Feedback Report

Rating Methodology for Counterparty Risk in Structured Finance Transactions Call for Comment

www.scoperatings.com

Scope summarises feedback and responses to its counterparty risk methodology

Scope Ratings (Scope) would like to thank market participants who provided feedback on the "Rating Methodology for Counterparty Risk in Structured Finance Transactions" published as a call for comments on 15 June 2015. This report addresses comments received and follows the end of our call-for-comment period on 31 July 2015.

We comment on two responses received but do not reproduce the feedback as respondents have asked them to remain confidential.

After careful consideration of comments, we have decided not to amend the methodology as the issues raised are already covered. The final rating methodology confirms the core principles of our rating approach. Scope has decided to publish the methodology as presented in the call for comments into its final "Rating Methodology for Counterparty Risk in Structured Finance Transactions".

Summary of clarifications and comments

Triggers based on other ratings than Scope's

Issue: Respondents asked for the flexibility to reference other ratings than Scope's for trigger events.

Response: Rating-based counterparty replacement triggers can simplify the monitoring of a likely credit impact for the rated notes. Trigger levels referencing ratings by Scope provide a high degree of certainty that a counterparty's negative credit migration will not impact the rating of the notes. In case trigger levels reference other ratings, a transactions rating might not be shielded as effectively.

Rationale: We take comfort from the presence of a replacement trigger as they can soften the negative credit implications of the counterparty exposure. Scope assesses the credit risk of the counterparty based on a Scope public rating and if not available, based on an internal assessment by Scope.

Scope takes all structural features available in the transaction to mitigate counterparty risk exposure into account, such as collateralisation, credit enhancement, but also risk substitutions mechanisms that are not based on a Scope rating. In that case, Scope assesses whether replacement mechanisms available in the transaction provide for a replacement of the counterparty that is sufficiently early to protect the transaction. Scope performs such analysis in the context of the transaction taking the nature of the referenced entity bank (resolvability) into account, as well as materiality and remaining length of exposure to the counterparty.

Type of effective remedies

Issue: Comments received suggested that effective remedies should be expanded and allow for "open up clauses" that provide alternative remedies.

Response: We provide examples of remedies that are not exhaustive. Transaction parties may choose to provide mitigants as presented in the methodology, but are not obliged to follow this methodology.

Analysts

Karlo Fuchs
k.fuchs@scoperatings.com

Guillaume Jolivet
g.jolivet@scoperatings.com

Scope Ratings AG

The Gridiron Building, 8th floor
One Pancras Square
London N1C 4AG
T: +44 203 714 4980

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300

info@scoperatings.com
www.scoperatings.com

Table of Contents

Rationale: Scope's counterparty risk framework is not mechanistically stipulating the suggested remedies as sole risk mitigants. When assessing alternative proposals we seek to understand how the documentation addresses potential adverse credit impacts and compare the proposal against the methodology to establish our rating opinion. If a transaction can be effectively shielded from an adverse credit event by such clauses, this is reflected in our credit opinion.

Collateral posting

Issue: Respondents asked for more formal guidelines (such as specific formulas) on how to establish rating commensurate collateral postings. Collateral posting addresses the potential credit risk of the derivative counterparty in case the derivative is in the money.

Response: As a rating agency we do not require specific collateral amounts. Our credit opinion reflects whether the amounts proposed by the transaction parties sufficiently mitigate the potential risk introduced, however.

Rationale: As a core principle of the counterparty rating methodology we acknowledge that there is no "one-size-fits-all" approach to mitigate counterparty risk. To assess whether the proposed collateralisation amounts are sufficient to mitigate potential credit risk – until the replacement of the counterparty is effected –we analyse the collateral amounts in the context of the transaction.

Generally, the adequate determination of the derivatives mark-to-market valuation (mtm) is the starting point of this assessment. We also incorporate in the assessment whether transaction parties have agreed on adequately sized add-ons. The add-on should address the likely mtm volatility of the derivative until the next revaluation date (volatility buffer).

Most structured finance derivatives are bespoke compared to standardised derivatives cleared on exchanges. Prescriptive and standardized collateralisation formulas do not typically allow capturing structured finance transaction specific aspects.

Proposed collateral amounts should reflect established market practices in the securitisation industry and differentiate between derivative types, maturity of the derivative and its size in respect to the relevant market. Agreed volatility buffers should also reflect the rating of the security the derivative is expected to support. For example, volatility buffers for derivatives supporting highly rated transactions have to be larger to cover "tail" events. Documentation of the collateralisation approach in the credit support agreements allows an independent validation and easier replacement. Documentation should be provided to Scope at closing.

Replacement period

Issue: Respondents commented on the envisaged 14 day replacement period as being operationally challenging and suggested alternative timings.

Response: Replacement timings provide a mitigant to continued credit deterioration after are trigger has been hit. If the replacement were to take longer, Scope would consider whether collateralisation has been provided to protect against further credit migration.

Rationale: To avoid contagion of the transaction after a trigger event, we envisage remedies coming on line as soon as possible. Depending on the type and complexity of the counterparty exposure, replacement timings can slip. Sufficient collateralisation until the replacement can provide an effective mitigant.

It should be noted that once a trigger has been breached and there was no replacement within the stipulated timeframe, Scope does not automatically downgrade the rated notes. We consider efforts undertaken and the resulting rating implications of the remaining exposure to the counterparty on a case-by-case basis.

Further guidance on expected wording in transaction documents

Issue: Respondents asked for further guidance in wording transaction documents

Response: We will not provide guidance on how a document should be worded to comply with our methodology.

Rationale: Transaction parties may choose to contract based on wording of their preference. As a rating agency we do not require a specific wording, nor are we party to the transaction. When we form our credit opinion we assess whether the provided wording is sufficiently clear. We seek to understand whether the proposed wording introduces ambiguities when interpreting and to what extent proposed mitigants address relevant aspects as detailed in our methodology.

Disclaimer

Scope Ratings AG

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300

info@scoperatings.com
www.scoperatings.com