Criteria for Rating Caps in Structured Finance Transactions

Cross-Sector Criteria

Scope

Ratings Sometimes Capped: India Ratings and Research (Ind-Ra) sometimes receives requests to rate structured finance (SF) transaction proposals, where the agency may view certain characteristics of the transaction as incompatible with the targeted rating categories. To protect the integrity and stability of SF ratings – especially those in the high investment-grade categories – Ind-Ra's ratings may be subject to a rating cap in certain cases or the notes may not be rateable at all.

Criteria Not Prescriptive: Each transaction proposal will have specific circumstances and characteristics, structural features and credit protection. Due to the potential degree of variety across SF asset classes, this criteria report does not define highly prescriptive and granular rules that apply in all circumstances.

Framework of Principles: The report provides a higher level framework of principles within which Ind-Ra's SF analysts will operate when assessing transaction proposals. In certain cases, transaction proposals will not achieve high investment-grade categories on principle, regardless of the degree of credit protection or structural mitigation around the notes concerned.

Key Rating Drivers

Portfolio and Data Quality: When there is insufficient originator and/or market-wide data, or if the portfolio quality is poor (particularly if combined with extreme portfolio concentration).

Asset Concentration: Caps will be considered if a transaction is fully or materially dependent on the performance of a single industry, a small geographic region or very few obligors, especially if these are combined with low credit quality.

Legal Terms and Conditions: The transaction's terms and conditions can include elements that Ind-Ra considers incompatible with the integrity of ratings at a certain category, or with any ratings.

Excessive Market Value Exposure: The cap considerations are dependent on the degree and type of market value exposure, as well as the liquidity or market value risk of the underlying assets.

Third-Party Dependency: Ratings may be constrained by the credit quality of third parties if the transaction performance depends, to a substantial degree, on their continued performance.

Incentives of Transaction Parties: In cases of substantial misalignments of interests or incentives of important transaction parties.

Certain mitigants may provide the agency with sufficient comfort to increase a rating cap or remove one entirely. However, certain situations where a rating cap could be applied may not be capable of having any mitigants.

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India Ratings may not assign high investment-grade ratings because of a lack of historical data or poor quality data.

A rating cap may apply where the originator and/or market data is insufficient or where portfolio quality is poor.

Criteria Limitations

The scope of this criteria report applies to all transactions across SF sectors. Where Ind-Ra decides to apply a rating cap in the analysis of a transaction or market sector, this will be disclosed in the sector-specific criteria reports (if caps apply for a whole sector) and/or in the transaction-specific rating communication.

Due to the potential degree of variety across SF asset classes, principles and rules described in this criteria report are assessed on a transaction-by-transaction basis. A transaction that does not meet all of the elements described in this criteria report may still be rated, if Ind-Ra determines that such transaction is compatible with the purpose and intent of Ind-Ra's ratings and where Ind-Ra believes it has sufficient information to form such credit opinion. Any such limitation will be specified in Ind-Ra's rating communication.

Data Adequacy and Compliance

Ind-Ra's SF rating criteria assumptions are derived with reference to data specified in sector-specific rating criteria. The adequacy of such sector-specific data will be described in the sector-specific rating criteria, as well as whether limitations in data adequacy have led to a rating cap in that sector.

Portfolio and Data Quality

Rating Caps are likely where:

- less than five years of data is available; or
- new asset types are being securitised;

As part of the transaction analysis, Ind-Ra expects to receive originator-specific historical performance data relevant to the securitised asset pool for the longer of the following: (a) five years; and (b) a period covering all phases of at least one economic cycle. If sufficient originator-specific information is not available, significant market-wide historical performance data covering at least the same timeframe may often provide proxy information. This would be the case, in particular, for asset classes where the originator information may provide a limited contribution to the expected asset performance (for example, assets originated for the syndicated loan market).

However, extensively available historical information for several years may not be adequate to develop robust assumptions, if it only covers a period of extended benign economic circumstances. Such data for a long benign period allows limited insight into how performance may unfold during the downturn part of the cycle, especially since a sustained extended up-cycle could itself be indicative of a "bubble". A lengthy benign period can mean a subsequent sustained and lengthy down-cycle, as performance reverts towards the long-term trend.

