proposed additions to the current methodology are as follows:

» **Provide more details on the credit implications of E, S and G (collectively, ESG), considerations for structured finance transactions and how we assign IPSs and CISs**. Under our proposal, we would add an appendix that describes how we would apply the existing general methodological framework for determining E, S and G IPSs, as well as ESG CISs, to structured finance transactions. Our assessment of a transaction's exposure to ESG risks and benefits would be primarily qualitative, and we would describe considerations that are generally applicable across structured finance transactions. Our qualitative assessment may be informed by quantitative metrics, although these are often not available for all rated transactions. While metrics may vary among structured finance asset classes, our framework aims to consistently present E, S and G IPSs and CISs across structured finance asset classes.

For the majority of structured finance transactions, we would provide the CIS at the transaction level incorporating liability and asset-level mitigants using the senior-most rated outstanding security as the reference. However, for transactions with a complex structure, such as multi-pool US RMBS transactions, we may consider a different reference for the CIS.

» **Introduce specific governance risk categories for structured finance**. We propose the adoption of specific governance risk categories for structured finance given that governance risks of structured finance transactions have certain unique aspects that differ from those of financial institutions or enterprises. These structured finance issuers are special purpose entities that are generally structured to mitigate governance concerns and are obligated under the contractual terms outlined in the transaction documentation, which also defines roles and responsibilities of transaction parties. We expect to assign a Neutral-to-Low G IPS to most structured finance transactions, since they are by design less exposed to governance risks.

We may also make some editorial changes to the existing methodology to enhance readability.

Following publication of the updated methodology, we would enhance transparency in our communication of E, S and G considerations, which we already incorporate into our credit analysis, by assigning IPSs and CISs to structured finance transactions over time.

Impact on Ratings

If this cross-sector methodology is updated as proposed, there will be no changes to outstanding ratings for structured finance transactions. In establishing E, S and G IPSs, we propose to use the general principles described in the existing methodology. The CIS is an output of the rating process that more transparently communicates our assessment of the impact of ESG considerations on assigned ratings in the context of other credit drivers. As such, our proposed publication of CISs will not change any ratings, currently or in the future.

This expected rating impact reflects only the methodological changes noted above and does not incorporate potential impact from other factors, including prevailing market conditions or factors specific to a particular transaction, such as pool performance or qualitative considerations, that may be relevant to the rating analysis.

How to Submit Comments

In this Request for Comment, we are seeking feedback on our proposed addition of an appendix to *General Principles for Assessing Environmental, Social and Governance Risks Methodology*. The proposed structured finance appendix for the methodology follows. Prior to publication of the revised rating methodology, we may also consider other changes to the methodology as a result of the consultation process and our internal review.

We invite market participants to comment on the Request for Comment by July 21, 2022, no later than 11:59 p.m. US Eastern time by submitting comments on the Request for Comment page at ratings.moodys.com. Upon appropriate consideration of received comments, we plan to adopt and publish a revised *General Principles for Assessing Environmental, Social and Governance Risks Methodology*.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on ratings.moodys.com for the most updated credit rating action information and rating history.

Proposed Appendix

Issuer Profile Scores and Credit Impact Scores for Structured Finance Transactions

In this appendix, we describe how we apply the general framework for determining E, S and G IPSs and ESG CISs (described in Appendices A and B of the existing methodology, respectively) to structured finance transactions. The proposed framework applies to all structured finance asset classes and covered bonds (collectively, structured finance transactions). These transactions are categorized under the private sector in our environmental and social sector scores.

Issuer Category Scores and Issuer Profile Scores

We establish E, S and G issuer category scores and overall IPSs for structured finance transactions by making a qualitative assessment of a given transaction's exposure to the related risks or benefits. Our assessment of E, S and G focuses on credit-relevant considerations and the extent to which they are positive or negative for transactions. Issuer category scores reflect our assessment of the likelihood and magnitude of current and future credit exposures related to the category of ESG risk, including, for example, the impact they have on the value of the underlying collateral backing the securities, in addition to considering how the transaction's governance affects its credit quality. In certain cases, such as covered bonds, which are exposed to both the issuer and the cover pool assets, our E, S and G issuer category scores will typically consider E, S and G risks for the issuer as well as the cover pool assets.

Our qualitative assessment may be informed by quantitative metrics, although these are often not available for all rated transactions. While metrics may vary among structured finance asset classes, our framework aims to consistently present E, S and G IPSs and CISs across structured finance asset classes.

