S&P Global
Ratings

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ARCHIVE | Criteria | Structured Finance | Request for Comment:

Request For Comment: Counterparty Risk Framework: Methodology And Assumptions

October 9, 2018

OVERVIEW AND SCOPE

1. S&P Global Ratings is proposing revisions to its criteria for assessing counterparty risk. Our assessment of counterparty risk may constrain the rating assigned to a security if the maximum supported rating as determined under these criteria is lower than what would be supported under other applicable criteria in our analysis of that security.

2. The proposed criteria apply primarily to structured finance and covered bond transactions. They also apply to the analysis of financial counterparty risk in project finance transactions. In addition, they apply in specific circumstances to our analysis of counterparties supporting other corporate and government issues that possess structured finance characteristics (e.g., catastrophe bonds, gas prepay financings, stand-alone tax-exempt single- and multifamily housing bonds, and equipment trust certificates). The proposed criteria would not apply to other issues where counterparty risk is managed by the corporate or government issuer and the rating on the notes is not higher than that issuer's creditworthiness.

Key Publication Dates

- Original publication date: Oct. 9, 2018
- Response deadline: Nov. 9, 2018
- Effective date: Immediately upon publication of final criteria, except in markets that require prior notification to, and/or registration by, the local regulator. In these markets, the criteria will become effective when notified by S&P Global Ratings and/or registered by the regulator.
- Impact on outstanding ratings: See the Impact On Outstanding Ratings section.
- These criteria address counterparty risk, as set out in "Principles Of Credit Ratings," published on Feb. 16, 2011.

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3. The proposed criteria consider exposures to counterparties that either hold assets or make financial payments that support the rated instrument's creditworthiness. Counterparties that perform administrative or operational roles are not in scope of the proposed criteria. In particular, paying agents (which typically do not hold cash overnight) and other providers of similar services are not in scope of the proposed criteria. Such exposures would typically be analyzed as administrative parties under "Global Framework For Assessing Operational Risk In Structured Finance Transactions," published Oct. 9, 2014. To avoid doubt, in transactions where servicers receive cash collections on the securitized assets, the financial exposure to the servicer is analyzed according to our counterparty criteria, whereas the operational risk is analyzed according to our operational risk criteria.

4. Counterparty risk is an important consideration in assessing the creditworthiness of structured finance and covered bond securities. Our analysis of counterparty risk focuses on third-party obligations to either hold assets (including cash) or make financial payments that support the instrument's creditworthiness. Counterparty risks include exposures to institutions that maintain key accounts and providers of derivative contracts such as interest rate and currency swaps. Our analysis considers both the type of dependency and the rating on the counterparty for each counterparty relationship in a transaction.

5. The foundation of these proposed criteria is the analysis of exposure to counterparty risk and of remedies that mitigate this risk, such as a contractual commitment the counterparty makes to act upon deteriorating creditworthiness. In particular, counterparties typically commit to replace themselves with a higher-rated counterparty if they are downgraded. For derivative obligations, counterparties often complement this replacement commitment with the posting of collateral. For other obligation types, counterparties may also fully fund ("draw-to-cash") their obligation so that the supported securities are no longer exposed to their credit risk.

6. These proposed criteria consider how much the combination of available contractual remedies mitigates the supported securities' exposure to counterparty credit risk before a counterparty default would disrupt payments on the rated notes. This consideration is broadly consistent with the approach described in our current criteria.

7. The key proposed changes relative to our current criteria are summarized below:

- The incorporation in our analysis of resolution counterparty ratings (RCR) as a measure of a counterparty's credit risk, where relevant;
- The determination of the maximum supported rating on the basis of our assessment of the collateral-posting framework for derivatives in which a counterparty has failed to replace itself once downgraded below the minimum eligible counterparty rating or in which there is no replacement commitment;
- The recalibration of volatility buffers, market-value haircuts, and currency haircuts on collateral assets to better align collateral-posting assumptions to the resources an issuer may need to replace a derivative on similar terms following a counterparty default;
- The simplification of our approach to the analysis of derivative volatility risks, which defines quantitative assumptions for typical derivatives in established structured finance markets. The current criteria define separate quantitative assumptions based on the currency in which a derivative is denominated. The proposed criteria capture the risks associated with derivatives in less-established markets through potential constraints on the maximum supported rating rather than separately calibrated quantitative assumptions;
- The simplification of our analysis of nonderivative counterparty exposures;
- The simplification of our approach to remedy periods. We propose to consider a single remedy

period of 90 calendar days after a counterparty is downgraded below the minimum eligible counterparty rating (other than for the posting of collateral on a derivative, for which we propose to maintain a 10-business-day remedy period). Our current criteria consider remedy periods of 30 or 60 calendar days, which may be extended by another 30 calendar days subject to our analysis of a counterparty's detailed action plan during the remedy period;

- The update to our approach to analyzing counterparty risk in covered bonds to incorporate the same considerations mentioned above, in particular the analysis of collateral posted by a derivative counterparty. We also propose to amend our approach to derivatives with termination payments that are not subordinated to covered bond payments in a counterparty default scenario.

IMPACT ON OUTSTANDING RATINGS

8. These proposed criteria would apply to approximately 38,000 ratings across approximately 10,000 transactions. We have analyzed the expected impact on outstanding ratings, based on current counterparty exposure information for a representative sample of transactions globally. Based on the proposed changes, we expect the largest impact in European structured finance transactions. We expect that we may upgrade our ratings on tranches within approximately 10% to 20% of European structured finance transactions by up to three notches, in situations where current ratings are constrained by a counterparty's rating (with one- or two-notch upgrades more common than three-notch upgrades). We also expect that we may downgrade our ratings on tranches within approximately 5% to 10% of European structured finance transactions by two or three notches. These potential downgrades may affect tranche ratings in transactions supported by derivatives that either hedge currency risk, or allow for currency risk on posted collateral, in the specific circumstances explained in the following paragraph and further detailed in table 15 in appendix 3. In other regions, we expect that the impact will be limited to transactions that include cross-currency derivatives, where we may downgrade ratings by two or three notches (or maintain current ratings, depending on our assessment of the documented downgrade remedies).

9. Specifically, we summarize below how we currently expect each key proposed change, relative to current criteria, to affect our outstanding ratings:

- The consideration of RCRs as the applicable counterparty rating, where relevant, will not affect ratings currently supported by a counterparty's commitment to implement downgrade remedies. It may positively affect ratings that are currently limited by a counterparty's issuer credit rating (ICR).

- The proposal to assign uplift above the rating of a derivative counterparty, based on an analysis of its collateral-posting framework, may lead to upgrades, as our current criteria only consider collateral in combination with the counterparty's replacement framework. This would affect ratings that are currently limited by the rating of a derivative counterparty, either because the counterparty has not committed to replace itself, because the documentation of its commitment does not reflect the considerations in our criteria, or the counterparty has failed to replace itself after a downgrade. This could lead to upgrades of up to three notches.

- The changes to the calibration of derivative collateral volatility buffers will not affect ratings on transactions that rely on derivatives to hedge interest rate risk. This is because the volatility buffers for such derivatives that we consider to be commensurate with a 'AAA' rating are lower under the proposal than under our current criteria.

- The changes to the calibration of derivative collateral volatility buffers may negatively affect certain ratings on transactions that rely on derivatives to hedge foreign exchange risk. The

proposal increases some of the volatility buffers that we consider to be commensurate with a 'AAA' rating because such derivatives have a fixed-floating or floating-floating interest rate profile (transactions supported by fixed-fixed derivatives would not be affected because the proposed volatility buffers are lower than those under our current criteria). This change could lead to downgrades of one to three notches.

- The changes to the calibration of derivative collateral volatility buffers may also affect the maximum supported rating, in cases where documented volatility buffers support ratings below 'AAA' under our current criteria. This impact may lead to upgrades or downgrades of generally up to two notches. We expect this to affect only a marginal number of transactions; typically, when volatility buffers have been documented in existing transactions, these have been calibrated to support 'AAA' ratings under our current criteria.
- The changes to the calibration of currency haircuts on derivative collateral may lead to downgrades of up to two notches, on 'AAA' transactions with interest rate derivatives where the counterparty may post collateral in a different currency to that of its obligation, if the counterparty applies a minimum eligible counterparty rating of 'BBB+' to support a 'AAA' rating on the securities. This is because the proposed currency haircuts to support a "strong" collateral assessment are calibrated to cover a 90-day exposure period, whereas the haircuts under our current criteria are calibrated to cover a five-business-day exposure period. This proposed change would not affect 'AAA' ratings on transactions with interest rate derivatives with a minimum eligible counterparty rating above 'BBB+' because we consider that the proposed change to currency haircuts is offset by the recalibration of volatility buffer amounts, described above. We also do not expect any rating impact from proposed changes to our market-value haircut assumptions or collateral asset eligibility criteria--for the same reason.
- For nonderivative counterparty exposure types, the proposed changes relative to our current criteria are limited. We expect only a marginal impact, where counterparty exposures are currently classified as "direct (substantial)" obligations under our current criteria. Under the proposed criteria, these exposures may be classified as "limited" (leading to a potential upgrade of up to three notches) or "too material to be mitigated through downgrade remedies" (leading to a potential downgrade of up to two notches). We estimate that this aspect is relevant to the analysis of fewer than 1% of structured finance transactions.
- The impact of changes to our analysis of counterparty risk in covered bonds are broadly neutral. We expect that approximately 2% of covered bond programs may be downgraded by one notch. These programs may be affected by the proposed treatment of derivatives with termination payments that are not subordinated to covered bond payments in a counterparty default scenario. Under our current criteria, a material rating adjustment is applied for this risk factor if the covered bond issuer's reference rating level (RRL) is lowered below 'bbb'. Under the proposal, the corresponding adjustment applies gradually as the issuer RRL decreases and begins to apply at issuer RRLs below 'a'.
- We do not expect the proposed changes to our current criteria to affect any ratings on corporate or government issues that are in scope of these criteria.

10. The above information is intended to serve as a broad, directional guide to the possible ratings impact if the proposed criteria are adopted. Ultimately, actual ratings impact may vary depending on the specifics and structural features of a particular transaction. In situations where currently committed downgrade remedies would no longer support the current rating under the proposed criteria, we note that counterparties may amend their commitment to continue to support the current rating. In particular, for a derivative counterparty where the applicable replacement option under current criteria would no longer support the current rating, the counterparty may switch the

applicable replacement option to continue to support the current rating.

QUESTIONS

11. S&P Global Ratings is seeking responses to the following questions, in addition to any other general comments on the proposed criteria:

- What do you think of our proposal to maintain some uplift over the rating of the initial counterparty, even if it fails to replace itself within the remedy period, to account for the availability of collateral to the issuer?
- What is your opinion about our proposal to introduce the use of RCRs as part of our analysis of counterparty risk?
- What do you think of the adequacy of the proposed volatility buffers, market-value and currency haircuts, to mitigate collateral volatility risks over a maximum 90-day exposure period after a counterparty default?
- What do you think of the proposed eligibility criteria for collateral posted under this framework? Are there other highly liquid and creditworthy collateral types that you think we should consider?
- What is your view regarding our proposal to consider a single 90-calendar-day remedy period to implement the downgrade remedy actions a counterparty commits to take if its rating is lowered below the minimum eligible counterparty rating?
- Do you have any comments about the way we propose to apply this updated framework to covered bond issuers?

RESPONSE DEADLINE

12. We encourage interested market participants to submit their written comments on the proposed criteria by Nov. 9, 2018, to
http://www.standardandpoors.com/en_US/web/guest/ratings/rfc
where participants must choose from the list of available Requests for Comment links to launch the upload process (you may need to log in or register first). We will review and take such comments into consideration before publishing our definitive criteria once the comment period is over. S&P Global Ratings, in concurrence with regulatory standards, will receive and post comments made during the comment period to
www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/requests-for-comment/filter/all#rfc
. Comments may also been sent to CriteriaComments@spglobal.com should participants encounter technical difficulties. All comments must be published but those providing comments may choose to have their remarks published anonymously or they may identify themselves. Generally, we publish comments in their entirety, except when the full text, in our view, would be unsuitable for reasons of tone or substance.

PROPOSED METHODOLOGY

13. These proposed criteria provide a framework for the analysis of counterparty risk and consider the following three broad fact patterns, as illustrated in :

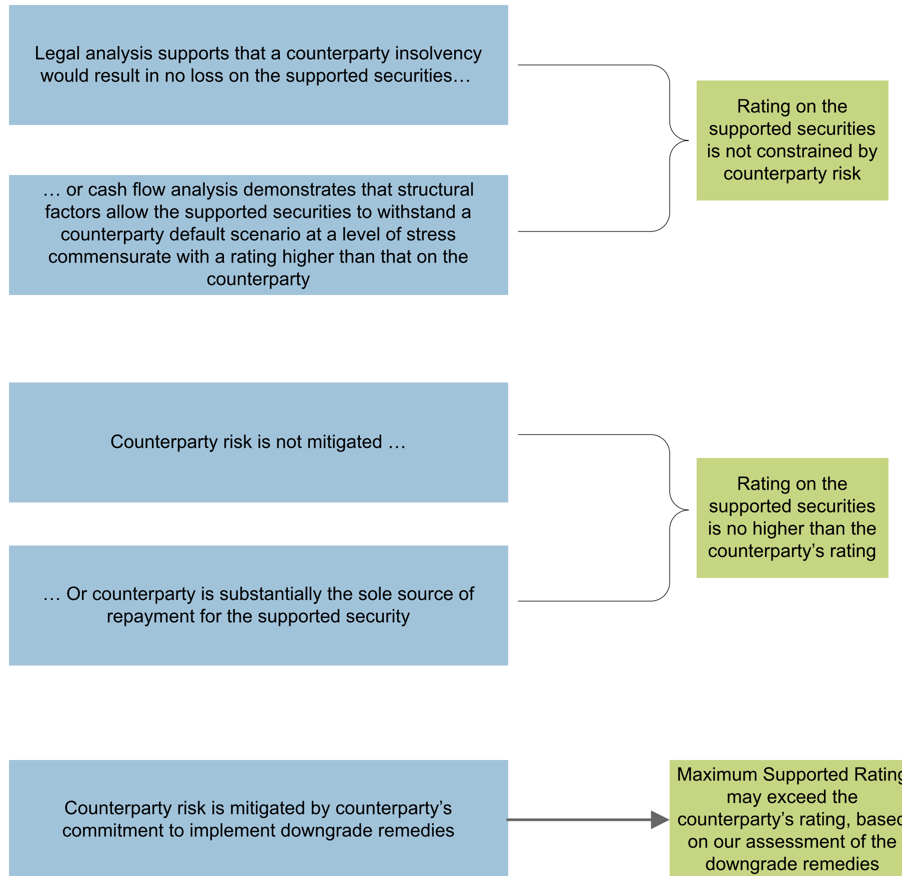
- The rating on the supported securities is not constrained by the rating on the counterparty

because counterparty risk is mitigated by legal or structural factors. For example, we may consider that commingling risk is fully mitigated if our legal analysis concludes that the issuer would not be exposed to commingling risk upon a counterparty insolvency or if structural mechanisms in the transaction protect the issuer from any loss or delay in receiving funds upon a counterparty insolvency.

