Fitch Ratings Links Structured Finance Ratings to Credit Quality of Related Hedge Counterparties

JAMES J. CROKE, PETER C. MANBECK, SHARAD A. SAMY, AND NIKIFOROS MATHEWS

The authors summarize the principal elements of a Structured Finance Criteria Report published recently by Fitch Ratings.

Fitch Ratings ("Fitch") published a Structured Finance Criteria Report in 2007 entitled *Counterparty Risk in Structured Finance Transactions: Hedge Criteria* (the "*Fitch Criteria*") in which it updated its ratings criteria for hedge counterparties to structured finance transactions.

The *Fitch Criteria* notes up front that the ratings Fitch assigns to structured finance transactions are very closely linked to the credit quality of each related hedge counterparty. As a result, much like other published rating agency structured finance hedge criteria, the *Fitch Criteria* establishes criteria intended to make the risk of loss on a rated structured finance transaction remote from hedge counterparty risk. As discussed in greater detail below, this remoteness is established primarily through the *Fitch Criteria's* emphasis on swift mitigating actions that should be taken upon the ratings downgrade of a hedge counterparty that executes a hedge

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The authors, attorneys with Orrick, Herrington & Sutcliffe LLP, can be reached at jcroke@orrick.com, pmanbeck@orrick.com, ssamy@orrick.com, and nmathews@orrick.com, respectively.

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transaction with a structured finance special purpose vehicle ("SPV"). However, the *Fitch Criteria* also describes certain of the preferences and expectations Fitch has in connection with default events and collateral provisions of ISDA Master Agreements (each, a "Master Agreement") governing hedges between a hedge counterparty and an SPV in structured finance transactions.

ELIGIBLE HEDGE COUNTERPARTIES

Fitch believes that the risk of a hedge counterparty rated "A" or higher going into default over a very short period of time is remote and, therefore, is consistent with a long-term risk of "AAA." Hence, assuming that the appropriate structural protections exist to rapidly address hedge counterparty downgrades to ratings below "A," Fitch is amenable to having a hedge counterparty rated at least "A" support higher-rated structured finance transactions. In particular, the *Fitch Criteria* permits hedge counterparties to have a Fitch short-term rating of at least "F1" and a Fitch long-term rating of at least "A" (or, where a hedge counterparty has only a long-term rating by Fitch, such long-term rating is at least "A") in connection with structured finance transaction notes that are rated "AA-" or higher.[1]

STRUCTURAL PROTECTIONS UPON DOWNGRADE

As noted above, Fitch's approach is based on the existence of structural mitigants that address ratings downgrades of hedge counterparties to levels below either "F1" or "A." In particular, the *Fitch Criteria* provides that upon any such downgrade one of the following actions be taken within 30 calendar days: (i) replacement of the hedge counterparty with a rated entity having ratings of at least "F1" and "A," as described above, (ii) arrangement of an unconditional guarantee of the hedge counterparty's obligations by a rated entity having ratings of at least "F1" and "A," as described above, or (iii) collateral posting by the hedge counterparty to cover the potential replacement cost of the hedge.[2] Where a hedge counterparty is downgraded to below "F2" or "BBB+" Fitch prefers that a replacement or guarantee be effected instead of collateral posting.

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The *Fitch Criteria* notes that, unlike a replacement of a hedge counterparty or a guarantee of its obligations, each of which result in the hedge counterparty's creditworthiness being restored to at least a pre-downgrade level, collateral posting relates to potential losses upon the hedge counterparty's default. As a result, the amount of collateral posted must be in an amount sufficient to ensure that any potential loss amount is virtually zero.[3] The *Fitch Criteria* generally seeks to accomplish this by determining the collateral amount that a downgraded hedge counterparty must provide according to the following formula:

CA = max[MV + VC x N;0][4]

CA = collateral amount required for hedge
MV = market value of hedge
VC = volatility cushion of hedge
N = notional amount of hedge

The use of a VC component in the determination of collateral requirements is unique to Fitch and is described in the *Fitch Criteria*. In short, the VC is the value at risk of the hedge, which necessarily depends on the hedge type and its weighted average life ("WAL"). Appendix 2 of the *Fitch Criteria* specifies the VCs for the most common hedge types, assuming weekly collateral posting.[5] For example, in connection with notes rated "AA-" or higher, a USD interest rate swap having a WAL of 1 year would have a VC of 0.6, whereas a USD interest rate swap having a WAL of 10 years would have a VC of 7.0.