Our qualitative assessments are forward-looking and may be informed by a transaction or transaction type's previous experience of these risks. In some cases, our assessment may be informed by scenario analysis, for example for risks that may materialize over the long term, such as carbon transition risk or physical climate risks. We incorporate material credit risks that could manifest over the life of the transaction into our assessments of issuer category scores and IPSs. We thus assess how ESG considerations may affect a transaction's credit quality over the expected life of the assets.

The E and S IPS and related category scores also incorporate asset-level mitigants (e.g., insurance and asset diversification) related to those specific exposures. Conversely, the G IPS and related category scores incorporate both asset and transaction-level mitigants. Risk mitigation on its own does not indicate an IPS or category score of 1. To score an IPS of 1 for any category or for the E, S or G IPS overall, a structured finance transaction must derive a material credit benefit. For example, a transaction may score S-1 if we assess that its underlying assets will have a positive credit impact from social considerations. We expect to assign a G IPS or category score of 1 in very rare cases because credit-relevant governance considerations for structured finance transactions typically carry material credit risks, rather than credit benefits.

For structured finance transactions with full asset-level guarantees, the E and S IPSs are generally Neutral-to-Low since there is no exposure to the E and S risks of the assets. On the other hand, the governance risks will depend on the specific transaction.

Sector Category Scores

The E and S sector category scores provide a general reference for an issuer category analysis. Individual issuers' E and S category scores may vary, potentially significantly, from the sector category scores, as a function of idiosyncratic characteristics of a transaction.

E and S sector category scores also do not incorporate E and S specific mitigants, which may result in an issuer category score that is better than the respective sector category score. For instance, in FFELP student loan securitizations, the US government guarantee provides substantial loss protection, therefore an issuer category score for the responsible production risk category could be better than the respective sector category score.

E, S and G risks may cross multiple categories. For example, potentially unfair and abusive loan terms on borrowers, including high interest rates and high fees, could drive heightened risks across S in the responsible production risk category (e.g., aggressive origination strategy or predatory lending) and G in the risk management framework risk category (e.g., weak internal controls and poor underwriting policies related to the originated assets). In assigning an E, S or G IPS, we consider the interplay and potential overlap among categories in that component to avoid overstating or understating the risks or benefits.

ESG exposure and the extent to which structured finance transactions are impacted by ESG risks may vary, reflecting regional differences in social or regulatory characteristics and the physical environment.