- The rating on the supported securities is no higher than the rating on the counterparty because the counterparty does not commit to take any appropriate remedy actions upon downgrade or because we have determined that the materiality of the counterparty risk is too great to be mitigated by typical downgrade remedies. We would generally reach this conclusion if the counterparty is substantially the sole source of repayment for the supported security, as in a credit substitution. In determining whether a specific exposure matches this description, we will consider the exposure's nature, size, and duration.
- The rating on the supported securities may be higher than the counterparty's rating because counterparty risk is mitigated by the counterparty's commitment to take certain remedy actions if its rating is lowered below a certain level. The remainder of these proposed criteria focuses primarily on the analysis of such downgrade remedies. If a downgraded counterparty does not implement a committed remedy action, we would lower the rating on the supported notes, potentially to the counterparty's rating, unless other mitigating factors support a higher rating level.

Chart 1

Overview Of The Proposed Framework For Analyzing Counterparty Risk



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14. In exceptional cases where atypical risks exist that are not contemplated in these proposed criteria, we may reduce the maximum supported rating. The magnitude of such a reduction is based on the available information and our view of the relevance of these factors to the overall assessment of counterparty risk.

15. The proposed criteria separate the analysis of derivative obligations from the analysis of other obligations due to the specific considerations applicable to the analysis of derivative agreements (in particular, collateralization and termination events).

Determining The Applicable Counterparty Rating

16. The first step in our analysis is to determine the applicable counterparty rating. To determine the maximum supported rating on the securities, our proposed analysis considers the minimum eligible counterparty rating (i.e., the rating level below which counterparties typically commit to

implement remedies), alongside the counterparty's current rating.

17. S&P Global Ratings assigns RCRs to certain financial institutions to address how, in the wake of the global financial crisis, bail-in resolution regimes (where investors bear some of the burden by having some of their debt written off) and resolution authorities in certain jurisdictions affect the default risk for certain senior liabilities (see the RCR criteria in the Related Criteria And Research section).

18. The applicable counterparty rating we will use for a specific obligation when applying these proposed criteria is either the counterparty's ICR or RCR, if relevant, depending on the obligation type. The local currency rating on the counterparty is relevant for obligations denominated in its local currency, whereas the foreign currency rating is relevant for obligations denominated in a different currency than the counterparty's local currency.

19. The applicable counterparty rating we would use in our counterparty risk analysis would be:

- The counterparty's RCR if we have assigned one and we believe the counterparty's obligation is an RCR liability according to the RCR criteria;
- The counterparty's ICR if we have assigned an RCR to the counterparty but we believe the counterparty's obligation is not an RCR liability according to the RCR criteria; or
- The counterparty's ICR if we have not assigned an RCR to the counterparty.

20. For example, we consider that collateralized derivatives and on-demand bank deposits (which the issuer can draw from at any time) would typically be RCR liabilities. Most other exposures we see in structured finance transactions, such as liquidity facilities, would typically not be RCR liabilities.

21. These proposed criteria reference long-term ratings on the counterparty when defining the minimum eligible counterparty ratings. Certain counterparties may only have short-term ratings or only reference short-term counterparty ratings in their documentation. In such cases, to assess the documented remedies, we would infer a long-term rating from the documented short-term rating. This is the lowest long-term rating that maps to the relevant short-term rating according to our criteria for linking long- and short-term ratings (see the Related Criteria And Research section).

22. Where a counterparty is not rated but belongs to a group with a rated parent, we may determine the counterparty's rating using our group rating methodology (see the Related Criteria And Research section) to the extent it is applicable to the group the counterparty belongs to.

23. Where a counterparty is the branch of a rated bank, the applicable counterparty rating for the purpose of these proposed criteria is determined under our bank branch creditworthiness criteria (see the Related Criteria And Research section).

24. **Counterparty ratings limited by the relevant sovereign rating** Where a counterparty's rating is limited by the relevant sovereign rating at 'BB' or below, we propose that the applicable counterparty rating may refer to the higher of:

- The ICR or RCR (as applicable to the relevant obligation type) and
- The counterparty's standalone credit profile (SACP).

25. If the counterparty's SACP is the applicable rating (because it is higher than the relevant sovereign rating), we consider that the counterparty risk analysis addresses the issuer's exposure to a counterparty's idiosyncratic default risk. However, we also consider that the issuer would remain exposed to counterparty risk in a sovereign default scenario. This risk may affect our assessment of the transaction's sensitivity to sovereign default risk, under our criteria for assigning structured

finance ratings that exceed the relevant sovereign rating. We also propose to cap the maximum supported rating in such cases at 'BB+.'

Nonderivative Counterparties

26. Nonderivative obligations for which we would analyze counterparty downgrade remedies include, for example, transaction bank accounts, servicers collecting cash from securitized assets (which may create a commingling risk), liquidity or credit facilities, or commitments to fund reserves covering specific risks in a transaction. These obligations may form all or part of the credit enhancement provided to a supported security but would not be the sole repayment source for the supported security, as in a credit substitution.

27. For such counterparty exposures, typical counterparty downgrade remedies include a clear commitment by the counterparty, to:

- Replace itself with, or obtain a guarantee from, a higher-rated counterparty at its own cost;
- Prefund its counterparty obligation for the transaction's life; and/or
- Implement structural mechanisms (or other mitigating factors) that remove counterparty risk, within the remedy period.

We consider that such downgrade remedies effectively mitigate counterparty risk if the remedy period is no longer than 90 calendar days. For bank accounts specifically, a replacement commitment may rest with the issuer or its trustee or with the counterparty; for other obligation types, we believe the counterparty should make the replacement commitment.

28. For transactions where counterparty replacement is the applicable remedy, we would consider the documented wording to be sufficiently firm if it states that the counterparty "will replace" itself if it is downgraded below the minimum eligible counterparty rating. We would also give credit to replacement commitments that are worded as "will make commercially reasonably efforts to replace" in the following situations:

- For bank accounts, if the commitment rests with the issuer or trustee rather than the counterparty; or
- For other nonderivative obligations, if the commitment is associated with a commitment to fund or draw to cash the obligation within the remedy period if it is not replaced.

29. We propose to determine the maximum supported rating on the basis of our classification of the exposure and the level of the remedy rating trigger, as shown in table 1.

30. We propose to classify the rated notes' counterparty risk exposures as "limited" or "minimal." We will classify an exposure as "limited" unless it meets both the conditions below to be classified as "minimal:"

- Sensitivity to the counterparty's performance on its obligation: We assess that the hypothetical scenario of the counterparty's insolvency would not, in itself, disrupt payments on the rated notes. Our assessment will consider any structural features or other mitigating factors that may prevent a disruption in payments on the rated notes upon a counterparty default.
- Materiality of the exposure: We assess that the materiality of the exposure to the counterparty is low, reducing the risk of a disordinate rating transition on the supported securities in the event that the counterparty fails to implement a remedy after its rating is lowered below the minimum eligible counterparty rating. Our assessment of materiality will consider the exposure size, which may be a fixed amount, or a function of transaction features, such as the payment profile of the securitized assets and the frequency of distributions to noteholders.

31. We will perform this classification when a new transaction is initiated and generally do not expect the classification to change over the transaction's life.

Table 1

Minimum Eligible Counterparty Rating And Corresponding Exposure

	Maximum supported rating	
Minimum eligible counterparty rating	**Limited exposure**	**Minimal exposure**
A and above	AAA	AAA
A-	AA	AAA
BBB+	A+	AAA
BBB	A	AAA
BBB-	A-	AA-
BB+	BBB-	A-
BB	BB	BBB
BB- and below	Counterparty rating	Counterparty rating

Derivative Counterparties

32. In our analysis, we would consider the combined strength of the contractual remedies to determine the maximum supported rating on the structured finance notes for a given derivative counterparty exposure. We would also consider the ranking of termination payments in situations where the counterparty is the defaulting or sole affected party, as well as other liquidity risks.

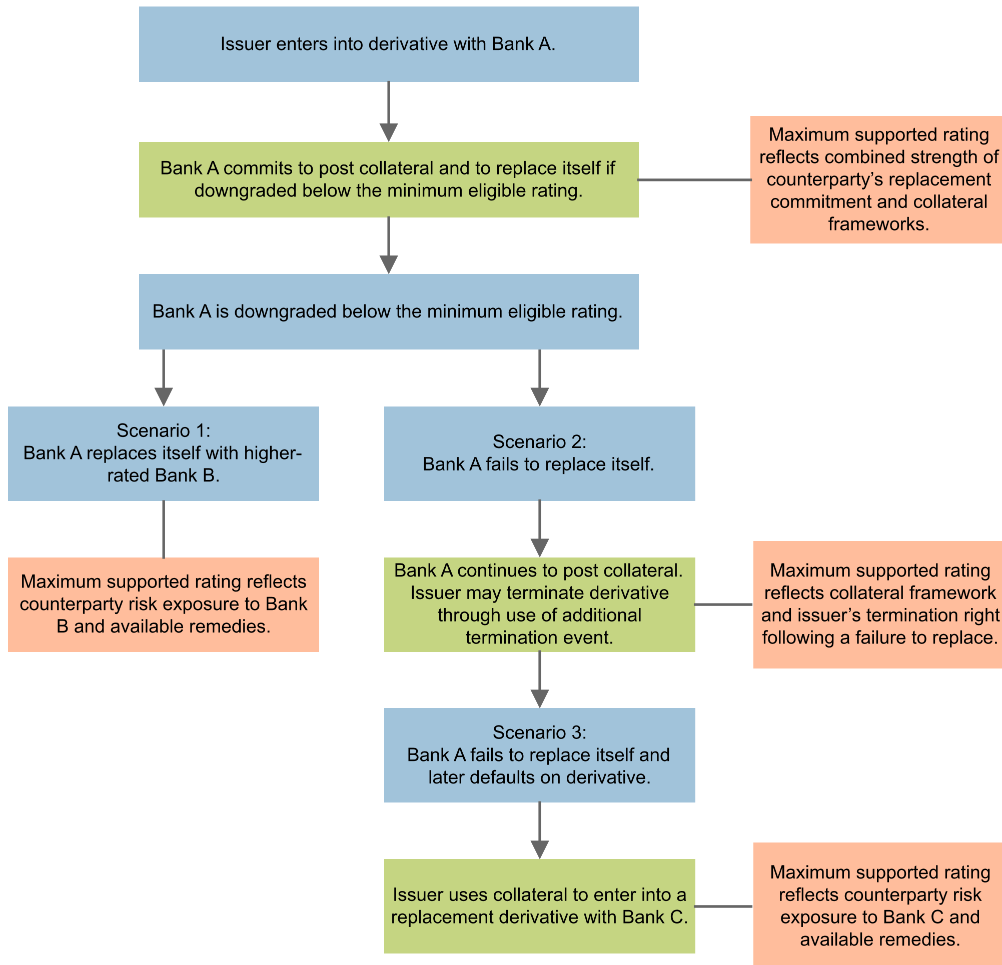
33. Derivatives typically include the following contractual commitments to implement certain remedies if the counterparty's credit rating is lowered:

- The counterparty posting collateral to mitigate the issuer's exposure to it;
- The counterparty's commitment to replace itself with an eligible counterparty;
- The issuer's ability to terminate the derivative if the counterparty fails to replace itself; and
- The subordination of termination payments in situations where the derivative terminates and the counterparty is the defaulting or sole affected party.

34. If a counterparty fails to replace itself within the remedy period after its rating is lowered below the minimum eligible counterparty rating, the maximum supported rating may remain above the counterparty's rating, depending on the strength of the collateral framework and the issuer's ability to terminate the derivative. This is because these two factors may allow the issuer to rehedge its exposure with an eligible replacement counterparty. The issuer may terminate the derivative with the initial counterparty and enter into a derivative on similar terms with a new counterparty if it receives a bid from an eligible replacement counterparty. If the issuer does not terminate the derivative and the initial counterparty eventually defaults, the issuer may still use available collateral to enter into a new derivative with an eligible replacement counterparty.

35. Chart 2 illustrates a typical derivative in a structured finance transaction from initiation through a hypothetical deterioration of a counterparty's credit quality and up to its default on the derivative. The chart highlights the points at which each remedy would be implemented and how this would affect our proposed analysis of counterparty risk.

Chart 2



36. Charts 3 and 4 show the steps of our proposed derivative counterparty risk analysis, illustrating how we would assess available remedies and determine the maximum supported rating.

37. Table 2 illustrates the maximum rating supported by the combination of replacement commitment and collateral posting, and table 3 indicates the uplift above the counterparty's rating for ratings supported by a collateral posting and the issuer's right to terminate the derivative. Both of the tables assume termination payments are subordinated.