Originator-specific and/or market-wide historical performance data is generally expected to cover the usual lifetime (origination to maturity) of the securitised products. However, for longer-dated assets (for example, residential mortgages), as a minimum, the period during which the majority of defaults is expected to occur, should be covered by the data. Where the data does not cover this minimum period, extrapolation of data points may in some cases be considered, but only where there is a flattening trend in the existing data, rather than one that continues to rise exponentially.

With very long-dated assets, Ind-Ra also considers how product types have evolved over the period for which data has been provided. If product features have changed significantly, then data provided regarding assets that originated 20 or more years ago (and in some cases even a shorter time) may no longer provide sufficient insight as to how assets might perform in future and, hence, become less relevant. Qualitative adjustments may be sufficient to address limited changes in product features, such that a rating cap may not apply. However, multiple layers of product change giving rise to several layers of additional risk, would be more likely to lead to a rating cap, unless there was supplementary data available to assess how such product evolution might influence future performance.

Applicable Criteria

Structured Finance Rating Criteria (October 2015)

The relevance of historical data to ratings analysis may be a particular issue for transactions with “tail end” market value risk (please refer to the *Excessive Market Value Exposure* section below). This may be a function of a fundamental systemic shift, whereby historical performance patterns may suddenly change, rendering analyses based on historical data (including observed mean and dispersion values) less predictive in assessing risk. The modelling framework will be subject to additional scrutiny in these circumstances, with a particular focus on how short-term liquidity stresses could affect the transaction.

If an originator is not capable of producing historical performance data in line with the above description for the assets targeted for securitisation, then the transaction proposal is unlikely to be rated by Ind-Ra unless strong mitigants, such as relevant market-wide data is available. In asset classes where the originator-specific underwriting criteria are expected to have a limited influence on the credit quality of the portfolio, for example syndicated loans or commercial property loans, available market data is expected to be more relevant than specific originator data.

Rating caps based on portfolio quality or attributes may also apply only to portions of a portfolio. In such a case, the transaction may still be eligible for ratings in the highest categories. In Ind-Ra’s analysis, the portion of the portfolio subject to a rating cap would effectively be expected to have 100% credit enhancement at the rating levels where the cap would be applicable.

The asset class-specific criteria reports provide a detailed description on the type and extent of data expected for each asset class that is in line with the above principles.

Possible Mitigating Factors

Proxy data may alleviate the uncertainty caused by deficient historical performance data.

If available originator data does not fully meet the standards described above, representative proxy data can be considered to supplement otherwise inadequate historical originator performance data (either in terms of length of time or direct relevance) and the rating of a transaction.

The proxy data may be data of other originators active in the same market or general industry-level data (in each case, the receivables that are the subject of the data should be similar in nature in terms of profile, as well as underwriting, origination and servicing standards). In limited cases, it might also include data available from different jurisdictions for similar asset classes, where the jurisdiction-specific aspects of the data can be addressed via reasonable adjustments.

If the jurisdiction where the receivables are originated has a significantly different legal and political regime compared to other jurisdictions where proxy data might be available, then it is unlikely that data from these jurisdictions can qualify as a proxy due to its limited relevance. In such cases, Ind-Ra is unlikely to assign a rating.

For those ratings that proceed subject to a rating cap, based on limited data supplemented with proxy information, default and loss severity assumptions will be more conservative than might usually be the case for the rating categories concerned, reflecting increased uncertainty regarding the data used to derive rating assumptions. This will be achieved by higher base case assumptions and/or higher stress levels.

Similarly, depending on the quality of historical data and/or proxy data available as described above, it may be possible to compensate for limited remaining data shortcomings through significantly higher asset stresses to reach higher investment-grade categories. Such an approach can be taken either at a criteria level if significant wider market information is available, or at a transaction-specific level.

Asset Concentration

Asset concentration concerns arise, for example, where the performance of a transaction is fully or materially dependent on a single industry, a small geographic region or very few obligors, especially if these are combined with a low credit quality. In such instances, a rating cap may apply, although it is in practical terms rarely an issue, as in most instances mitigating factors apply.

Significant concentration risks may not be consistent with high investment-grade ratings.