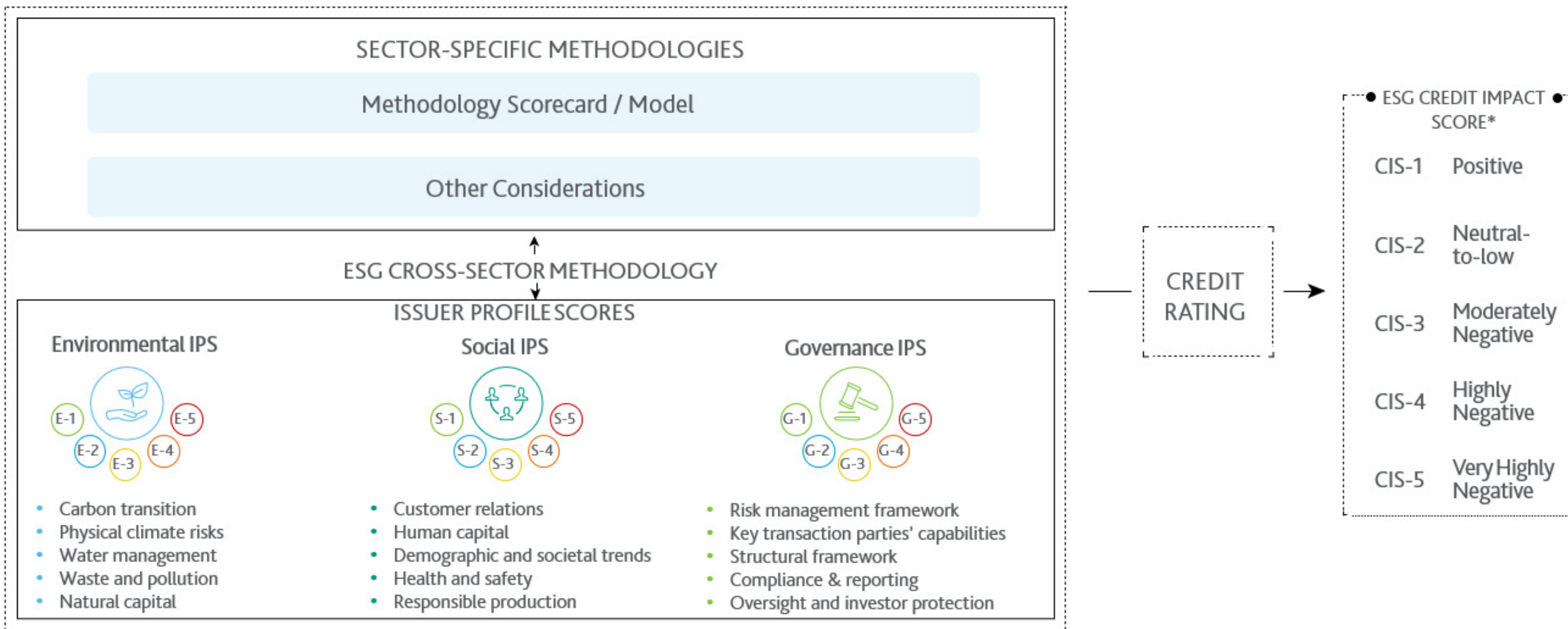
Credit Impact Scores

As discussed in Appendix B of the existing methodology, the CIS explains the impact of ESG considerations in the context of a transaction's other credit drivers that are material to a given rating. For the majority of structured finance transactions, we provide the CIS at the transaction level, incorporating liability and asset-level mitigants using the senior-most rated outstanding security as the reference. However, for transactions with a complex structure, such as multi-pool US RMBS transactions, we may consider a different reference for the CIS. Additionally, if a structured finance transaction has both long- and short-term security ratings, we will use the long-term security as the reference for the CIS.

Exhibit 1 below illustrates how we may incorporate ESG considerations into our ratings.

EXHIBIT 1

An Illustration of How ESG Considerations Are Captured in Ratings



The ESG credit impact score (CIS) is an output of the rating process that more transparently communicates the impact of ESG considerations on the credit rating of an issuer or transaction.
Source: Moody's Investors Service

Issuer Profiles

Environmental Issuer Profile

Regulatory or policy initiatives aimed at reducing or preventing negative environmental trends or hazards, as well as the trends and hazards themselves, may affect structured finance transactions. Environmental considerations that increase capital expenditures and operating costs for obligors or increase a transaction's potential losses can reduce its cash flows.

The type of risk exposure varies by asset class and region. Asset-level mitigants, such as insurance, short loan tenors and asset diversification reduce these risk exposures.

In the sections below, we describe the principal credit implications from environmental considerations for structured finance transactions.

CARBON TRANSITION

Carbon transition risk encompasses policy, legal, technological and market changes associated with a transition to a lower carbon economy.

In structured finance asset classes backed by contracts for carbon-intensive assets, energy-efficiency mandates can weaken values for assets noncompliant with regulations. In other cases, carbon transition can impact cash flows that depend in part on carbon-intensive energy production.

In transactions backed by vehicles, changes in emission-based restrictions or technology could affect residual values or the recovery value of the vehicles on defaulted contracts. These risks are largely mitigated by the short tenor of the assets for some of the transactions, which would require revolutionary shifts in a short period to have a material negative impact on the securitizations. In certain markets, such as Japan, investors typically do not benefit from recoveries from the sale of repossessed vehicles.

In Europe, energy-efficiency classifications exist for some residential properties and buildings. Rules restricting or prohibiting the use of buy-to-let residential properties that fail to adhere to minimum energy-efficiency levels could have credit implications on transactions backed by these types of properties.

For commercial properties in Europe and increasingly in the US, landlords either face financial penalties or must increase capital spending to comply with energy-efficiency regulations to address carbon transition, which may put pressure on operating margins. Noncompliant properties face higher cash flow and value volatility, and the risk of leasing prohibition. Compliant properties should see cash flow benefit from long-term expense reductions, enhancing property value.

PHYSICAL CLIMATE RISKS

The nature and the geographical location of a transaction's underlying assets may create vulnerability to extreme weather events (e.g., hurricanes, floods, wildfires), heat stress or water stress, as well as long-term trends such as rising sea levels. For example, severe weather events linked to climate change can temporarily reduce revenue available for asset-backed securities (ABS) backed by utility cost recovery charges. The physical climate risks category excludes geophysical risks, such as earthquakes, volcanoes and tsunamis.

Physical climate risks may damage commercial properties. Conduit transactions backed by multiple commercial property loans have greater diversity than single-asset transactions, and are therefore less sensitive to idiosyncratic environmental risks. For both the diversified and single-asset transaction, natural disasters, such as hurricanes and wildfires, can damage individual properties. The transaction requirement to

maintain comprehensive insurance is typically the norm and reduces or mitigates the risk. Rising property insurance premiums triggered by increasing physical climate risks increase expenses and could marginally affect property values. Besides the potential damage to commercial properties, physical climate risks could contribute to a value decline for properties located in the area hit by an extreme weather event.