Chart 3

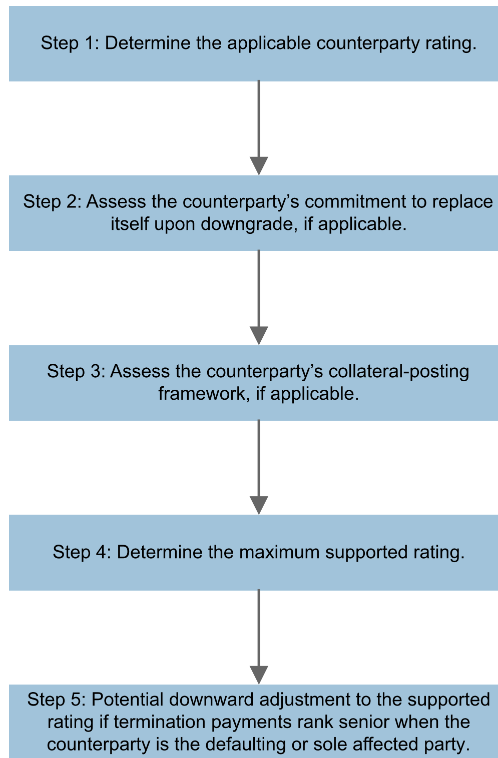


Chart 4

Step 4: Determine The Maximum Supported Rating Based On The Applicable Remedies

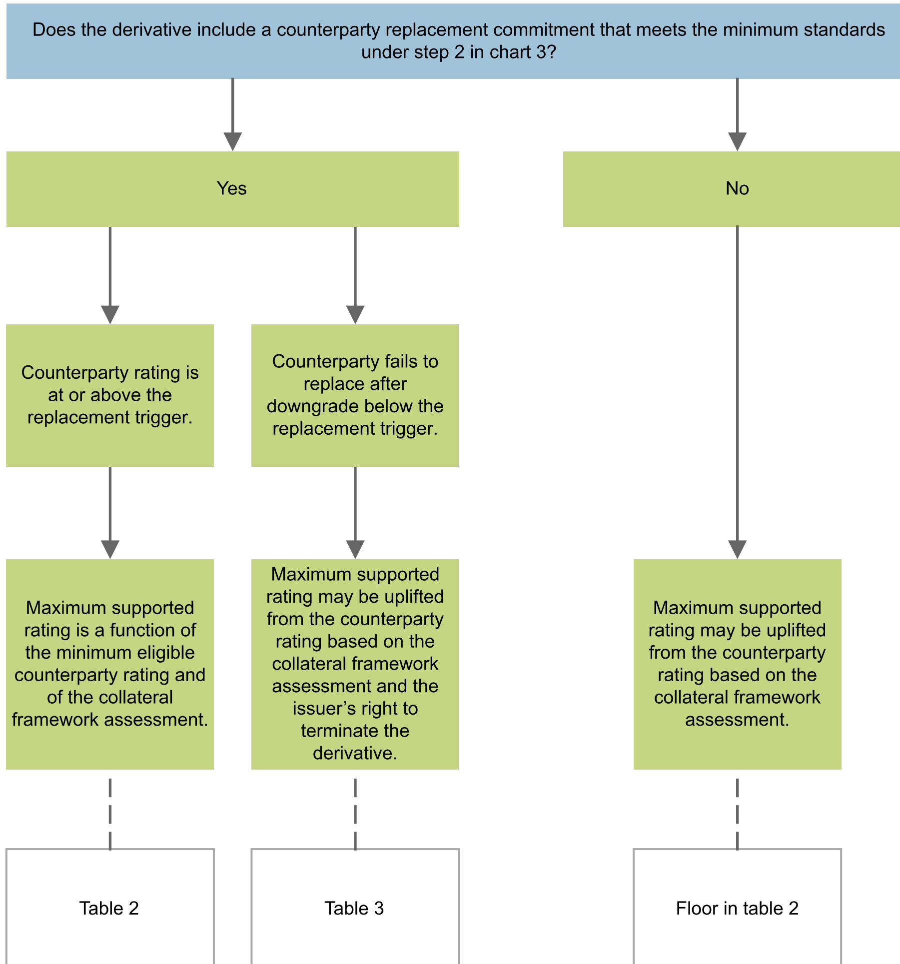


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Table 2

Maximum Rating Supported By The Combination Of Replacement Commitment And Collateral Posting

If termination payments are subordinated

	Maximum supported rating			
	"Strong" collateral	"Adequate" collateral	"Moderate" collateral	"Weak" collateral
Replacement trigger				
AAA	AAA	AAA	AAA	AAA
AA+	AAA	AAA	AAA	AAA
AA	AAA	AAA	AAA	AAA
AA-	AAA	AAA	AAA	AAA
A+	AAA	AAA	AAA	AAA
A	AAA	AAA	AAA	AA
A-	AAA	AAA	AA+	AA-
BBB+	AAA	AA	AA-	A
BBB	AA	A+	A	BBB+
BBB-	A+	A-	BBB+	BBB-
Floor to supported rating	Counterparty rating + 3 notches	Counterparty rating + 2 notches	Counterparty rating + 1 notch	Counterparty rating
Maximum supported rating is equal to the floor above in the following cases				
Replacement trigger at 'BB+' or below				
Replacement commitment does not meet minimum standard				
No replacement commitment				

Table 3

Uplift For Ratings Supported By Collateral Posting Framework And The Issuer's Right To Terminate The Derivative After The Counterparty's Failure To Replace

If termination payments are subordinated

Strength of collateral framework	Proposed uplift above counterparty rating
"Strong"	Five notches
"Adequate"	Three notches
"Moderate"	Two notches
"Weak"	No uplift

Adjusting the maximum supported rating to reflect senior termination payments

38. A termination payment is owed when the derivative contract is terminated. The payment's size and direction is determined by the contract's value on the termination date. For derivative contracts in structured finance transactions, termination payments are typically subordinated if the

counterparty defaults on the derivative or if the counterparty is the sole affected party following an additional termination event (ATE).

39. If we assess that termination payments rank senior, then the maximum supported rating will be lower than if the termination payments were subordinated. This reflects liquidity risk upon a counterparty default and the reduced effectiveness of an ATE as an incentive for the counterparty to replace itself (see Appendix 1). However, we would apply no adjustment for the senior termination payments if the issuer must post margin to the counterparty and we have assessed that it would have sufficient resources to do so (see our special-purpose vehicle criteria article listed in the Related Criteria And Research section).

Replacement commitment

40. We will give credit in our analysis to a counterparty's contractual commitment to replace itself if the derivative documentation includes each of the following:

- The counterparty's clear and unambiguous commitment to replace itself (or make "commercially reasonable efforts" to do so) within a defined remedy period if its rating is lowered below the minimum eligible counterparty rating;
- A minimum eligible counterparty rating, of at least 'BBB-', below which a counterparty commits to replace itself (under this proposal, a higher minimum eligible counterparty rating supports a higher maximum rating on the securities);
- An ATE, which allows the issuer to terminate the derivative if a counterparty fails to replace itself within the contractual remedy period. If the remedy period is not quantified (see the next bullet point), we would assess how the issuer's termination right may be enforced in a timely manner. We consider that the applicability to the counterparty of the "breach of agreement" event of default supports this timely enforceability;
- A contractual remedy period no longer than 90 calendar days, or, if the remedy period is not quantified, it is defined as "as soon as reasonably practicable" (or similar language; in this case we would also consider that a counterparty has failed to replace if it has not done so within 90 calendar days of its downgrade below the minimum eligible counterparty rating);
- Coverage by the counterparty of all costs from the replacement.

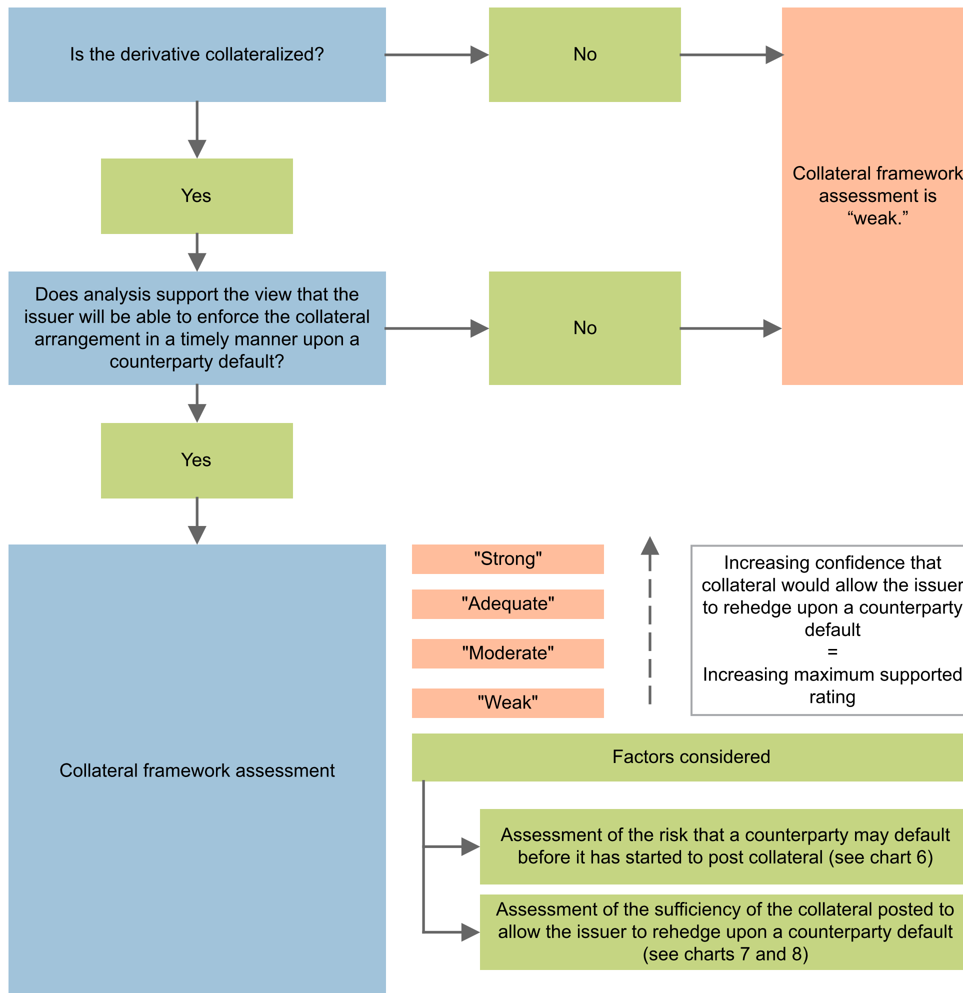
Collateral-posting frameworks

41. We will categorize the counterparty's collateral-posting framework for a given derivative contract as "weak," "moderate," "adequate," or "strong" based on our assessment of the likelihood that collateral would allow the issuer to rehedge its exposure upon a counterparty default. The factors that we propose to consider in this determination are shown in chart 5.

42. We will generally rank a collateral framework in a given category only if it meets all of that category's conditions unless we consider a specific variation to be de minimis or otherwise mitigated.

Chart 5

Determining The Collateral Framework Assessment



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43. **Collateral enforceability analysis** Our analysis considers the issuer's ability to enforce the collateral arrangement if the counterparty defaults, so that it can access the collateral in a timely manner and use it to rehedge its exposure.

44. We expect that sophisticated market participants, in consultation with their legal advisers, have performed the necessary legal analysis to conclude that the issuer will be able, if the counterparty defaults, to enforce, access, and use the collateral posted by the counterparty to rehedge its exposure in a timely manner.

45. A key assumption underlying these proposed criteria is that derivative collateral arrangements are legally enforceable in typical derivatives that we have seen in structured finance transactions where:

- The derivative agreement follows a standardized market-wide framework, such as the templates provided by the International Swaps and Derivatives Assn. (ISDA);

- The derivative is a market-rate hedge in the structured finance transaction (e.g., hedging interest rate or foreign exchange movements);
- The counterparty is a regulated financial institution;
- The use of derivatives in structured finance transactions in the counterparty's jurisdiction is well-established;
- The collateral posted by the counterparty is held by an independent third party that is located in a jurisdiction that is typical for such accounts in structured finance transactions; and
- The assets eligible to be posted as collateral are limited to assets that are eligible under either our proposed criteria or the Basel regulatory framework for margin requirements on noncentrally cleared derivatives.

46. In such cases, our analysis will focus on the review of elections made by the counterparties under the credit support annex (CSA), according to our criteria article "Global Derivative Agreement Criteria," published June 24, 2013. We will consider whether the elections made by the parties in the CSA give the issuer clear enforcement rights against the collateral if the counterparty is the defaulting party or the sole affected party.

47. In less typical cases, for example, where one or more of the above conditions are not met, we may request additional legal comforts, such as legal opinions, to support the assumption that the derivative collateral arrangement is legally enforceable.

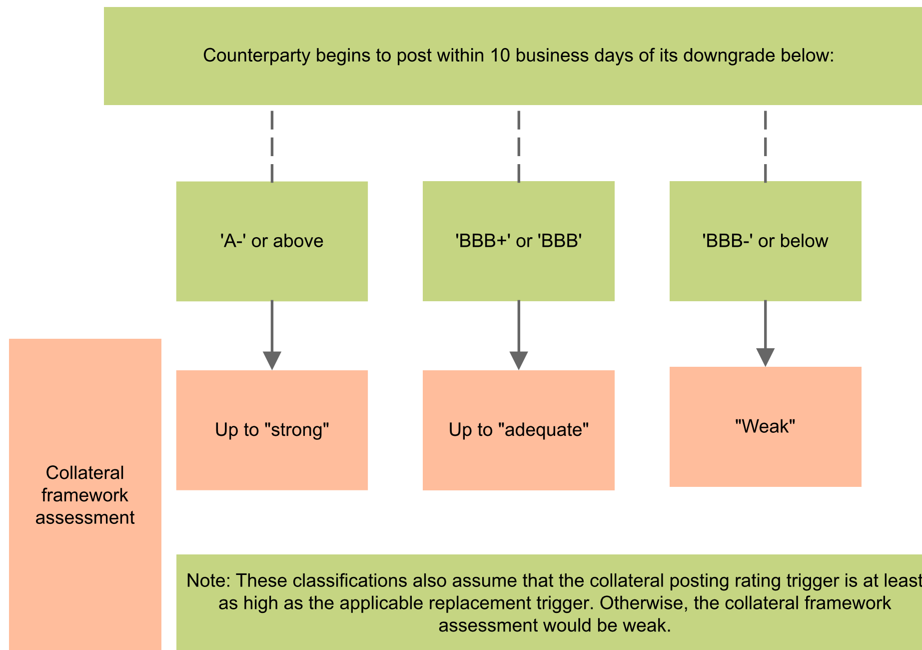
48. If we conclude that the likelihood of enforceability of the collateral arrangement is commensurate with the uplift contemplated under these proposed criteria, our enforceability analysis will not constrain the collateral framework assessment. If we do not reach this conclusion, we would categorize the collateral framework as "weak."