The result of the collateralization formula proposed in the *Fitch Criteria* is that a downgraded hedge counterparty must post collateral to cover potential losses unless the hedge mark-to-market is significantly in its favor.

Once a hedge counterparty is rated below investment grade, Fitch expects that counterparty to be replaced (or its obligations to be guaranteed) and, until such action is taken, for collateral calculated in accordance with the above formula to be posted by the downgraded hedge counterparty.

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HEDGE DOCUMENTATION

The *Fitch Criteria* also specifies its preferences as to which of the standard Events of Default and Termination Events contained in a hedge Master Agreement should be applied and/or modified to ensure that events that generally do not conform to those set forth in the structured transaction deal documents do not trigger an early termination against the SPV and that events relating to a hedge counterparty's creditworthiness apply against the hedge counterparty. In particular, the events of Breach of Agreement, Credit Support Default, Misrepresentation, Default under Specified Transaction, Cross Default and Credit Event Upon Merger generally should not apply to the SPV, and Bankruptcy (if it applies at all) should be modified to conform with the equivalent definition in the underlying structured finance transaction documents. The SPV should be permitted to terminate the hedge for a Tax Event Upon Merger where it is the "burdened party" (i.e., payments made to it by the hedge counterparty are subject to withholding as a result of a party's merger event and the hedge counterparty is not required to gross up its payments). Also, upon a Tax Event, Fitch expects the SPV to have the ability to terminate the hedge if withholding were to apply to a hedge counterparty's payments due to a change in tax law and the hedge counterparty were not obligated to gross up such withheld amounts.

Fitch looks favorably upon each of the above-referenced events generally applying to the hedge counterparty (subject to the risks of the relevant transaction structure in the case of a Credit Support Default and/or Default under Specified Transaction). With respect to a Tax Event Upon Merger, the *Fitch Criteria* states that the hedge counterparty generally should not be permitted to terminate the hedge where it is the burdened party. Also, with respect to a Tax Event, Fitch expects that the hedge counterparty will accept the risk of a change in tax law and, therefore, (i) be unable to terminate the hedge if it must gross up its payments to the SPV and (ii) agree to accept less than a full payment from the SPV if a withholding tax is imposed on payments made by the SPV.

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COLLATERAL CHARACTERISTICS

Appendix 3 of the *Fitch Criteria* specifies "Advance Rates" (or haircuts) that are to be applied to the most common collateral, namely, certain fixed-rate government bonds. These Advance Rates are intended to cover movements in a collateral's market value over time. Essentially, Advance Rates account for the risk of change to a collateral security in the time it takes to find a substitute counterparty upon the default of the posting hedge counterparty, which is assumed by Fitch to be a four-week period. The longer the remaining maturity of the collateral, the greater the impact of the relevant Advance Rate on the collateral amount required. For instance, with respect to notes rated "AAA," assuming weekly collateral posting,[6] U.S. government bonds maturing in one year or less have an Advance Rate of 99.5, whereas U.S. government bonds maturing in between ten and fifteen years have an Advance Rate of 92.7.[7]

WATERFALL CONSIDERATIONS

If a downgraded hedge counterparty fails to effect one of the three mitigants set forth above and the hedge terminates, a shortfall of principal and/or interest to noteholders may exist if the SPV must make an early termination payment to the hedge counterparty. As an additional protection in such a case, the *Fitch Criteria* proposes that termination payments owed to a hedge counterparty that has defaulted be subordinate to payments of principal and/or interest on the relevant notes (or topping up any reserve fund relating to such notes) under the relevant priority of payments. Fitch does not expect such subordination to apply to situations where a hedge terminates due to an event beyond the control of either party (such as an Illegality under a Master Agreement); rather, in such cases, Fitch expects that termination payments owed by the SPV to the hedge counterparty would be payable prior to or on parity with the most senior notes under the relevant priority of payments established in the structured finance transaction documents.