In residential mortgage-backed securities (RMBS) transactions and residential mortgage-backed covered bonds, diversification largely mitigates environmental risks. Transactions with regional concentrations are rare – for instance, a European RMBS transaction has properties on islands that are exposed to physical climate risk. Homeowners commonly maintain property insurance and, in some cases, casualty insurance, that acts as a mitigant. Transactions with concentrations in drought, flood, typhoon or hurricane-prone areas may be more impacted. In US RMBS transations, servicers' proactive loss mitigation programs could also reduce losses incurred from extreme weather events. These include, among others, waiving late penalties and fees, suspending foreclosures and reporting to credit bureaus and offering repayment plans.

WATER MANAGEMENT

Water management focuses on the management and governance of water resources. Climate change considerations such as drought or changing rainfall patterns that could affect water supply are covered under the physical climate risks category.

As with physical climate risks, geographical location is an important consideration because certain regions have higher water stress (i.e., a greater supply-demand imbalance), and water shortages could be a destabilizing factor for a wide range of transactions. For example, obligors in an equipment loans and leases securitization backed by agricultural equipment are vulnerable to water shortages because obligors rely on a constant water source to operate their business. Geographical diversification of obligors and crop insurance mitigate these risks.

In transactions backed by commercial mortgage loans, local water management could lead to higher water costs, but also limit the supply of new properties and potentially increase the value of existing properties.

WASTE AND POLLUTION

Waste and pollution cover air and land-based waste and pollution, including air pollutants, hazardous and non-hazardous waste, as well as human-caused accidents (spills, leaks and related incidents). This category excludes greenhouse gases not regulated as pollutants, such as carbon dioxide and methane emissions. Water pollution considerations are covered in the water management category.

In aircraft ABS, non-carbon-related emission regulations could make older aircraft more expensive to operate or require retrofits that may still make them less attractive to airlines, reducing demand for these aircraft. The lower demand could negatively affect both the values and lease rates of aged aircraft.

Waste and pollution could also affect tobacco settlement ABS. Potential regulation to address cigarette litter and second-hand smoke pollution could reduce cigarette consumption, thereby lowering the revenue available to repay tobacco securities.

NATURAL CAPITAL

Natural capital refers to resources provided by nature that are essential for human habitation and economic activity. Damage from, and costs to avoid, pollutants released into the air and soil are captured in the waste and pollution category.

Natural capital risks principally affect transactions where there is a dependency on goods and services derived from nature. Damage or degradation of the environment can lead to a loss of economic activity and

revenue, increased environmental compliance costs and regulatory penalties, potentially affecting a transaction's performance where it relies on natural capital.

In commercial mortgage-backed securities (CMBS), upfront environmental due diligence performed by third parties helps to limit exposure to natural capital and liability risk.

Arriving at the E IPS

To arrive at a transaction's environmental IPS, we typically place the most emphasis on the worst category score.

Social Issuer Profile

Social issues represent a broad category of considerations that pose varied levels of credit risk and potential benefits to structured finance transactions. Social issues that could impact a transaction's credit quality result from the interactions with, and dependencies on, employees, customers, supply chain partners, counterparties and society more broadly.

In structured finance transactions, social risks can affect not only the credit quality of the assets but also certain transaction parties, such as sponsors, servicers or obligors, and could in turn impact the assets' credit quality. For example, credit card ABS sponsors could face customer relation risks related to regulatory uncertainty around high interest rates, data security and customer privacy.

The levels of social risk vary across structured finance transactions, driven primarily by demographic and societal trends and customer relations.

In the sections below, we describe the principal credit implications from social considerations for structured finance transactions.

CUSTOMER RELATIONS

Customer relations risks encompass how transaction parties interact with customers. Such interactions can lead to lost business and increased costs, with the potential for financial stress for the transaction. Customer relations issues include the handling of data security and customer privacy, fair disclosure and labeling, and responsible marketing and distribution. Adverse events damage a counterparty's reputation and increase the potential for litigation and regulatory action, all of which can lead to financial losses that impact a transaction's credit quality.

In FFELP student loan ABS, for example, customer relation risks associated with complex servicing guidelines and increases in regulatory scrutiny around fair disclosure concerns and practices could have credit implications for this asset class. Australian transactions backed by buy-now-pay-later receivables are exposed to elevated risks associated with legal and regulatory uncertainty for a relatively novel credit product.

For RMBS, risks associated with customer interactions have decreased since the 2007-2009 financial crisis, especially in the US, where additional legislation and regulatory oversight were implemented by government agencies or government-sponsored enterprises.