Initiation of collateral posting and remedy period

49. Typically, counterparties will either begin to post collateral upon entering into a derivative agreement or will begin to post collateral when the counterparty is downgraded below a specified rating (the collateral-posting trigger). Our proposed analysis for the latter case is set out in chart 6. In particular, in order to support an assessment better than "weak," the counterparty should begin to post collateral within 10 business days of its downgrade below a trigger set at or above 'BBB' (and no lower than the replacement trigger, if applicable).

Chart 6

Assessment Of The Risk That A Counterparty May Default Before It Has Started To Post Collateral



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Assessing the sufficiency of the collateral amount posted

50. After the initial counterparty defaults, for the issuer to enter into a replacement derivative with a new counterparty on similar terms, the issuer may need to pay an upfront premium to the new counterparty. Posted collateral can help fund this. To assess the collateral framework, our proposed criteria assess the risks to the sufficiency of the collateral amount for this purpose, and any provisions that mitigate these risks, as illustrated in charts 7 and 8.

Chart 7

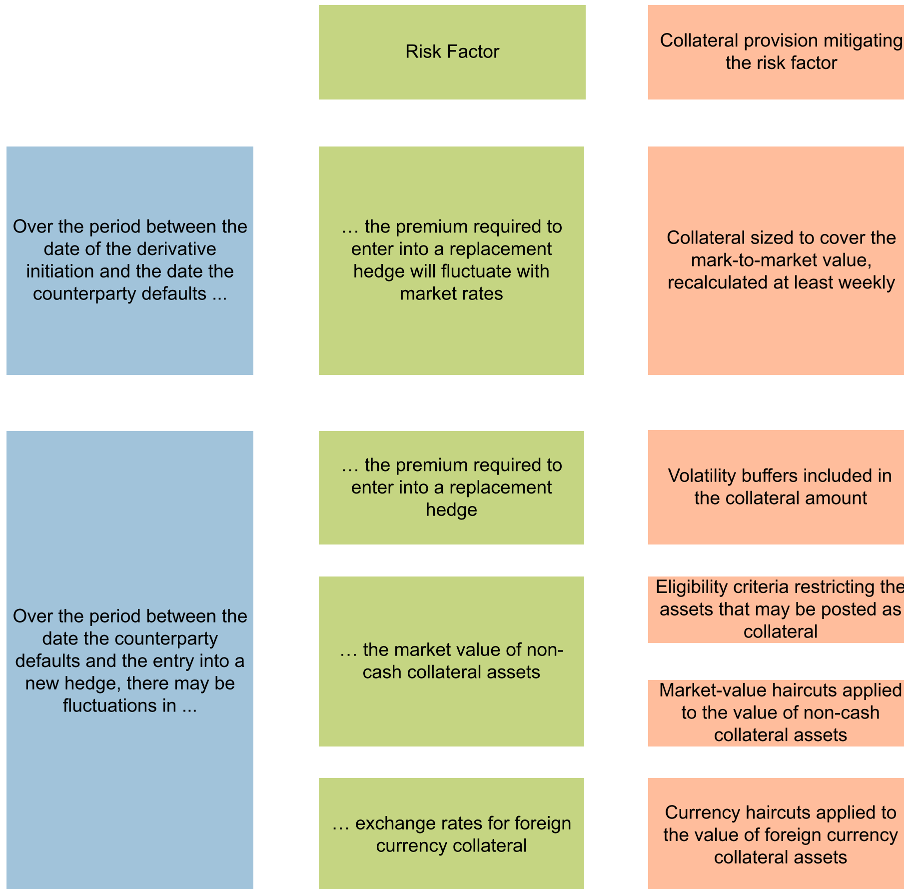

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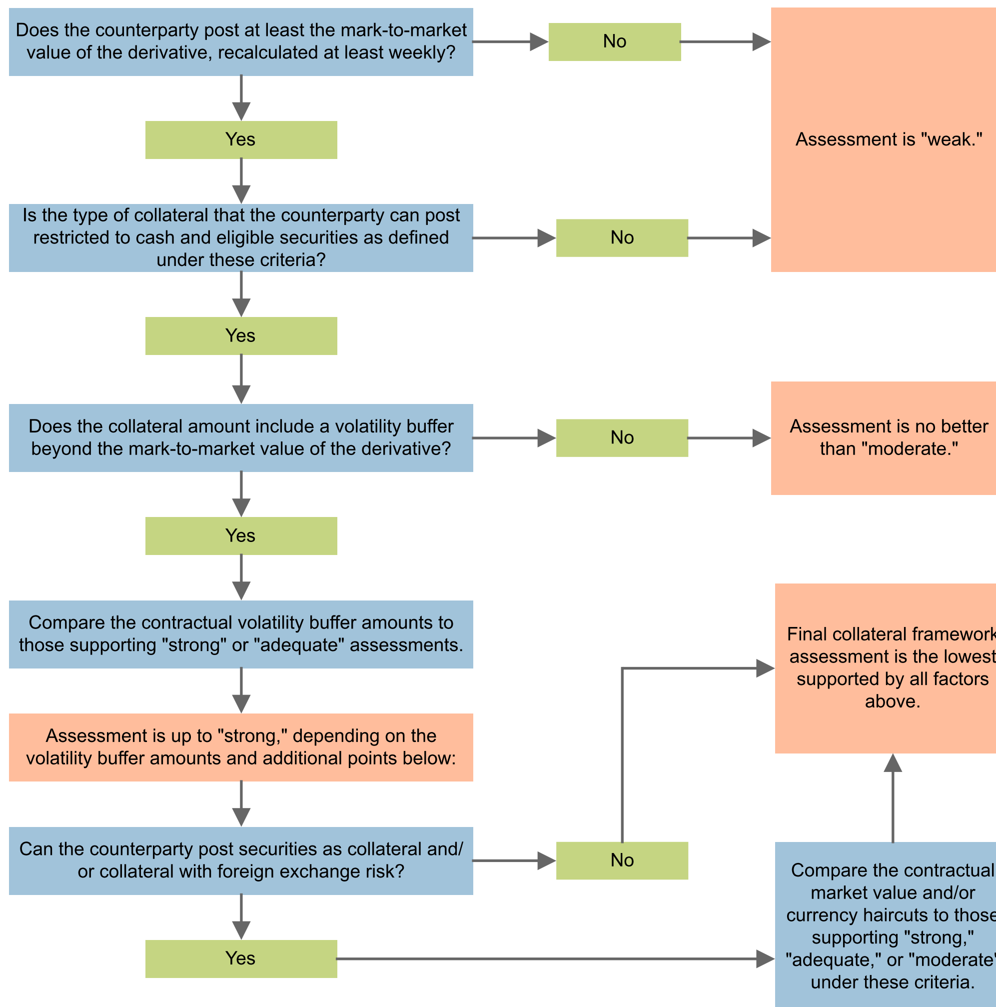
Chart 8

Collateral Framework Assessment Based On The Sufficiency Of The Collateral Amount



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51. We propose to calibrate the quantitative assumptions for the volatility buffers and market-value and currency haircuts above, as follows:

- Volatility buffers: based on the simulation of mark-to-market (MTM) volatility on idealized swaps in hypothetical rate volatility scenarios, historical data on the volatility of swap prices, and, as a proxy, sovereign bond prices, in each case differentiated by remaining weighted-average life (WAL);
- Market-value haircuts: based on observed historical market-value declines for those asset types considered as eligible, differentiated by remaining asset term to maturity;
- Currency haircuts: based on observed historical volatility for the relevant currencies. We intend to include, and update from time to time, a list of currencies that we consider to be eligible and the currency haircuts that we consider to be commensurate with a given collateral framework assessment for a given currency mismatch;

- For all of the above, we may also consider other market reference points (e.g., applicable haircuts or margin requirements under over-the-counter derivative regulation) and external research that may inform the calibration of specific assumptions.

52. We propose to differentiate collateral framework assessments based on how robustly volatility risks are covered, by volatility buffers and market-value and currency haircuts. Specifically, we will assess the collateral framework as:

- "Strong, " if we consider that volatility risks would be covered for at least 90 calendar days after the counterparty's default;
- "Adequate, " if we consider that volatility risks would be covered for at least two weeks (but less than 90 calendar days) after the counterparty's default;
- "Moderate, " if we consider that volatility risks would be covered up to the time of the counterparty's default only, with no coverage thereafter;
- "Weak," if we consider that the value of collateral posted at the time of the counterparty's default may be lower than the MTM value of the derivative.

53. The output of the above methodology to calibrate volatility buffers, commensurate with "strong" and "adequate" collateral framework assessments, for typical structured finance interest rate and currency derivatives is shown in table 4 below. In our analysis of documented volatility buffers, we assess the range of possible prepayment assumptions that may be used in computing the remaining WAL (typically by referencing low prepayment speed assumptions from the relevant asset-class-specific S&P Global Ratings criteria).

54. We may publish additional assumptions for other types of derivatives. In such cases, we would consider the assumptions in table 4 as a reference point for comparison, in addition to the factors listed above.

Table 4

Volatility Buffers For Interest Rate And Currency Derivatives Under the Proposed Criteria

As a % of the derivative notional amount

	Volatility buffers supporting a "strong" collateral framework			Volatility buffers supporting an "adequate" collateral framework		
Remaining Weighted-average life of swap (years)(i)	Interest rate swap--fixed-floating	Interest rate swap--floating-floating	Cross-currency swap	Interest rate swap--fixed-floating	Interest rate swap--floating-floating	Cross-currency swap
[0; 1]	2.0%	2.0%	14.0%	1.0%	1.0%	6.0%
(1; 3]	6.0%	2.5%	14.5%	2.5%	1.0%	6.0%
(3; 5]	8.5%	3.0%	15.0%	3.5%	1.5%	7.0%
(5; 10]	12.0%	4.0%	18.0%	5.0%	2.0%	7.5%
(10; 15]	14.0%	4.5%	21.0%	6.0%	3.0%	8.0%
(15; 20]	14.5%	5.0%	22.5%	6.5%	3.5%	9.0%
Greater than 20	15.0%	5.5%	24.0%	7.0%	4.0%	10.0%

(i)The symbol "(" denotes exclusion of the first data point in the range, and the symbol "]" denotes the inclusion of the last data point in the range.

55. We propose that, to support a collateral framework assessment better than "weak," the assets posted as collateral should be limited to high-credit-quality and liquid assets that are not issued

by the counterparty itself (or one of its affiliates). In determining which asset types are eligible, we will consider in particular the S&P Global Ratings credit rating on the asset and the classification of the asset type under liquidity coverage regulations for financial institutions. We will also consider other factors that may affect our view of the asset's liquidity. For example, for sovereign bonds, we would also consider whether the bond is issued in the sovereign's local currency, whether this is a reserve currency, and the depth of the market for the sovereign's issuances. We intend to publish, and update from time to time, a list of asset types that we consider to be eligible, as well as the market-value haircuts that we consider to be commensurate with each asset type.

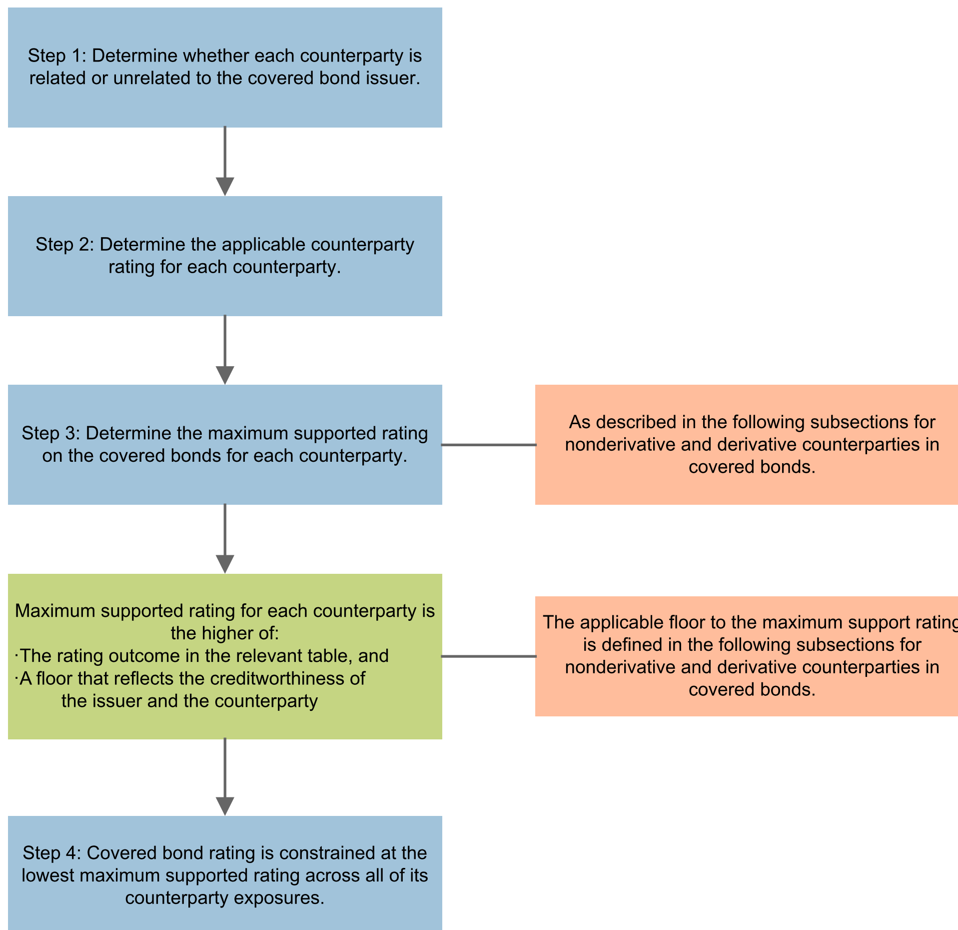
56. Derivatives in structured finance transactions typically include unilateral collateral posting: The counterparty may be required to post collateral to the issuer, depending on the calculation of the collateral-posting amount, but the issuer does not post collateral to the counterparty, regardless of the calculation of the collateral-posting amount. When a derivative contract requires the issuer to post collateral to the counterparty, we will apply our criteria for assessing special-purpose vehicle margin requirements for swaps to assess the issuer's provisions for posting collateral.