In case of industry concentration, Ind-Ra analyses the type of industry, or the small number of connected industries as the case may be, and analyses if it is characterised by very volatile asset performance, few players or a large degree of uncertainty (for example, through the obsolescence of key technology). If such considerations are dominant, a rating cap would apply.

Rating caps may apply because of material dependency on the performance of a single industry, a geographic region or very few obligors.

Examples where such an industry concentration rating cap may apply, include (a) a securitisation of junior commercial property loans (B-notes), particularly if in a single or related jurisdictions or regions; or (b) a securitisation of shipping loans, particularly if strongly dependent on volatile spot freight rates. An example of where such a cap may not apply would include a securitisation of senior unsecured financial institution debt, which meets the criterion of a single industry, but usually benefits from a good individual credit quality of the assets combined with expected systemic support available to this sector.

Similarly, if significant geographic concentration is present, a rating cap may also apply. This can be the case, for example, if an RMBS transaction is mainly backed by mortgages of secondary or holiday homes located in a region, or an island, dominated by the tourism industry. Ind-Ra believes that such a transaction may be subject to performance volatility that is inconsistent with 'IND AAA(SO)' ratings. Determination of whether a rating cap will apply will depend on a specific analysis of the economic profile of the region concerned. Less acute geographic concentrations may be addressed by specific analytical adjustments that would be described in related criteria or transaction-specific reports.

Rating caps may also be applicable if significant asset or obligor concentration is present in a transaction portfolio. However, this is also dependent on the asset class, the type of obligor or asset concentration and the asset credit quality. For example, the securitisation of a single high quality New York commercial property is unlikely to be subject to a rating cap due to the expected high quality, liquidity and re-sale value of the underlying property. On the other hand, a transaction backed by unsecured debt of only five 'IND BBB' rated corporate obligors is unlikely to achieve a rating above 'IND A(SO)'.

A transaction's terms and conditions can include elements incompatible with the integrity of ratings at a certain category, or with any ratings.

Nevertheless, despite their concentration in one sector, Ind-Ra does not consider standard granular SF transactions to fall into the single industry exposure discussed in this section. While it can be argued that these asset classes are to some extent exposed to a single industry (i.e. specific segments of the consumer finance market or of the commercial real estate market), they typically are characterised by markets with adequate performance data, such that robust analytical assumptions may be developed. While these sectors may be exposed to cyclical behaviour, Ind-Ra typically does not apply a rating cap because of the relatively low degree of uncertainty associated with the robust performance data. Consumer finance transactions are also exposed to a large granular pool of obligors where an opinion can be formed on collective behaviour in stressed scenarios.

Similarly, a securitisation of a diversified portfolio of high-yield corporate obligations would also not be considered to be subject to the single industry exposure. While the lower credit quality assets are subject to higher performance volatility, the transactions usually demonstrate significant industry and obligor diversification, which provides for sufficient stability, such that, in Ind-Ra's view, a rating cap does not apply.

Legal Terms and Conditions

Ind-Ra generally assigns ratings to SF instruments that address the likelihood of receiving payments in accordance with the terms and conditions on which the investor makes his investment, that is, in accordance with the terms and conditions of the transaction documents.

Nevertheless, a transaction's terms and conditions can include elements that Ind-Ra considers incompatible with high investment-grade ratings, particularly at the 'IND AAA(SO)' level, which would result in ratings being capped or limited. Some elements may be incompatible with any rating being assigned. Examples include, but are not limited to, those listed below.

Deferability of Notes

Ind-Ra's rating of SF instruments addresses the likelihood of receiving payments in accordance with the terms and conditions on which the investor makes its investment.

This means that, for principal repayment, Ind-Ra's rating addresses the repayment by the legal final maturity of the note, in accordance with Ind-Ra's rating definitions (unless there is a pre-defined principal repayment schedule which would represent an event of default if not met).

However, Ind-Ra will not assign or maintain 'IND AAA(SO)' or 'IND AA(SO)' ratings for notes that it believes have a high level of vulnerability to interest shortfalls or deferrals, even if permitted under the terms of the documents. This would generally include any deferrals that would be expected to be incurred in stress scenarios up to those associated with the rating under consideration.