Data security is another critical aspect of customer relations. A data security breach may affect a sponsor's or servicer's operational ability or credit quality, which could then in some cases affect a transaction's performance, such as those in which the sponsor retains some responsibility related to the assets (for example, by continuing to service the assets). For instance, a CMBS transaction backed by casino resorts can face customer relation risks related to data privacy and cyber risk with collection of player data.

HUMAN CAPITAL

Human capital risks primarily relate to recruiting, training and retaining employees and maintaining a diverse and inclusive workforce environment.

Asset classes with exposure to small businesses, such as small and medium-sized enterprise (SME) ABS have a higher exposure to human capital risks than larger firms because of elevated key person risks or centralized control and smaller workforces. SMEs typically have fewer financial resources to manage human capital risks (relying perhaps on a human resources individual, rather than a department) and to implement compliance with any government mandates or changes of policy.

SME ABS and some equipment ABS backed by corporate obligors are at risk from raises to the minimum wage. Such policies may result in increasing expenses and weakening the financial viability of the small businesses whose obligations back these transactions.

DEMOGRAPHIC AND SOCIETAL TRENDS

Demographic trends refer to the characteristics of a population. Societal trends largely relate to consumer preferences as well as to government policy agendas and funding.

Both demographic and societal trends may affect a transaction's cash flows and how transaction parties do business or the products they offer. For example, longer life expectancy and an aging population affect retirement and estate planning products. They also affect the pricing of life and health risks as insurers manage mortality, longevity and morbidity risks. This could result in lower cash flows in life insurance ABS. Additionally, changes in mortality or morbidity rates as a consequence of demographic trends can have a negative credit risk impact on reverse mortgage transactions.

Societal trends may sometimes support a transaction's credit quality. For instance, the robust growth of wireless data consumption, given the increased use of mobile devices, raises the value of the collateral of wireless tower ABS, as wireless carriers expand their network coverage and capacity by placing more equipment on towers.

Trends and preferences that drive demand for space could affect building owners and the credit risk of commercial real estate backing CMBS and some mortgage covered bonds. The most notable social trends are the shift towards online shopping and remote working. Technological advances such as artificial intelligence and augmented reality are likely to support these trends.

Other demographic trends may also affect demand for certain types of real estate at the regional level. For example, the growing preference for renting over homeownership, urbanization, and the migration of an aging and retiring population. As the wealth and income gap continues to grow, local governments and regulatory agencies are likely to address housing affordability through incentive systems and new tax benefits for affordable housing construction, as well as penalties such as rent control.

In Europe, social issues have been very present in the political agenda related to housing and consumer protection, particularly in economic downturns. For some European RMBS, borrower-friendly measures such as banning evictions and constraining foreclosure initiation have limited the creditors' rights when related to first homes and vulnerable collectives.

In the US, the high usage of payment plans (e.g., deferment, forbearance) motivated by demographic and societal trends drive maturity risk for FFELP student loan ABS.

HEALTH AND SAFETY

Health and safety risks relate to the management of employee and contractor health and safety, and the mitigation of industrial accidents.

For instance, SME ABS and some equipment ABS backed by corporate obligors have limited financial resources, and could be more vulnerable to changing regulatory requirements with respect to health and safety. However, such risks are limited because these transactions typically benefit from diversification in their constituent industries.

RESPONSIBLE PRODUCTION

Responsible production refers to the risks associated with aggressive lending practices, as well as how transaction parties and obligors manage their supply chain and production processes. These include the potential impact of product failures, recalls or contamination, and headline risks from supply chain practices, such as human rights controversies and violations.

For example, while most auto loan ABS are backed by originations of captive finance companies with oversight of the dealer network, smaller finance companies in some markets also originate loans to non-prime borrowers through their relationships with franchise and independent dealers, potentially generating responsible production risk for some transactions. Dealer fraud could lead to the risk of early payment defaults, which can be mitigated by representations requiring repurchases of early defaulting loans.

Tobacco settlement ABS are also exposed to responsible production risks, as regulatory scrutiny regarding cigarette ingredients is high. The development of a regulation that could potentially ban menthol cigarettes would add pressure on future cigarette consumption, reducing the revenue available to repay tobacco securities.

Arriving at the S IPS

To arrive at a transaction's social IPS, we typically place the most emphasis on the worst category score.