Covered Bonds

57. Covered bond programs may be exposed to similar forms of counterparty risk as structured finance issues, such as derivatives that hedge interest rates or currency mismatches between assets and liabilities, accounts holding cash that belongs to the cover pool, or liquidity support mechanisms. Compared to structured finance issues, the holder of a covered bond benefits from dual recourse, first to the issuing bank and then to the cover pool assets. This recourse to the issuer is an additional factor to consider when assessing counterparty risk in covered bond programs. For simplicity, in these proposed criteria, the terms "issuer" and "covered bond issuer" refer to a financial institution that sponsors a covered bond program, though the actual issuer may be a special-purpose entity or a specialized lender.

58. Our proposed analysis will consider whether counterparties are related or unrelated to the covered bond issuer and how much this may influence the issuer's ability and willingness to manage counterparty risk before a default. A counterparty is related to an issuer when it is a subsidiary that we assess as "core," "highly strategic," or "strategically important" and that we rate according to group rating methodology (see the Related Criteria And Research section).

Chart 9



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Applicable counterparty rating

59. In addition to the considerations regarding RCRs for counterparty risk in structured finance transactions, if we believe covered bonds would be protected in a resolution, we would typically expect that any instruments supporting them that are obligations of the issuing bank would also be protected. This is the case even if we consider that this obligation type would not be protected in the general sense. Therefore, the issuing bank's RRL would be the applicable counterparty rating when assessing the counterparty risk to the covered bond program. The RRL is our assessment of an issuer's creditworthiness regarding its covered bonds and considers the treatment of covered bonds under the applicable bank resolution regime (see the covered bonds criteria article listed in Related Criteria And Research).

Nonderivative counterparty risk In covered bonds

Exposure types

60. We would consider bank accounts held with counterparties unrelated to the covered bond issuer as minimal exposure. Given the dual-recourse nature of covered bonds, the risk relating to an account at an unrelated bank should only adversely affect a covered bond rating if multiple events occur, such as the simultaneous failures of the bank account provider and the issuer.

Remedy actions

61. Bank account risk in covered bonds may also be mitigated through additional remedy actions, such as through additional collateral provided by the issuer or the issuer's commitment to increase the cover pool's overcollateralization to cover this amount, if its rating falls below the minimum level commensurate with the rating on the covered bond.

62. As for structured finance issues, covered bond ratings would reflect the securities' exposure to nonderivative counterparty risk and any mitigating factors we consider under these proposed criteria. However, because the bonds are dual-recourse, our counterparty analysis of nonderivative exposures would not generally lead us to rate covered bonds lower than a floor that is the higher of the issuer's RRL or the applicable counterparty rating under these proposed criteria.

63. If a bank account or commingling risk exposure is with an entity that is unrelated to the issuer, we believe the issuer has an incentive to manage the exposure to such a counterparty (e.g., moving its accounts and notifying borrowers to redirect payments to a higher-rated institution if the original counterparty's credit quality has deteriorated). Because the issuer has an incentive to manage the risk, we believe the risk does not reduce the likelihood of jurisdictional support to the covered bond program, as defined in our covered bonds criteria. In this situation, bank account or commingling risk does not constrain the covered bond rating below a rating floor, which is the higher of the RRL on the issuer plus one notch, the jurisdiction-supported rating level on the covered bond program, or the applicable counterparty rating under these proposed criteria.

Derivative counterparty risk in covered bonds

64. Relative to our proposed analysis of derivative counterparty risk for structured finance securities, our proposed analysis of derivative counterparty risk in covered bonds considers the following additional factors:

- The covered bond issuer's RRL: the higher the RRL, the greater the issuer's ability to mitigate counterparty risk, in our view;
- Whether the counterparty is related to the covered bond issuer: If the counterparty is unrelated to the issuer, there are two parties (the issuer and the counterparty) that may support a replacement framework; and
- Whether the exposure to counterparties that are unrelated to the covered bond issuer is concentrated or diversified: If the exposure to unrelated counterparties is diversified, the issuer's ability to manage counterparty risks is enhanced, in our view, due to the possible availability of existing counterparties to act as replacements to a downgraded counterparty.

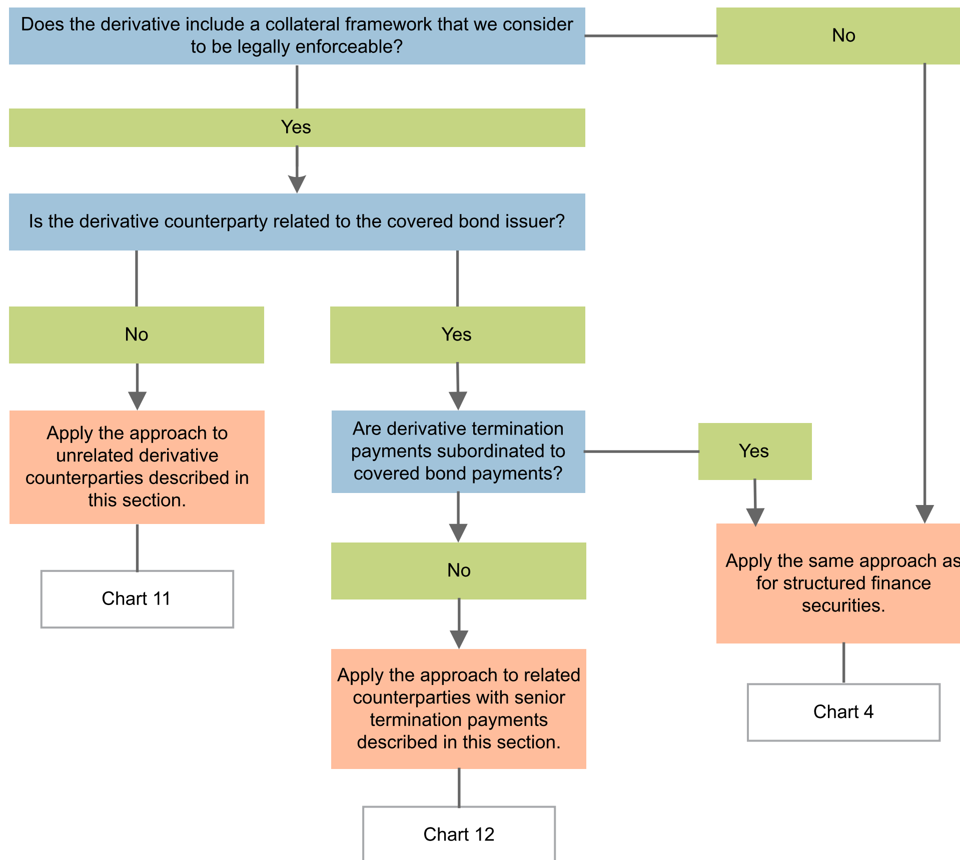
65. The driving consideration of the proposed derivative analysis in covered bonds is that the combination of these factors may support a higher rating for a covered bond program with

derivative counterparty risk, relative to a structured finance security, if certain conditions are met.

66. Charts 10, 11, and 12 set out an overview of the proposed analysis of derivative counterparty risk in covered bonds and reference the applicable tables that provide the maximum supported rating outcomes in each case.

Chart 10

Overview Of The Proposed Derivative Counterparty Risk Analysis In Covered Bonds



Note: The covered bond rating may exceed the maximum supported rating for a given derivative counterparty(ies) if the cumulative total exposure (based on notional amount) to counterparties that support lower ratings does not exceed 5% of the balance of outstanding covered bonds.

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Unrelated counterparties

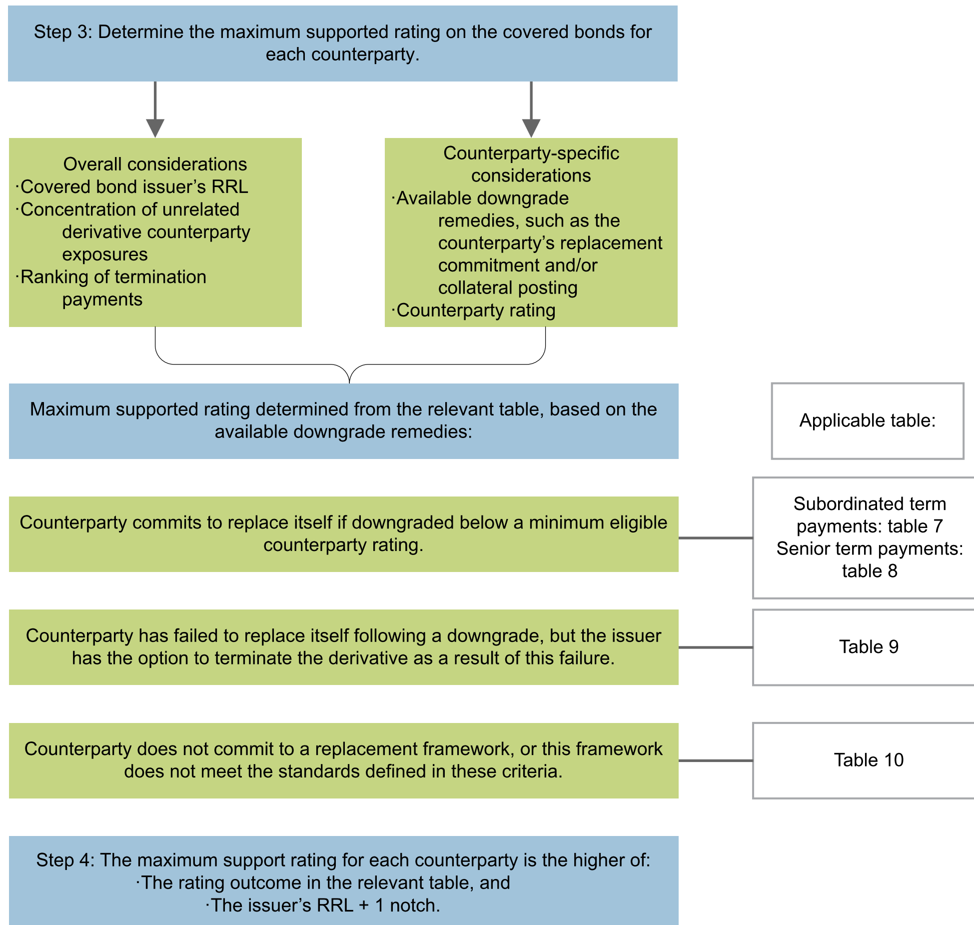
67. Chart 11 sets out how we propose to determine the maximum supported rating if a derivative counterparty is not related to the covered bond issuer. It also highlights the applicable table based on the available remedies, as well as the ranking of termination payments.

68. If a derivative counterparty is not related to the covered bond issuer, we propose to consider that the collateral framework assessment is at least "moderate" if the derivative agreement includes an industry-standard collateral framework (e.g., an ISDA CSA) that we consider to be legally

enforceable. This means that we would not assess asset eligibility criteria or market-value or currency haircuts to support a "moderate" collateral framework assessment but would analyze these factors to support a higher assessment.

Chart 11

Derivative Counterparty Risk Analysis In Covered Bonds, Steps 3 And 4 For Counterparties Unrelated To The Covered Bond Issuer



RRL--Reference rating level.

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Related counterparties with senior termination payments

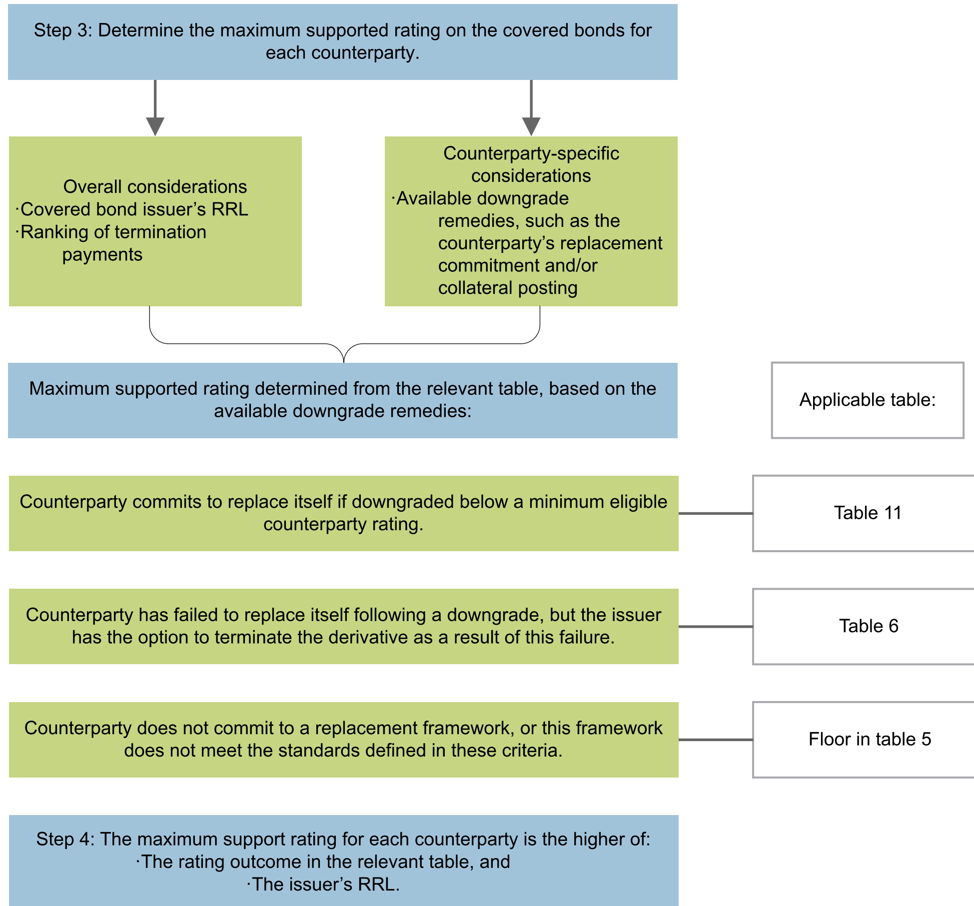
69. For derivatives with counterparties that are related to the covered bond issuer, we would generally apply the same methodology we would use for assessing derivative counterparty risk in other structured finance securities. However, if termination payments rank senior following an ATE or the counterparty's default, we consider that this may represent a lesser risk factor than for structured finance securities. At higher covered bond issuer rating levels, the impact of the senior ranking of the termination payments is offset by the issuer's incentive to support the covered bond program and its potential ability to provide an alternative remedy--such as increased credit

enhancement--if it cannot replace itself once downgraded below the minimum eligible counterparty rating.