In assigning 'IND A(SO)' or 'IND BBB(SO)' ratings, Ind-Ra will generally only consider ' IND A(SO)' or 'IND BBB(SO)' ratings for bonds that are not expected to incur deferrals. However, Ind-Ra will consider ratings up to 'IND A(SO)' in such circumstances if the following conditions are met:

- deferrals are permitted under the terms of the documents;
- deferrals must be fully recovered with interest well in advance of the legal final maturity in the rating scenario associated with the rating category assigned to the note;
- the deferral period is not deemed excessive;
- noteholders are viewed as being in a substantially similar economic position as if deferral had not occurred; and
- noteholders are given clear indications that deferrals may occur (for example, notes are titled 'deferrable notes' or deferral is outlined as a key risk factor of the notes in the offering documents).

Where the notes are not structured to allow for interest deferrals or shortfalls and the notes do not receive their full interest on a specified payment date, Ind-Ra will consider such notes as defaulted and the ratings of the notes would be downgraded to 'IND D(SO)' to register the default in Ind-Ra's transition studies. However, the rating of the note may subsequently be raised again from 'IND D(SO)' to reflect future performance expectations for the note. The rating may be raised in this way where all defaulted interest has been fully repaid and Ind-Ra does not expect any future interest deferrals in its expected case.

Where the notes allow for interest deferrals or shortfalls and the notes defer or capitalize interest on a specified payment date, but in Ind-Ra's opinion, funds will be insufficient to repay the deferred interest at legal final maturity, then Ind-Ra will consider default on the notes as "imminent or inevitable" and the ratings of the notes would be downgraded to 'IND C(SO)'. At the final maturity date, or termination of the transaction, if the principal, interest and deferred interest are not paid in full, then the notes will be downgraded to 'IND D(SO)' to record the default.

Ind-Ra will review cash flow results or similar analysis to assess the likelihood and frequency of

interest deferrals in expected and stress scenario cases. In each case, Ind-Ra will explain in its rating communication if the rated notes can, according to their terms, defer or capitalise interest, if — according to the rating analysis — deferral is expected to occur and whether ratings have been capped as a result.

Conditional Reduction of Interest and/or Principal

Ind-Ra has been approached with transactions where the terms and conditions specify the reduction of an interest distribution and/or the reduction of principal proceeds subject to certain credit events (for example, the reduction in an interest rate coupon if a sovereign credit defaults — thereby embedding credit risk within the definition of the interest coupon — or reducing the principal repayment if an equity index falls below a certain level). In such cases, when assigning SF ratings, Ind-Ra would depart from the principle of rating to the documents and will also consider the likelihood of such a "conditional event" occurring in combination with other structural arrangements.

This is because, in such circumstances, a credit rating opinion delivered on the "form" of the transaction as described in the transaction documents would not effectively express an opinion on the "substance" of the entire credit profile of the transaction when considered as a whole (i.e. Ind-Ra would apply the principle of "substance over form" in such cases). This could result in a rating cap or make a transaction not rateable at all.

In instances where receipt of an interest coupon (or part of an interest coupon) is conditional on credit risk (for example, the earlier example of the reduction of a coupon on the default of a sovereign credit), Ind-Ra's rating will address the credit risk embedded in the interest coupon, as well as the return of principal. This is because a credit opinion can be formed regarding the likelihood of the conditional reduction in the interest coupon. The rating would therefore be capped or limited by the credit position of the sovereign credit, if lower than that of the entity which has the obligation to make interest and principal payments.

For clarification, rating caps would not be considered if interest distribution amounts change over time because payments are based on floating interest rate or inflation indices.

Generally, Ind-Ra would be more concerned about a conditional reduction of principal payments than interest payments, although either can in Ind-Ra's view justify a rating cap or make a note not rateable.

Principal-Only Ratings and Principal-Protected Notes

Occasionally, Ind-Ra assigns ratings that only address the ultimate payment of the principal at or before the maturity, and do not include an opinion on the ongoing or ultimate payment of any interest distribution. This will typically be the case where either no coupon is specified (for example, zero-coupon notes) or where the interest distribution is conditional on the performance of market value risk, such as an equity or commodity index. Ind-Ra will not assign principal-only ratings where an interest coupon for a note exists and where Ind-Ra believes it has sufficient information to form a credit opinion, based on expectations of receiving interest from the note.