Governance Issuer Profile

Governance captures the set of controls, policies, and procedures that help direct and manage structured finance transactions. Structured finance transactions are generally structured to mitigate governance concerns and are ruled by the contractual terms outlined in the transaction documentation, which also defines roles and responsibilities of transaction parties. As a result, we typically score structured finance transactions G-2 (Neutral-to-Low), especially in cases where a transaction's securities can achieve a Aaa rating or the highest rating achievable in a relevant country,[1] since they are less exposed to governance risks by design. Conversely, we assign a G IPS worse than 2 to a transaction that by construct does not fully mitigate governance risks.

Governance considerations for structured finance transactions focus primarily on the strength of controls on asset quality and the adherence of the transaction parties to the documentation. For example, key transaction parties noncompliant with important provisions of the transaction documentation or weak servicing arrangements can influence cash flow or a transaction's credit quality.

[1] For more information, see our cross-sector methodology for assessing local currency country risk ceilings. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Some legal risks may fall within our governance framework, however, not all legal risks are considered governance risks. For instance, the strength of a structured finance transaction's legal arrangements that provide for bankruptcy remoteness are key governance considerations.[2]

Governance risk tends to be transaction-specific, compared to environmental and social risks. Governance is relevant for all structured finance asset classes, regardless of the region in which they operate, although certain governance weaknesses, such as weak servicing arrangements, are relatively common for transactions in some regions.

For covered bonds, the degree of governance risk will often be driven by the existence of a dedicated legal and regulatory framework in the issuer's jurisdiction or transaction documentation. The corporate governance of the bank supporting the covered bonds will also be relevant.

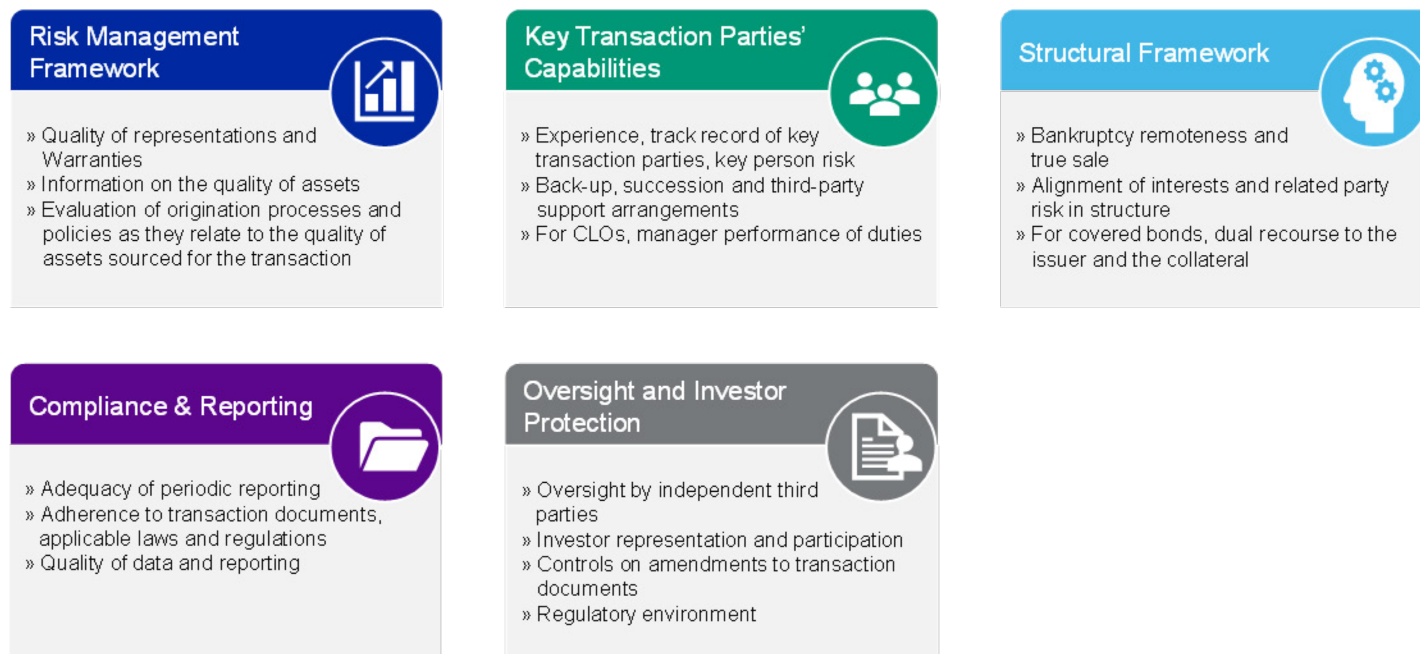
For structured finance transactions, we broadly classify governance risks that are generally most relevant from a credit perspective into five categories: (i) risk management framework; (ii) key transaction parties' capabilities; (iii) structural framework; (iv) compliance and reporting; and (v) oversight and investor protection. See Exhibit 2 for further details.