70. Chart 12 sets out our proposed analysis for derivatives with senior termination payments with counterparties that are related to the covered bond issuer.

Chart 12

Derivative Counterparty Risk Analysis In Covered Bonds, Steps 3 And 4 For Counterparties Related To A Covered Bond Issuer With Senior Termination Payments



RRL--Reference rating level.

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APPENDIXES

Appendix 1: Adjusting The Maximum Supported Rating To Reflect Senior Termination Payments

71. If termination payments rank senior, then the maximum supported rating will generally be lower

than if the termination payments were subordinated. The proposed maximum supported ratings are shown in tables 5 and 6 below. In some cases, a 'AAA' rating may be supported, based on a higher replacement trigger than would support a 'AAA' rating if termination payments were subordinated.

Table 5

Maximum Rating Supported By The Combination Of Replacement Commitment And Collateral Posting

If termination payments are senior

	Maximum supported rating			
	"Strong" collateral	**"Adequate" collateral**	**"Moderate" collateral**	**"Weak" collateral**
Replacement trigger				
AAA	AAA	AAA	AAA	AAA
AA+	AAA	AAA	AAA	AAA
AA	AAA	AAA	AAA	AAA
AA-	AAA	AAA	AAA	AA+
A+	AAA	AAA	AA+	AA
A	AA+	AA	AA-	A+
A-	AA	AA-	A+	A
BBB+	A+	A	A-	BBB+
BBB	A-	BBB+	BBB	BBB
BBB-	BBB+	BBB	BBB-	BBB-
Floor to supported rating	Counterparty rating + 1 notch	Counterparty rating	Counterparty rating	Counterparty rating
Maximum supported rating is equal to the floor above in the following cases				
Replacement trigger at 'BB+' or below				
Replacement commitment does not meet minimum standard				
No replacement commitment				

Table 6

Senior Termination Payments: Notch Uplift For Ratings Supported By Collateral Posting Framework And The Issuer's Right To Terminate The Derivative

Strength of collateral framework	**Proposed uplift above counterparty rating**
"Strong"	Two notches
"Adequate"	One notch
"Moderate" or "weak"	No uplift

Appendix 2: Tables For Determining The Maximum Supported Rating For Derivative Counterparties In Covered Bond Programs

Counterparties unrelated to the covered bond issuer

72. We differentiate the maximum supported rating by assessing the concentration of exposures to derivative counterparties unrelated to the covered bond issuer (see tables 7, 8, 9, and 10). We generally consider that counterparty exposures are concentrated if there is exposure to a single counterparty for which the total net notional amount is greater than 25% of the total net notional amount of derivatives with unrelated counterparties. If no single counterparty concentration exceeds this 25% threshold, we would consider the exposures to be diversified.

Table 7

Covered Bonds With Unrelated Derivative Counterparties: Maximum Rating Supported By The Combination Of Replacement And Collateral Posting

Subordinated termination payments

	Covered bond issuer RRL (concentrated/diversified)			
Replacement trigger (counterparty rating)	**A and above/ A- and above**	**A-/ BBB+**	**BBB+/ BBB**	**BBB and below/ BBB- and below**
"Strong" collateral framework				
A and above	AAA	AAA	AAA	AAA
A-	AAA	AAA	AAA	AAA
BBB+	AAA	AAA	AAA	AAA
BBB	AAA	AAA	AA+	AA
BBB-	AA+	AA	AA-	A+
Subject to minimum uplift above counterparty rating	3 notches	3 notches	3 notches	3 notches
"Adequate" collateral framework				
A and above	AAA	AAA	AAA	AAA
A-	AAA	AAA	AAA	AAA
BBB+	AAA	AAA	AA+	AA
BBB	AAA	AA+	AA	A+
BBB-	AA+	AA	A+	A-
Subject to minimum uplift above counterparty rating	3 notches	2 notches	2 notches	2 notches
"Moderate" collateral framework				
A and above	AAA	AAA	AAA	AAA
A-	AAA	AAA	AA+	AA+
BBB+	AAA	AA+	AA	AA-
BBB	AAA	AA	A+	A
BBB-	AA+	AA-	A	BBB+

Table 7

Covered Bonds With Unrelated Derivative Counterparties: Maximum Rating Supported By The Combination Of Replacement And Collateral Posting (cont.)

Subordinated termination payments

	Covered bond issuer RRL (concentrated/diversified)			
Replacement trigger (counterparty rating)	**A and above/ A- and above**	**A-/ BBB+**	**BBB+/ BBB**	**BBB and below/ BBB- and below**
Subject to minimum uplift above counterparty rating	3 notches	2 notches	1 notch	1 notch

RRL--Reference rating level.

Table 8

Covered Bonds With Unrelated Derivative Counterparties: Maximum Rating Supported By The Combination Of Replacement And Collateral Posting

Senior termination payments

	Covered bond issuer RRL (concentrated/diversified)			
Replacement trigger (counterparty rating)	**A and above/ A- and above**	**A-/ BBB+**	**BBB+/ BBB**	**BBB and below/ BBB- and below**
"Strong" collateral framework				
AA and above	AAA	AAA	AAA	AAA
AA-	AAA	AAA	AAA	AAA
A+	AAA	AAA	AAA	AAA
A	AAA	AAA	AAA	AA+
A-	AAA	AAA	AA+	AA
BBB+	AAA	AA+	AA	A+
BBB	AAA	AA	A+	A-
BBB-	AA+	AA-	A	BBB+
Subject to minimum uplift above counterparty rating	3 notches	2 notches	2 notches	1 notch
"Adequate" collateral framework				
AA and above	AAA	AAA	AAA	AAA
AA-	AAA	AAA	AAA	AAA
A+	AAA	AAA	AAA	AAA
A	AAA	AAA	AA+	AA
A-	AAA	AA+	AA	AA-
BBB+	AAA	AA+	AA-	A
BBB	AAA	AA	A+	BBB+
BBB-	AA+	AA-	A	BBB
Subject to minimum uplift above counterparty rating	2 notches	1 notch	1 notch	0 notches
"Moderate" collateral framework				
AA and above	AAA	AAA	AAA	AAA

Table 8

Covered Bonds With Unrelated Derivative Counterparties: Maximum Rating Supported By The Combination Of Replacement And Collateral Posting (cont.)

Senior termination payments

	Covered bond issuer RRL (concentrated/diversified)			
Replacement trigger (counterparty rating)	**A and above/ A- and above**	**A-/ BBB+**	**BBB+/ BBB**	**BBB and below/ BBB- and below**
AA-	AAA	AAA	AAA	AAA
A+	AAA	AAA	AAA	AA+
A	AAA	AA+	AA	AA-
A-	AAA	AA	AA-	A+
BBB+	AAA	AA	A+	A-
BBB	AAA	AA	A	BBB
BBB-	AA+	AA-	A-	BBB-
Subject to minimum uplift above counterparty rating	1 notch	0 notches	0 notches	0 notches

RRL--Reference rating level.

Table 9

Covered Bonds With Unrelated Counterparties: Supported Uplift Above The Counterparty Rating

Based on the collateral-posting framework and the issuer's right to terminate following a failure to replace

	Covered bond issuer RRL (concentrated/diversified)			
Ranking of termination payments	**A and above/ A- and above**	**A-/ BBB+**	**BBB+/ BBB**	**BBB and below/ BBB- and below**
"Strong" collateral framework				
Subordinated	5 notches	5 notches	5 notches	5 notches
Senior	5 notches	4 notches	3 notches	2 notches
"Adequate" collateral framework				
Subordinated	5 notches	4 notches	3 notches	3 notches
Senior	3 notches	2 notches	2 notches	1 notch
"Moderate" collateral framework				
Subordinated	5 notches	4 notches	3 notches	2 notches
Senior	2 notches	1 notch	1 notch	0 notches

RRL--Reference rating level.

Table 10

Covered Bonds With Unrelated Counterparties: Supported Uplift Above The Counterparty Rating

Based on the collateral-posting framework only

	Covered bond issuer RRL (concentrate/diversified)			
Ranking of termination payments	A and above/ A- and above	A-/ BBB+	BBB+/ BBB	BBB and below/ BBB- and below
"Strong" collateral framework				
Subordinated	3 notches	3 notches	3 notches	3 notches
Senior	3 notches	2 notches	2 notches	1 notch
"Adequate" collateral framework				
Subordinated	3 notches	2 notches	2 notches	2 notches
Senior	2 notches	1 notch	1 notch	0 notches
"Moderate" collateral framework				
Subordinated	3 notches	2 notches	1 notch	1 notch
Senior	1 notch	0 notches	0 notches	0 notches

RRL--Reference rating level.

Counterparties related to the covered bond issuer with senior termination payments

73. Table 11 shows the maximum supported rating in these cases as a function of the covered bond issuer's RRL and the level of the replacement trigger if the derivative agreement includes a counterparty replacement commitment with a replacement trigger of at least 'BBB.' In other cases, the maximum supported rating for a counterparty related to the issuer with senior termination payments would be the same as for a structured finance transaction.

Table 11

Covered Bonds With A Related Counterparty: Maximum Rating Supported If Termination Payments Rank Senior

	Issuer RRL					
Replacement trigger	**A+ and above**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**
"Strong" collateral framework						
A and above	AAA	AAA	N/A	N/A	N/A	N/A
A-	AAA	AAA	AAA	N/A	N/A	N/A
BBB+	AAA	AAA	AA+	AA	N/A	N/A
BBB	AA	AA	AA-	A+	A	N/A
"Adequate" collateral framework						
A and above	AAA	AAA	N/A	N/A	N/A	N/A
A-	AAA	AAA	AA+	N/A	N/A	N/A
BBB+	AA	AA	AA-	AA-	N/A	N/A

Table 11

Covered Bonds With A Related Counterparty: Maximum Rating Supported If Termination Payments Rank Senior (cont.)

		Issuer RRL					
	Replacement trigger	**A+ and above**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**
	BBB	A+	A+	A	A	A-	N/A
"Moderate" collateral framework							
	A and above	AAA	AAA	N/A	N/A	N/A	N/A
	A-	AA+	AA+	AA	N/A	N/A	N/A
	BBB+	AA-	AA-	A+	A+	N/A	N/A
	BBB	A	A	A-	A-	BBB+	N/A
"Weak" collateral framework							
	A+ and above	AAA	N/A	N/A	N/A	N/A	N/A
	A	AA	AA	N/A	N/A	N/A	N/A
	A-	AA-	AA-	AA-	N/A	N/A	N/A
	BBB+	A	A	A	A	N/A	N/A
	BBB	BBB+	BBB+	BBB+	BBB+	BBB	N/A

RRL--Reference rating level. N/A--Not applicable.

Appendix 3: Proposed Guidance Document

74. This appendix provides additional information and guidance relating to our proposed revised criteria article, and we expect to publish this information and guidance in a "guidance document." It is intended to be read in conjunction with that Request For Comment. Guidance documents provide guidance on various matters, including articulating how we may apply specific aspects of criteria; describing variables or considerations related to criteria that may change over time; providing additional information on non-fundamental factors that our analysts may consider in the application of criteria; and/or providing additional guidance on the exercise of analytical judgment under our criteria. Our analysts consider guidance documents as they apply criteria and exercise analytical judgment in the analysis and determination of credit ratings. However, in applying criteria and the exercise of analytic judgment to a specific issuer or issue, analysts may determine that it is suitable to follow an approach that differs from one described in the guidance document. Where appropriate, the rating rationale will highlight that a different approach was taken.

Guidance: General Considerations

Determining whether a counterparty exposure is fully mitigated through legal or structural considerations (see paragraph 13 of the proposed criteria)

75. The proposed criteria contemplate that the rating on the supported securities would not be constrained by the rating on the counterparty in situations where we assess that counterparty risk is mitigated by legal or structural factors. We may reach this conclusion if we assess that the supported securities would not suffer any losses in the event that the counterparty defaulted on its relevant obligations. We provide some examples of this analysis below.

Example 1: mitigation of the counterparty risk of a bank account provider by using trust or custodial arrangements

76. We may conclude that the exposure to a bank account provider is fully mitigated if we believe that the cash or securities deposited in a trust or custodial institutions would be subject to laws and regulations that isolate these accounts from the counterparty's insolvency risk.

77. To date, we have assessed that accounts holding securities may be isolated from the counterparty's default risk, particularly in the U.S., U.K., Argentina, Japan, Australia, and Mexico. In the U.S., we also consider that the counterparty risk of a bank account provider holding the issuer's cash is fully mitigated if the account provider is acting in a fiduciary capacity and the account is governed by Title 12 section 9.10(b) of the U.S. Code of Federal Regulations, or a similar U.S. state law. This requires that collateral be set aside to protect account beneficiaries of fiduciary funds held in a deposit account.

78. If the account provider is placing the issuer's cash in a deposit account that would not benefit from comparable legal protection, we would analyze the resulting counterparty risk according to the proposed criteria. If the account provider is investing the issuer's cash in securities, the issuer is exposed to credit risk and market-value risk on those securities. We analyze these risks under our criteria article, "Global Investment Criteria For Temporary Investments In Transaction Accounts," published May 31, 2012.

Example 2: coverage of counterparty risk through credit enhancement

79. Credit enhancement is an example of a structural feature that may lead us to conclude that a particular counterparty risk is fully mitigated and would not constrain the rating under the proposed criteria. To reach this conclusion, we may perform a cash flow analysis of the transaction that simulates a counterparty default, in addition to the applicable rating stresses. If this supports a rating higher than that based on reliance the relevant counterparty's performance, we would typically assign such higher rating to the notes (which would not be constrained by the rating on the counterparty). For example:

- For a derivative counterparty, our cash flow analysis would simulate the issuer's unhedged exposure to the risk that is hedged by the counterparty;
- For a liquidity facility provider, our cash flow analysis would consider a scenario where the liquidity facility is unavailable.