For principal-protected notes, the principal is typically protected by a pledged asset or benefits from the guarantee of the sponsoring bank. Such protection would typically be limited to the creditworthiness of the guarantor and terms of the guarantee. Additionally, Ind-Ra may consider applying rating caps to certain principal-protected notes where the transaction structure is deemed too complex or where the potential ratings do not address the lower credit quality of a subset of the underlying collateral. Any such limitation of the rating will be specified in Ind-Ra's rating communication.

Step-Up Interest Coupons

SF transactions sometimes include arrangements for a step-up interest coupon, or increased

interest margin, which is intended to provide an incentive for the originator or equity tranche holder to exercise an early prepayment option for the transaction. Usually such step-up coupons are part of the defined coupon and are paid equally with the given note class. Occasionally Ind-Ra is approached with transaction structures where it would be paid subordinate in a transaction waterfall, i.e. junior to the lowest-rated note and where the non-payment of the step-up coupon would not cause an event of default according to the transaction documentation. Arrangers may look for such step-up coupons to be "carved out" of the rating opinion, such that the rating opinion does not address the likelihood of payment of the step-up coupon. Ind-Ra will generally avoid "carving out" isolated interest cash flows from its rating opinion, as this risks a misunderstanding on the part of rating users as to what the rating opinion addresses.

As highlighted above, Ind-Ra's rating addresses the likelihood of receiving all payments according to the terms on which the money is invested, which includes any defined step-up coupon, regardless of its position in the waterfall structure of a transaction. Consequently, if a step-up coupon is paid equally with other note interest, the ratings of the notes are unaffected (the additional cash flow needed to service the debt is taken into account in the cash flow modelling). In cases where a step-up coupon is paid subordinate in a transaction waterfall, the rating will be limited by the likelihood of receiving this payment at the subordinate level. This may have the effect of a rating cap consistent with the payment of the subordinate payment or make such notes not rateable.

Practical Application – Ind-Ra may not assign ratings where there is a greater potential for the rating to be misinterpreted, misused or misrepresented. Therefore, ratings assigned to interest-only (IO) securities will be directly linked to the credit risk of the referenced tranche or tranches:

- IOs that reference a single tranche will be rated at the same level as the referenced tranche.
- IOs that reference multiple tranches will be rated at the level of the lowest referenced tranche.
- IOs that reference non-rated tranches or the entire or partial pool balance will not be assigned ratings by Ind-Ra.

Additionally, Ind-Ra will not assign interest-only ratings where principal cash flows exist and Ind-Ra believes it has sufficient information to form a credit opinion, based on expectations of receiving principal on the note.

Ratings with Limited Credit Value

A rating cap may apply if there is high potential for performance volatility of the underlying assets, as was experienced from 2008-2010.

Ind-Ra may cap ratings with material exposure to illiquid assets, knock-out triggers or reliance on an orderly liquidation in a short timeframe.

Previously Ind-Ra has been asked to assign ratings that are non-traditional, or have no or limited credit substance, due to the defined terms and conditions of the notes concerned. Examples are mortgage early redemption certificates, where investors will receive distributions only to the extent that early redemption payments are received by the SPV. The rating can only address the mechanics of whether the distribution of funds from early redemption will happen, but not express any form of credit opinion as to the extent of such redemptions. Such notes would only be subject to rating action resulting from issues related to the defined terms and conditions, rather than any real credit opinion. Such a rating would therefore be of limited value from a credit perspective and will not be assigned at any rating category.

As a general guide, if Ind-Ra cannot envision scenarios where a note's ratings may be subject to rating actions due to credit issues, it is very likely that the rating would be considered to lack any real substance. In such situations, no Ind-Ra's rating will be assigned.

IDRs for SPVs

Ind-Ra will not assign ratings to SPVs used in SF, due to their lack of standalone commercial

substance. The ratings of SF transactions relate to the obligations of the SPV issuer and do not address the SPV issuer itself, which is generally not an operating company. Any IDR that would be assigned to an SPV would be inconsistent with Ind-Ra's IDR definitions and criteria and, as described in the previous section, would lack any credit substance.