Within each category, we provide some examples of subcategories that we evaluate to determine governance concerns, if any, in the transaction. The subcategories that pertain to different types of asset classes may vary.

We expect to assign a G IPS or category score of 1 in very rare cases because credit-relevant governance considerations for structured finance transactions typically carry material credit risks, rather than credit benefits.

[2] For more information, see our bankruptcy remoteness criteria for special purpose entities in global structured finance transactions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

EXHIBIT 2
Moody's Governance Risk Categories – Structured Finance



Notes: While the categories of risk are reasonably distinct, in some cases there are interrelationships among the categories. Subcategories are representative and not exhaustive.
Source: Moody's Investors Service

In the sections below, we describe the principal credit implications of governance considerations for structured finance transactions.

RISK MANAGEMENT FRAMEWORK

Under the risk management framework category, we would focus on controls on quality of assets included in the portfolio and asset eligibility criteria. Securitizations typically have representations and warranties and covenants with respect to the collateral.[3] Certain asset classes, such as US RMBS, typically include third-party reviews performed on the assets. These third-party reviews support loan quality because they increase the likelihood of identifying defective loans and strengthen the integrity of the loans' reported characteristics.

Transactions that are actively managed, have pre-funding periods, or have revolving pools may feature documentation that delineates rules governing asset eligibility. For example, collateralized loan obligations (CLOs) feature documentation stipulating asset types that qualify as eligible assets and the rules regarding which pool assets may be traded.

RMBS warehouse transactions include eligibility criteria that constrain the pool composition. In the case of covered bonds, cover pool loans remain on the issuer's balance sheet, therefore, we expect them to receive prudent management undifferentiated from loans outside the cover pool.

[3] For more information, see our global structured finance data quality methodology. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

KEY TRANSACTION PARTIES' CAPABILITIES

In this risk category, we would focus on whether counterparties with operational responsibilities have sufficient experience and resources to perform their duties per the transaction documentation. We also consider the adequacy of contingency planning.[4]

First-time transaction sponsors and new business models pose elevated risks if they lack the experience to perform the duties outlined in the transaction documentation. For example, CLOs with first-time managers may have named back-up managers or include key person provisions that provide for an orderly replacement of the key personnel.

A financially weak sponsor and servicer could, in certain cases, lose the ability to effectively service the assets. Back-up servicing agreements or a back-up servicer facilitator are examples of contingency planning to ensure continuity in servicing the portfolio.

Transactions with weak servicing arrangements, such as certain legacy European RMBS, are exposed to elevated governance risks and therefore are not consistent with a Aaa rating on the transaction's securities.

STRUCTURAL FRAMEWORK

This risk category focuses on how a transaction structure addresses bankruptcy risk and alignment of interest between transaction's parties and the SPE.

Structural framework may expose a transaction to governance risks. The structural framework includes legal arrangements that provide for bankruptcy remoteness of the SPE and isolation of the assets from the risk of a key transaction party's bankruptcy. Securitizations typically use bankruptcy-remote SPE structures, which limit the transaction's ability to issue additional debt and engage in activities other than those related to the underlying assets and the transaction. Such structures help to protect investors from bankruptcy risk.

Transactions may also be structured to ensure the relevant counterparties do not take actions that may adversely affect the transaction. An example of such a structure includes the sponsor or manager taking a stake in the continued performance of the assets through the retention of some of the transaction's debt or equity.

Covered bonds are obligations of credit institutions, so their exposure to governance risk can be impacted by the institution's exposure. However, if the institution fails, the cover pool assets are subject to a country-specific legal and regulatory framework that typically provides protections for investors.

COMPLIANCE AND REPORTING

Strong compliance with transaction documentation and reporting functions, and the timeliness and accuracy of reporting, are foundational aspects of governance for structured finance transactions.

Transaction parties failing to adhere to important legal or contractual obligations under the transaction, as well as a lack of adequate periodic reporting, may expose a transaction to elevated governance risks to the extent that a transaction's securities will not be consistent with a Aaa rating.

OVERSIGHT AND INVESTOR PROTECTION

This risk category focuses on mechanisms and third parties that are in place to protect the interests of the SPE and the investors. For instance, amendments to transaction documentation lacking oversight by investors may expose a transaction to governance risks.

[4] For more information, see our methodology for assessing counterparty risks in structured finance transactions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

Arriving at the G IPS

To arrive at a transaction's governance IPS, we typically place the most emphasis on the worst category score.