Example 3: government-sponsored deposit insurance schemes as a mitigant to commingling and/or set-off risks

80. Government-sponsored deposit insurance schemes may mitigate:

- Deposit set-off risks where the insurance applies to the underlying borrower's deposits; or
- Commingling risks where the insurance applies to the issuer's funds.

81. Examples of government-sponsored entities that provide deposit insurance include the Financial Deposit Insurance Corp. in the U.S., the Deposit Insurance Corp. of Japan, and the Financial Services Compensation Scheme in the U.K. Examples where the insurance mitigates commingling risks include certain residential mortgage-backed securities transactions originated by Japanese deposit-taking institutions.

82. We will consider that the issuer is not exposed to the counterparty risk of the relevant depositary institution on the insured amount if we assess that the deposit insurance will pay out unconditionally and in a timely manner. If the insurance covers the full amount of the issuer's exposure and we expect it to pay out in a timely manner, the rating on the supported securities may not be constrained in relation to the counterparty risk of the depositary institution. We may also conclude that this counterparty risk is mitigated--even if we believe that timely payment on the insurance is not certain--if our cash flow analysis demonstrates that a delay in payment will likely not result in a default on the supported security. If the insurance does not cover the full exposure, we will assess the counterparty risk exposure to the relevant depositary institution on the uninsured amount.

83. Exposures to government-sponsored deposit insurers are typically not mitigated through downgrade remedies that are common in other counterparty exposure types in structured finance transactions. If we consider that the creditworthiness of a government-sponsored deposit insurer is equivalent to that of the relevant sovereign, we do not constrain the structured finance rating under our counterparty criteria. Rather, we assess the transaction's sensitivity to sovereign default risk under our criteria for assigning structured finance ratings above the sovereign.

Examples where the counterparty risk materiality is too great to be mitigated by typical downgrade remedies (see paragraph 13 of the proposed criteria)

84. In exceptional cases, we may conclude that the exposure to a bank account provider is too material to be mitigated through downgrade remedies. For typical transaction bank accounts, the

available cash will be distributed per the transaction's payment priority on each payment date, such that the account balance at any point in time is relatively limited. However, some transaction structures may allow the issuer to accumulate larger balances in an account. In such cases, we may conclude that the exposure is too material to be mitigated if we expect that the exposure amount may remain at a similar magnitude to the total balance of the supported securities, for longer than a typical 90-calendar-day remedy period.

85. In our analysis of funded synthetic transactions, we would also typically consider that certain counterparty exposures are too material to be mitigated by typical downgrade remedies. This would be the case, for example, for certain derivatives, bank accounts holding cash collateral for longer than 90 calendar days, and other obligations of counterparties that provide functional equivalents (such as total return swaps, repurchase agreements, or investment agreements). We typically consider such counterparties in funded synthetic transactions to be substantially the sole source of repayment of the supported securities.

86. Our assessment of whether an obligation is too material to be mitigated considers the size, nature, and duration of the issuer's exposure to the counterparty. When considering the duration of an exposure, we also consider the nature of the remedy a counterparty has committed to take. If a counterparty commits to draw its obligation to cash during a remedy period, we may consider the issuer's exposure to the counterparty to be limited to the remedy period. We may, therefore, assess that, although the size of a specific exposure is material, the exposure's limited duration allows it to be mitigated. To avoid doubt, we would not assess that the exposure duration is limited to the remedy period if the counterparty commits to replace itself but does not commit to draw its obligation to cash.

87. For example, if a transaction is supported over its entire life by a material letter of credit facility, and the counterparty commits only to replace itself if downgraded below the minimum eligible counterparty rating, we may assess that the exposure is too material to be mitigated. However, if the counterparty also commits to draw the full obligation to cash if it has not replaced itself by the end of the remedy period, we may consider that counterparty risk is mitigated by the downgrade remedies. This means that we may assign a higher rating than the rating on the counterparty if supported by our analysis of the counterparty's committed downgrade remedy actions. We note, however, that implementing the draw-to-cash remedy may create a further counterparty dependency on the entity holding the drawn amount, and we would assess the materiality of this exposure and any applicable downgrade remedies or alternative mitigating factors accordingly.

Applicable counterparty rating--unrated counterparty with a rated parent (see paragraph 22 of the proposed criteria)

88. The proposed criteria contemplate that we may determine the applicable counterparty rating using "Group Rating Methodology," published Nov. 19, 2013. This analysis would consider the rating on the counterparty's group parent and the counterparty's group status. Under the proposed criteria, we will assess whether the documented downgrade remedies reflect both the rating on the parent and the counterparty's group status.

Guidance: Nonderivative Counterparties

Covering the cost of implementing downgrade remedies (see paragraph 27 of the proposed criteria)

89. Counterparties in structured finance transactions typically commit to cover any cost associated with implementing downgrade remedies, insulating the cash flows available to the rated notes from the impact of such costs. Without this commitment, our assessment of whether the implementation would result in any losses on the rated notes would follow our criteria article "Criteria Methodology Applied To Fees, Expenses, And Indemnifications," published July 12, 2012.

Classifying counterparty exposures as "minimal" or "limited" (see paragraph 30 of the proposed criteria)

90. Under the proposed criteria, a counterparty's obligation is classified as "limited" or "minimal" based on the issuer's sensitivity to the counterparty's performance on its obligation and the materiality of the issuer's counterparty exposure.

91. The following examples illustrate situations in which we may reach the conclusion that a counterparty's default on its obligation may not result in disrupted payments on the rated notes:

- The counterparty covers a risk that would not materialize as a direct consequence of the counterparty's default. An example of this would be a counterparty's obligation to fund a reserve to cover set-off risks on the securitized assets, where the issuer would only be exposed to losses if borrowers made set-off claims in the future;
- Structural features exist in the transaction that would mitigate the counterparty's default. An example of such a structural feature would be the frequent sweeping of cash amounts held on a bank account to limit the amount of cash that may accumulate on the account at any point in time. In this situation, we may assess that the resulting exposure would be small relative to the issuer's other available resources; therefore, a counterparty default would likely not directly disrupt payments on the rated notes.

92. If we have assessed that the counterparty's default on its obligation would not in itself result in disrupted payments on the rated notes, under the proposed criteria, we then assess the materiality of the exposure to the counterparty. We explain below how we generally assess the materiality of counterparty risk for those exposures that are quantified as a fixed amount and for those exposures where the amount is a function of the payment profile of the assets and the frequency of distributions to noteholders, such as typical bank account exposures.

Fixed amount

93. When the exposure amount is fixed (or capped) at a certain amount, we generally classify the sensitivity to counterparty risk relative to a materiality threshold of 5% of the original pool balance (or, for revolving structures and programs with ongoing issuance, the higher of the original and current pool balances). We classify exposures above the threshold as "limited" and exposures below the threshold as "minimal".

94. A transaction may have multiple fixed (or capped) amount exposures (e.g., a liquidity facility and a reserve fund commitment) to the same counterparty. If we assess that failure to perform on any of these obligations individually would not lead to a direct disruption in payments on the rated notes,

then we consider such exposures' materiality in aggregate relative to the 5% threshold to determine whether the exposures are collectively "limited" or "minimal". If we determine that default on any one of these obligations could itself lead to a payment disruption, we will generally classify such exposure as "limited" and exclude it from the aggregate by which we assess the remaining exposures' materiality.

95. We will generally not include in this aggregation calculation those exposures that are a function of the payment profile of the assets and the frequency of distributions to noteholders, such as for bank accounts, for which our analysis is described below.

Bank account providers with amounts that vary with the asset payment profile and are distributed to noteholders on each payment date

96. For accounts where collections from securitized assets are held, the size of the exposure to the counterparty depends on the payment profile of the securitized assets and the frequency at which the amount on the account is distributed to noteholders. For typical accounts with monthly or quarterly distributions, we generally classify the sensitivity to counterparty risk as shown in table 12 below. These classifications reflect the materiality of the exposure to a bank account provider based on the amount of cash that may accumulate for a typical asset pool payment profile.

Table 12

Typical Classification Of Exposures To Bank Account Providers

Securitized asset type	If we assess that counterparty default would directly disrupt payments on supported securities	If we assess that counterparty default would not directly disrupt payments on supported securities
Residential mortgages	Limited	Minimal
Auto loans	Limited	Minimal
Auto lease	Limited	Limited (may also be Minimal in the absence of concentrations of residual value maturities in any given month)
Student loans	Limited	Minimal
Consumer loans	Limited	Minimal
Credit cards	Limited	Limited
Trade receivables	Limited	Limited
Commercial mortgages	Limited	Minimal
Auto dealer floorplan loans	Limited	Limited
Equipment loans and leases	Limited	Minimal
Corporates/SMEs (CDO/CLO)	Limited	Minimal
Manufactured housing	Limited	Minimal

SME--Small- to medium-size enterprise.
CDO--Collateralized debt obligation.
CLO--Collateralized loan obligation.

97. For accounts in transactions secured by assets not covered in table 12 above or by assets listed in table 12 but that feature atypical payment profiles or structural features that may affect our typical classification, we would generally assess materiality of the counterparty risk exposure relative to the 5% materiality threshold described above. We provide guidance on the sizing considerations in the Analysis of commingling risks and potential mitigating factors section.

98. For some transactions, amounts may not be distributed to noteholders on each payment date. For example, in revolving structures, principal receipts may accumulate on an account before reinvestment. In structures where a tranche has a scheduled amortization, principal receipts that exceed the scheduled distributions may accumulate on an account. In these cases, we would generally assess materiality of the counterparty risk exposure relative to the 5% materiality threshold described above.

Commingling risks and potential mitigating factors (see paragraphs 13 and 30 of the proposed criteria)

Legal and structural factors that mitigate commingling risks (see paragraph 13 of the proposed criteria)

99. Investors may be exposed to payment delays (liquidity risk) or losses (credit risk) if remittances from the underlying assets in a structured finance transaction are collected into a servicer account and the servicer becomes the subject of insolvency proceedings, i.e. commingling risk. In structured finance transactions, this risk is primarily related to a servicer insolvency scenario. However, it may also arise if a third party holding cash on the servicer's behalf, depending on the servicer's obligations to the issuer, becomes insolvent.

100. Under the proposed criteria, we may conclude that such commingling risks do not constrain the rating on the supported securities because:

- Our legal analysis concludes that the issuer would not be exposed to commingling risk upon a counterparty insolvency;
- We consider that structural mechanisms effectively protect the issuer from any loss or delay on receiving funds upon the counterparty's insolvency; or
- Our cash flow analysis demonstrates that the supported securities could withstand any loss or delay on the commingled funds.

Assessment of structural mitigants (see paragraph 13 of the proposed criteria)

101. Structural mechanisms that we believe may reduce or eliminate the issuer's exposure to servicer commingling risk include:

- A commitment to deposit all collections that the issuer is entitled to receive into a deposit account with an eligible counterparty in the issuer's name within two business days of receipt. However we must believe that no further amounts would be lost due to borrowers continuing to make payments to the servicer following a servicer default. Both the potential exposure amount and impact on the supported security are considered in determining whether this two-day exposure is consistent with the rating on the security without the benefit of additional mitigating factors.
- The provision of a cash reserve, additional credit enhancement, or a liquidity facility to cover potential delays.
- Obligor payments made directly into an account in the issuer's name.
- Obligor payments made into a lockbox account to which the servicer has limited access until the funds are transferred into a bank account in the issuer's name.

102. If commingling risk is mitigated through cash reserve funds, we will assess whether the amount funded covers commingling risk fully or partially. Our assessment would consider both the

amounts that may accumulate with the servicer before its insolvency and any amounts that may be paid to the servicer following its insolvency. To assess the amounts that may accumulate with the servicer, we will generally consider the borrower payment schedules on the securitized assets and the frequency at which the servicer will pay the issuer the collections it is entitled to receive. To determine whether the issuer may be exposed to losses on (or delays in receiving) collections paid to the servicer after its insolvency, we may consider any legal or operational factors that mitigate this risk, such as any automatic redirection of payments. If we believe there is a risk of loss or delay after the servicer's insolvency, we would assess the time required to notify borrowers to switch their payments to determine the magnitude of the potential loss or delay to the issuer.

Classifying exposures as "minimal" or "limited" (see paragraphs 27 and 30 of the proposed criteria)

103. We may also assess under the proposed criteria that commingling risks are mitigated up to a certain rating level, the maximum supported rating, based on a counterparty's commitments to implement certain remedies if it is downgraded below a minimum eligible counterparty rating. The proposed criteria provide the framework for determining the maximum supported rating, based on the minimum eligible counterparty rating and our classification of the counterparty risk exposure. Typical downgrade remedies include:

- The replacement of the servicer; or
- Implementing structural mechanisms that effectively protect the issuer from any loss or delay on receiving funds upon the counterparty's insolvency.

104. In our assessment of the issuer's exposure to commingling risks as "limited" or "minimal" under the proposed criteria, we would determine whether the loss or delay in receiving (as relevant) the amount of funds at risk upon a servicer insolvency would in itself result in disrupted payments on the rated notes. If so, we would classify the exposure as "limited." If not, we would assess the exposure's materiality (see guidance above regarding the consideration of materiality for exposure sizes that are a function of the payment profile of the assets and the frequency of distributions to noteholders).

105. **Third-party collection accounts** If a servicer holds collections received from securitized assets in an account with a third party, before transferring these collections to the issuer, we also may assess whether this arrangement exposes the issuer to the counterparty risk of this third party in addition to its exposure to the servicer counterparty risk.

106. In particular, in certain jurisdictions, servicers often provide (for the issuer's benefit) a declaration of trust over the account or an equivalent mechanism to protect the issuer's collections access from securitized assets held with a third party if the servicer becomes insolvent. While these mechanisms may mitigate the issuer's exposure to the servicer counterparty risk, they do not protect the issuer from the insolvency of the third-party account provider.