Lack of Transaction Economic Substance

It is Ind-Ra's practice not to rate transactions that exist, in the agency's view, solely for tax and/or accounting considerations without serving any fundamental economic purpose. While tax and/or financial reporting considerations are often one of a number of motivating factors for issuers of SF transactions, such considerations will generally be complementary to a principal economic motivation. In the event that there appears to be no economic substance to the structures, apart from tax-avoidance schemes or accounting window-dressing, Ind-Ra will not rate the transaction. While the agency may have no reason to believe such transactions are illegal in any way, such structures are not compatible with the purpose and intent of Ind-Ra's ratings.

Excessive Market Value Exposure

A rating cap may be applied depending on the degree and type of market value exposure as well as the liquidity or market value risk of the underlying assets.

The agency identifies as particularly problematic those transactions with illiquid assets and/or knock-out market value triggers. In the latter, the breach of a pre-specified trigger (albeit usually set far from current market levels) will result in a default of the transaction with often nominal recoveries.

In addition, transaction structures that rely on the ability to liquidate collateral in an orderly fashion in the most stressed environments and/or a limited time horizon and the inclusion of assets with limited trading, pricing and liquidity history are viewed as problematic.

In Ind-Ra's view, these examples demonstrate a level of "tail end" risk (or risk of extreme events) that — particularly with respect to market price movements — is deemed to be incompatible with high investment-grade ratings. As a result, the ratings are capped as a matter of principle. No level of data, credit protection or other mitigants will achieve ratings higher than the cap. Unlike asset performance data, historical data with respect to market price movements may provide less insight into the future path of such price movements.

The rating cap is largely driven by the limitations of effectively assessing the liquidation prospects in the tail-risk scenarios. For certain assets, forced liquidation prices in most severe scenarios may be so low such that no credit could be given to them in such an environment.

Third Party Dependency

The principles of structured finance involve isolation from idiosyncratic risk of individual counterparties.

One of the basic principles of structured finance is to achieve the maximum structural "isolation" of a transaction's performance from the idiosyncratic credit or operational exposure of the counterparties involved. In other words, the aim is that any credit deterioration or default of transaction counterparties does not have a material negative effect on the performance of the SF transaction itself. The intended result is that SF transaction performance reflects primarily that of the underlying collateral and is isolated from the specific risks that affect corporate counterparties.

However, there are situations where the SF transaction performance can depend to a substantial degree on the continued performance of a third party, for example the originator, seller, servicer, derivative counterparty or others. This can result in material credit exposure to that counterparty, or provide operational dependency if the counterparty performs crucial functions that may not be replaceable and are crucial to the transaction performance. An example would be the case where a significant percentage of the pool is comprised of employee loans tied to one originator.

Ind-Ra has or may imposed rating caps for third party dependency in certain instances:

Servicers — when assets are complex to service.

Originators — when doubts exist about the asset segregation.

Derivative or Account Providers — when minimum mitigants are not included or excessive dependency exists

In such instances, the rating may be capped at the level relative to the relevant counterparty or at a certain level above the originators rating. The list of such counterparties can be extensive, but includes those listed below.

Servicer

Ind-Ra may consider a rating cap in transactions where continuation of the asset servicing is doubtful post default of the servicer, either because (a) the legal documentation does not provide for adequate back-up servicing provisions, and/or (b) the jurisdictions lack a well-developed servicer market for the assets at hand, and/or (c) the legal regime is not considered supportive in case of servicer insolvency. This is particularly relevant for, but not limited to, servicers with a non-investment-grade IDR or unrated entities.

A rating cap may not be applicable if Ind-Ra believes the transaction can withstand a liquidity shock in the event of a sudden default of the servicer, or when concerns surrounding continuation of servicing are sufficiently mitigated at the transaction and/or jurisdiction level. In some cases, this may include additional liquidity to continue payment of the notes during the transitional period. The existence of a back-up or standby servicing agreement at transaction closing may also mitigate the need for a rating cap, whereby the type of standby agreement and operational and credit quality of such back-up entities would be considered.

Originator

Generally, SF transaction performance aims to be detached from the performance of originators. However, in Ind-Ra's view, this may not always be achieved and may have rating implications. For example, where the true sale or a clear segregation of the assets cannot be achieved or where there is no clear legal comfort that such asset segregation is effective, the rating of the SF securities will in the absence of other mitigants be capped at the rating of the originator.