Assessing the Credit Impact Score

As discussed in Appendix B of the existing methodology, the CIS explains the impact of ESG considerations in the context of the other credit drivers that are material to ratings on a transaction's securities. For structured finance transactions, we provide the CIS at the transaction level, incorporating liability and asset-level mitigants. Our CIS reflects the impact of ESG considerations on a security's rating assuming no other changes to the transaction including the capital structure.

For the majority of structured finance transactions, the reference security for the CIS is the senior-most rated outstanding security. However, for transactions with a complex structure, such as multi-pool US RMBS transactions, we may consider a different reference for the CIS.

When the senior-most security can achieve a Aaa rating or the highest rating achievable in the relevant country, we would in most cases assign a CIS-2 (Neutral-to-Low) given that the rating could not be higher in the absence of ESG considerations. In these cases, the credit impact of the exposure reflected in the IPSs may be less prominent than the impact these risks and benefits have on the security's rating, resulting in a CIS that is low in comparison to the IPSs.

Assigning the CIS requires an assessment of other material considerations of a transaction's credit risk that may create resilience to, or dilute, the exposure to ESG considerations. Substantial non-ESG-related credit strengths or external support (e.g., third-party guarantees) may help to mitigate the impact of asset-level ESG exposures on the security ratings, resulting in a lower CIS in comparison to IPSs.

In addition, the expected time horizon of E and S exposure may mute the effect on the rating (as explained in Appendix B of the existing methodology). Structured finance transactions can have meaningful exposure to risks that are expected to become material over a relatively long time frame; however, in our assessment, we consider the impact of ESG risks that are expected to unfold by the earlier of the date when the senior-most security would pay off and the legal final maturity of the transaction.

Specific Types of Structured Finance Transactions

In the sections below, we describe how we assign IPSs and CISs to specific types of structured finance transactions. These include, among others, CLOs and transactions rated under the repackaged securities, resecuritizations or credit substitution methodologies.

CLOs and Others

For certain structured finance transactions backed by corporate loans or securities where we may have sector scores available on the underlying assets, we generally follow a different approach to assign E and S IPSs. For ease of reference, below we describe how we derive E and S IPSs for a CLO transaction.

CLOs are backed by portfolios of loans to corporate entities and, therefore, the exposure to environmental and social risks is directly linked to the underlying corporate loans. On the other hand, the governance risks will depend on the specific transaction.

We typically derive E and S IPSs for CLOs based on sector category scores as follows:

» We map each asset in the portfolio to its associated sector

» We apply corresponding sector's E and S scores to each asset

» We convert each sector score (Very High Risk, High Risk, Moderate Risk and Low Risk) to a numerical scale (5, 4, 3 and 2)

» We compute the weighted average of the sector scores for each E and S risk category as well as the overall E and S, using the outstanding asset balance, to assess the E and S issuer category scores and overall E and S IPS for the CLO transaction, respectively

» We generally convert the weighted average of the sector scores per Exhibit 3.

EXHIBIT 3

Deriving E and S IPSs for CLOs and Others

Weighted Average Sector Scores of the Underlying Portfolio	Transaction's E and S IPSs
[2, 2.5]	2
(2.5, 3.5]	3
(3.5, 4.5]	4
> 4.5	5

Source: Moody's Investors Service

The E and S sector scores illustrate the inherent exposure, from a credit perspective, to E and S categories of individual sectors, using a four-point scoring scale of Very High Risk, High Risk, Moderate Risk and Low Risk. Therefore, the sector scores do not include a positive category.

Transactions Rated Under the Repackaged Securities, Resecuritizations or Credit Substitution Methodologies

We typically derive the IPSs and CIS of repackaged securities with one underlying security as a pass-through of the underlying IPSs and CIS. We may not assign scores to these securities when the underlying IPSs and CIS are not available. For complex repackaged securities transactions with multiple underlying securities, we may take the weighted average of the underlying IPSs or sector scores similar to the approach described in the previous section.

For resecuritizations, we determine the IPSs as a pass-through of the underlying security and follow the standard approach to assign the CIS. Additionally, an explicit guarantee from a third-party entity that meets our credit substitution criteria and drives the ratings of a security will most likely result in a CIS-2 (Neutral-to-Low) for a structured finance transaction.

Monitoring

We generally expect to see limited changes throughout the life of a structured finance transaction with respect to the E, S and G IPSs and CIS.

Moody's Related Publications

Cross-sector credit ratings are typically applied in tandem with sector credit rating methodologies, but in certain circumstances may be the basis for assigning credit ratings. A list of sector and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings, please click here.

For further information, please refer to *Rating Symbols and Definitions*, which is available here.

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