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CREDIT SUPPORT ADMINISTRATION

Fitch recognizes that a collateral arrangement, typically in the form of an ISDA Credit Support Annex ("CSA") to a Master Agreement, often takes a substantial amount of time to negotiate and execute. As a result, Fitch expects that a CSA will be drafted and approved by the hedge counterparty and SPV before Fitch assigns its final ratings to the structured finance transaction. In addition, Fitch expects the market valuation of a hedge (i.e., "Exposure" under a CSA) and the value of any collateral (i.e., "Value" under a CSA) to be determined at least weekly and collateral to be delivered, at the latest, on the day (presumably, one business day) following such a valuation date. The *Fitch Criteria* also clarifies that the SPV's exposure under a hedge to a downgraded hedge counterparty should not have to meet any "threshold" for collateral posting to occur and expresses a preference for a "minimum transfer amount" (or, simply, the nuisance amount which a collateral deficiency under the hedge must exceed before additional collateral must be posted) of USD 25,000 (or its equivalent).

CONCLUSION

Beginning in May 2006, each of Standard & Poor's and Moody's published criteria in connection with hedges to structured finance transactions. Through the *Fitch Criteria*, Fitch now has also provided more specific guidance regarding its requirements in this area. As described above, the *Fitch Criteria* essentially expects the rating of an SPV's notes to be unaffected by a downgrade of a hedge counterparty (assuming that it remains rated investment grade), so long as one of the three mitigating actions it proposes is effected within the specified time period. However, Fitch states quite clearly that if such a period expires without any such action being taken, it will put the affected tranches of the structured finance transaction at issue on Rating Watch Negative and, for approximately 10 business days, apply risk stress scenarios to the structured finance transaction as if it were unhedged to determine whether the credit enhancement available to the notes at issue and/or the quality of the underlying portfolio warrants an affirmation of the ratings on the notes or, rather, a downgrade of such ratings.

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NOTES

[1] Appendix 1 of the *Fitch Criteria* also sets forth minimum hedge counterparty ratings for structured finance transaction notes rated below "AA-."

[2] Where a hedge counterparty is the buyer of protection under a credit default swap, the *Fitch Criteria* notes that it also may be acceptable for such hedge counterparty to post the premium for one payment period.

[3] Where a hedge counterparty elects to remedy its downgrade by posting collateral, the *Fitch Criteria* states that it expects the mark-to-market calculations, as well as the correct and timely posting of collateral, to be verified by an independent third party.

[4] Note that the VC is to be adjusted by a factor of 105 percent for balance-guaranteed swaps under which the notional amount is not predetermined according to a fixed schedule (or by fixed boundaries) to account for differences in hedge market value that may exist due to market participants' different views of a hedge's amortization profile.

[5] The *Fitch Criteria* notes that VCs corresponding to daily collateral posting will be provided by Fitch on a case-by-case basis.

[6] The *Fitch Criteria* notes that Advance Rates will be determined by Fitch on a case-by-case basis where daily collateral valuation and posting exist.

[7] Advance Rates for U.S. agency debt are calculated by applying a multiplier of 0.99 to the applicable U.S. government bond rate. For instance, assuming weekly posting and "AAA" notes, the Advance Rate for U.S. government debt maturing in between one and three years is 98.2; the Advance Rate for U.S. agency debt having the same characteristics in these circumstances is the product of 0.99 and 98.2, or 97.22.

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