Ratings caps may also apply where there is a material reliance on the ongoing operations of the originator. This is the case in future-flow transactions, which securitise the cash flow originating from a specific business line of a bank or company that produces goods or services for (foreign) obligors. Ind-Ra assesses the risk through a going concern assessment score (GCA) that allows for a rating between zero and six notches above the IDR of the originator.

Derivative Exposure and Other Counterparties

In Ind-Ra's view, it is not possible to fully "structure away" counterparty risk for SF transactions. However, it is possible to employ structural mitigants that allow for this risk to be minimised. Ind-Ra has counterparty risk assessment framework for SF transactions that express the agency's opinion as to the minimum arrangements that it believes are necessary to achieve the maximum degree of isolation from a counterparty. In these instances Ind-Ra will consider the SF ratings to be sufficiently remote from the ratings of the key transaction counterparties. In the absence of such arrangements, a rating cap may be applied.

Notwithstanding these arrangements, Ind-Ra also identifies instances where the reliance on a counterparty can be so excessive that normal structural mitigants may not be deemed sufficient to overcome the counterparty dependency, as it would become the dominant factor in the rating analysis. This may include hedging arrangements, often with a large notional, that seek to significantly increase the distributions to the SPV as a means of providing credit enhancement at high investment-grade levels. Other examples would be account bank structures where large sums are held with one bank outside of trust or security arrangements that may provide protection against the bank's default. In such cases, a rating cap at the rating of the counterparty will apply due to the excessive counterparty dependency.

Ind-Ra's counterparty risk assessment framework is predicated upon the expectation that counterparties are obligated and committed to implementing remedial actions upon becoming ineligible. However, where upon the breach of eligibility thresholds, transaction parties choose either to amend or not follow documentation, Ind-Ra may revise its expectations for the affected transactions. In such instances, the ratings may become subject to a rating cap. The application of the rating cap will depend upon the degree of importance of the relevant counterparty exposure, the counterparty's credit profile, any specific mitigating factors, Ind-Ra's expectations of future remedial action, and the involvement of independent third parties in the decision making process.

For material counterparty exposures where Ind-Ra observes a lack of commitment to implementing future remedial actions, the note ratings may be capped at the Issuer Default Rating of the relevant counterparty. Alternatively, where a restructuring or amendment undermines a transaction's integrity more fundamentally, such that respect for the provisions of transaction documentation cannot be assured, Ind-Ra may choose to withdraw ratings on the basis that a robust rating opinion cannot be maintained.

Incentives of Transaction Parties

Ideally, the incentives of transaction parties are aligned with the interests of the noteholders. This is, however, not always the case and some misalignments of interests or incentives can be so material that a rating cap may apply, or ratings not achievable at any rating level. For example, especially for originators that are in some form of financial distress (as may be indicated by a low rating), an analysis of the incentive structure of the originator and any counterparty dependency is needed.

This is particularly the case in revolving or managed transactions where the collateral may significantly change over time and originators or managers may have the incentive to sell or substitute low quality assets into the portfolio to maintain short-term funding to the company. While eligibility criteria typically provide some protection against this, they usually do not fully address a material misalignment of interests. Depending on transaction-specific arrangements to address such concerns, a rating cap may apply or the transaction may not be rateable. Ind-Ra notes that regulators have introduced requirements for originators to retain an interest in the notes sold to investors in certain circumstances. Such provisions may provide a mitigating factor to incentive issues where they arise.

Issuers may also sometimes look to include provisions in transactions that allow for optionality on the part of the originator or other counterparties. How transaction counterparties may behave when exercising such optionality provisions is a consideration when assigning ratings to SF transactions. Where a specific action of a counterparty (other than the investor(s)) could lead to a significant note impairment, Ind-Ra may not be able to rate the transaction at any level. Examples for this situation would be (a) the option of an originator to call the transaction notes (or repurchase all the assets) at a price that could lead to a loss of either interest or principal for the noteholders; or (b) the ability to redeem notes at any level chosen by the originator, thereby potentially altering the credit protection position across the structure.

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