107. If the servicer must still pay the issuer any amounts that would be lost following this third-party account provider's default, we may consider that the issuer is only exposed to the counterparty risk of the servicer and not the third-party account provider. On the other hand, if the third party's insolvency could result in a loss to the issuer, we may consider the issuer to be exposed to bank account counterparty risk; in such cases, we would assess any available remedies or mitigating factors to determine the maximum supported rating.

Guidance: Derivative Counterparties

Analysis of the enforceability of the collateral arrangement (see paragraphs 43-48 of the proposed criteria)

108. We may revise our enforceability assessment over time if new facts emerge that increase or decrease our view of the likelihood of successfully enforcing the collateral arrangement in a counterparty default scenario (e.g., a change in law or relevant new case law emerges). If we do revise our enforceability view, this would likely affect our assessment across transactions with collateralized derivatives in the relevant jurisdiction.

109. Our analysis of the enforceability of the collateral arrangement considers whether the collateral posted by the derivative counterparty is held by an independent third party (i.e., custodian). If applicable, we will analyze the issuer's exposure to the counterparty risk of the custodian. To the extent that we are relying on custodian downgrade remedies (rather than legal factors) to mitigate the risk, we would generally expect to assess the exposure as "limited" (rather than "minimal") under these proposed criteria. This is because a default of the entity holding the collateral would render that collateral unavailable to the issuer. The issuer would therefore be unable to return collateral to the derivative counterparty if required or to use the collateral to replace the derivative counterparty if it defaults.

110. A derivative counterparty may only be required to post collateral if its rating is lowered below a certain threshold. As a result, the ultimate custodian may not be identified at the time the derivative is executed, or the documentation may identify an initial custodian that is related to the derivative counterparty. If we assess that the issuer's exposure to the counterparty risk of the account provider is mitigated through the documented minimum eligible counterparty rating for the custodian, we consider that the condition of independence is met. This is because the minimum eligible counterparty rating supports, in our view, that the ultimate custodian will be independent from the derivative counterparty if the derivative counterparty approaches default.

Assets eligible to be posted as collateral (see paragraph 55 of the proposed criteria)

111. We currently consider that local currency bonds (coupon-bearing or zero-coupon bonds that mature within one year) issued by the following sovereigns would be eligible while their local currency sovereign ratings remain at least as high as 'A':

- Australia;
- Austria;
- Belgium;
- Canada;
- Denmark;
- Finland;
- France;
- Germany;
- Hong Kong;

- Japan;
- Netherlands;
- Norway;
- Singapore;
- South Korea;
- Sweden;
- Switzerland;
- The U.K.; and
- The U.S.

112. We also consider that coupon-bearing covered bonds are eligible if they meet all of the following conditions:

- Their S&P Global Ratings long-term rating is at least 'AA-';
- They are eligible as level one high-quality liquid assets under the counterparty's national liquidity coverage ratio regulation; and
- They are not issued by the counterparty or an affiliate of the counterparty.

Quantitative assumptions for the coverage of volatility risks after a counterparty default (see paragraphs 51 to 55 of the proposed criteria)

Market-value and currency haircuts

113. The proposed criteria set out the factors considered in the calibration of quantitative assumptions for market-value and foreign exchange haircuts commensurate with each collateral framework assessment better than "weak". The output of this calibration is shown in tables 13 and 14.

Table 13

Applicable Market Value Haircuts For Eligible Assets Under The Proposed Criteria(i)

Remaining term to maturity (years)	[0; 1]	(1; 3]	(3; 5]	(5; 7]	(7; 10]	(10; 15]	(15; 20]	>20
Proposed haircuts for "strong" collateral assessment (%)								
Sovereigns	8.0	10.0	12.0	14.0	18.0	19.0	20.0	21.0
Covered bonds	12.0	15.0	18.0	21.0	27.0	28.5	30.0	31.5
Proposed haircuts for "adequate" collateral assessment (%)								
Sovereigns	5.0	5.0	7.0	7.0	8.0	8.0	9.0	10.0
Covered bonds	7.5	7.5	10.5	10.5	12.0	12.0	13.5	15.0
Proposed haircuts for "moderate" collateral assessment (%)								
Sovereigns	0.5	2.0	2.0	4.0	4.0	4.5	5.0	5.5
Covered bonds	1.0	4.0	4.0	8.0	8.0	9.0	10.0	11.0

(i)The symbol "(" denotes exclusion of the first data point in the range, and the symbol "]" denotes the inclusion of the last data point in the range.

Table 14

Currency Haircuts Commensurate With Each Collateral Framework Assessment

"Strong"	"Adequate" or "moderate"
20%	8%

114. Currently, eligible currencies for posting collateral and that are consistent with the haircuts set out in table 14 above are:

- U.S. dollar;
- Euro;
- Japanese yen;
- British pound;
- Canadian dollar;
- Danish krone;
- Norwegian krone;
- Swedish krone;
- Swiss franc;
- Australian dollar;
- New Zealand dollar;
- Singapore dollar;
- Hong Kong dollar; and
- Korean won.

Examples of additional factors that may limit the maximum supported rating (see paragraph 14 of the proposed criteria)

Limiting the collateral framework assessment for derivatives with increased volatility risks

115. An example where we may apply such flexibility is where we assess that a specific type of swap may exhibit higher volatility risks than the typical interest-rate and currency derivatives seen in established structured finance markets, which are reflected in volatility buffer assumptions included in the proposed criteria. We may reach such a conclusion, for example, for transactions in jurisdictions where the use of derivatives in structured finance is less established. In such cases, we assess the collateral framework as no better than "adequate" depending on our assessment of the incremental volatility risk relative to typical derivatives in established structured finance markets. We would assess the collateral framework as "moderate" if we consider that there is no effective coverage of volatility risks that may arise after the counterparty's default. In extreme cases, we may assume a collateral framework assessment as low as "weak". A "weak" assessment reflects our view that the likelihood that collateral could be used to enter into a new hedge following a counterparty default is insufficient to warrant any ratings uplift.

Issuer fails to exercise termination rights following a counterparty's failure to replace itself

116. An example where we may apply such flexibility to assign a weaker collateral framework assessment is when we monitor a transaction in which a counterparty has not replaced itself and the issuer has not exercised its termination right to replace the counterparty. We would assign a weaker collateral framework assessment than would otherwise be supported if we conclude that this failure shows that the issuer will likely not secure a replacement if the counterparty defaults. We may reach such a conclusion, for example, if the issuer has not secured a replacement counterparty even though significant time has elapsed following the initial downgrade or if the counterparty's creditworthiness has continued to deteriorate following the initial downgrade.

Material liquidity risks upon counterparty default (other than swap termination payments)

117. Another example where we may allow for a downward adjustment to the collateral framework assessment is if we believe a transaction would be exposed to a material liquidity risk between the initial swap counterparty's default and the entry into a swap with a new counterparty (other than the liquidity risk associated with senior termination payments, which are already captured in the proposed criteria). We would generally apply such an adjustment where the derivative counterparty's creditworthiness has deteriorated and is closer to default (e.g., where the counterparty's rating is below the minimum eligible counterparty rating and has failed to replace itself within the remedy period) because we would have some visibility as to the circumstances that an issuer would be facing in a counterparty default scenario (particularly in terms of the rate environment).

118. In particular, we may apply this adjustment if we believe the issuer will likely not make payments on the rated securities without a hedge in the short-term aftermath of a counterparty default. To assess the potential for and materiality of liquidity risk in a counterparty default scenario, we may consider:

- The transaction's payment mechanics, particularly whether principal receipts may be used to make interest payments on the notes;
- Any cash reserves in the transaction that would provide available liquidity;
- The issuer's ability to use the collateral received from the counterparty to make interest payments on the notes before entering into a new swap;
- The materiality of the swap cash flows to the transaction; and
- Any other structural features that may support or hinder the issuer's liquidity profile in a counterparty default scenario (e.g., excess spread between interest received on the assets and interest paid on the liabilities may provide short-term liquidity to the issuer).

119. In these cases, we would determine the adjustment to the maximum supported rating by benchmarking the magnitude of the liquidity risk to that of senior-ranking termination payments as follows:

- If we identify a liquidity risk of commensurate magnitude to the senior termination payments, we may align the maximum supported rating with the rating that would be supported if termination payments were senior, all else equal.
- If we identify a liquidity risk that is material but less so than a senior termination payment, we may determine the maximum supported rating between a situation with senior termination payments and a situation with no liquidity risk.
- In assessing a liquidity risk's materiality, we may consider the potential magnitude of the liquidity risk relative to the interest payments the issuer owes on the supported securities.

Assessing legacy exposures under the proposed criteria

Derivative exposures--currently supporting 'AAA' security ratings

120. Both current and proposed criteria assess the counterparty's replacement commitment and collateral-posting framework in determining the maximum supported rating. They also consider that a lower minimum eligible counterparty rating may be offset by a stronger collateral framework and vice versa. The current criteria present different combinations of minimum eligible counterparty ratings and volatility buffer amounts as replacement options 1/2/3/4. The proposed criteria classify the collateral framework into four buckets ("strong"/"adequate"/"moderate"/"weak"). In most cases, the combinations that support 'AAA' ratings under current criteria would continue to do so under the proposed criteria. In some cases, the recalibration of volatility buffers under the proposed criteria may lead to a rating impact. Our recalibration focuses the volatility buffer assumptions on the volatility risk of each derivative type over a specified timeframe (90 calendar days for a "strong" assessment and 10 business days for "adequate"). Our current criteria include a less-specific calibration of volatility buffer assumptions and are focused on the analysis of a counterparty's economic incentive to replace itself following a downgrade. This recalibration generally leads the volatility buffer assumptions commensurate with a "strong" assessment to be lower than our current criteria's 'replacement option 1' volatility buffer assumptions for interest rate swaps but higher for floating-floating currency swaps.

121. Table 15 provides some general guidance on the mapping of maximum supported ratings from the current to the proposed criteria for different swap types commonly seen in structured finance transactions. This mapping considers all proposed changes to our assumptions in the sizing of collateral-posting amounts. We have compared the total collateral amount that would be posted for:

- A derivative reflecting each replacement option under our current criteria, and
- A derivative reflecting each collateral framework assessment under the proposed criteria.

This comparison of the total collateral amount means that a shortfall in one of the assumptions (such as market-value or currency haircuts) may be offset by an excess in another (such as the documented volatility buffer assumptions).

Mapping Of Replacement Options In Current Criteria To Maximum Supported Rating Outcomes Under Proposed Criteria

Table 15

	Replacement option under our current counterparty criteria			
	Option 1	**Option 2**	**Option 3**	**Option 4**
Interest rate swaps	If collateral can only be posted in the currency of the counterparty's obligation: Collateral framework assessment is "strong." No rating impact. If collateral can be posted in a different currency to that of the counterparty's obligation: Collateral framework assessment is "adequate." Potential 2 notch downgrade.	Collateral framework assessment is "adequate." No rating impact.	Collateral framework assessment is "moderate. " No rating impact.	Collateral framework assessment is "weak." No rating impact.

Mapping Of Replacement Options In Current Criteria To Maximum Supported Rating Outcomes Under Proposed Criteria (cont.)

Cross-currency swaps--fixed-floating	Collateral framework assessment is "adequate. " A "strong" assessment may be supported if the counterparty can only post collateral in the currency of its obligation, depending on the maturity of the swap. Potential 2 notch downgrade.	Collateral framework assessment is "adequate." No rating impact.
Cross-currency swaps--floating-floating	Collateral framework assessment is "adequate" or "moderate" depending on maturity. Potential 2-3 notch downgrade.	Collateral framework assessment is "moderate." Potential 1 notch downgrade.
Cross-currency swaps--fixed-fixed	Collateral framework assessment is "strong." No rating impact.	Collateral framework assessment is "adequate." No rating impact.

122. Existing swap documents often allow the counterparty to switch between the replacement options in our current criteria. This means that the counterparty may commit to post higher collateral amounts but to replace itself below a lower minimum eligible counterparty rating, while maintaining the same rating on the supported securities. Under our current criteria, S&P Global Ratings must be notified of such option switches. Under the proposed criteria, we determine the maximum supported rating based on the currently applicable replacement and collateral-posting provisions. To the extent that the counterparty elects to switch to a different combination of replacement and collateral-posting provisions in the future, we will assess at that point whether the new provisions modify the maximum supported rating. Table 15 shows situations where we expect a potential rating impact under the proposed criteria, based on the currently applicable provisions, whereas a different replacement option would support the current rating. If we receive notification that a counterparty has elected to switch to a replacement option that does support the current rating, the proposed criteria would not affect the rating supported by that counterparty.

Related Criteria And Research

Criteria To Be Fully Superseded

- Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013

Criteria To Be Partially Superseded

- Methodology And Assumptions For Market Value Securities, Sept. 17, 2013

Related Criteria

- Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Special-Purpose Vehicle Margin Requirements For Swaps--Methodology And Assumptions, Oct. 10, 2017
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Guarantee Criteria, Oct. 21, 2016
- Ratings Above The Sovereign – Structured Finance: Methodology And Assumptions, Aug. 8, 2016
- Covered Bonds Criteria, Dec. 9, 2014
- Global Framework For Cash Flow Analysis Of Structured Finance Securities, Oct. 9, 2014
- Counterparty Risk In Terminating Transactions, Aug. 15, 2014
- Group Rating Methodology, Nov. 19, 2013
- Methodology Applied To Bank Branch-Supported Transactions, Oct. 14, 2013
- Stressing Foreign Currency Risk In Unhedged Or Partially Hedged Structured Finance Transactions, Sept. 23, 2013
- Global Derivative Agreement Criteria, June 24, 2013
- Derivative Product Companies Rating Methodology And Assumptions, March 22, 2013
- Criteria Methodology Applied To Fees, Expenses, And Indemnifications, July 12, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology: Credit Stability Criteria, May 3, 2010
- Understanding S&P Global Ratings' Rating Definitions, June 3, 2009
- Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities, Oct. 1, 2006

Related Research

- Assessing Credit Quality By The Weakest Link, Feb. 13, 2012

This report does not constitute a rating action.

The proposed criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Once proposed criteria become final, their use is determined by issuer- or issue-specific attributes as well as our assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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