

**Structured Finance Hedge Criteria Compared:**  
*An Overview and Comparison of Rating Agency Hedge Criteria  
 Relating to Structured Finance Transactions*

Beginning in May 2006, each of Moody's Investors Service ("Moody's"), Standard and Poor's Ratings Services ("S&P") and Fitch Ratings ("Fitch" and, together with Moody's and S&P, the "Rating Agencies") published criteria for hedge transactions relating to highly-rated structured finance transactions: (i) Moody's *Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions: Moody's Methodology* (pub. May 25, 2006, repub. May 9, 2007) (the "Moody's Criteria"); (ii) S&P's *Revised Framework for Applying Counterparty and Supporting Party Criteria* (pub. May 8, 2007) (the "S&P Criteria"); and Fitch's *Counterparty Risk in Structured Finance Transactions: Hedge Criteria* (pub. August 1, 2007) (the "Fitch Criteria" and, together with the Moody's Criteria and the S&P Criteria, the "Rating Agency Criteria"). The Rating Agencies took varied approaches in these publications, yet their primary goal was the same: to establish uniform criteria for derivatives documents and hedge counterparties in structured finance transactions. In short, each of the Rating Agency Criteria aims to make the risk of loss in rated structured finance transactions remote from hedge counterparty risk by specifying remedial actions that a hedge counterparty must take within a specified period of time following certain downgrades of its credit ratings.<sup>1</sup>

Moody's was the first Rating Agency to publish its structured finance hedge criteria. In the Moody's Criteria, Moody's sets forth criteria that hedge counterparties must satisfy before it will "de-link" hedge counterparty risk from the credit risk of the structured finance transaction. The Moody's Criteria is comprehensive. As discussed in greater detail below, it includes "pro forma" hedge documents,<sup>2</sup> specifies the applicability of default events against both the hedge counterparty and the SPV engaging in the structured finance transaction, lists the types of collateral eligible for posting (as well as the haircuts on that collateral), provides guidelines on allocating withholding tax risk and modifies the valuation and termination mechanics of the hedge transaction.

The publication of the S&P Criteria<sup>3</sup> followed, but it took a simpler approach than the Moody's Criteria. It focuses primarily on establishing collateralization requirements for a downgraded hedge counterparty that are designed to greatly increase the likelihood that the downgraded hedge

---

<sup>1</sup> The Moody's Criteria states that the purpose of the Moody's Criteria is to explain the circumstances under which it will "de-link the credit risk of a [hedge counterparty] from the credit risk associated with a cashflow transaction" such that it need not model the contribution of a hedge counterparty to the expected loss of such a transaction. *Moody's Criteria*, at 1-2. In contrast, S&P describes the approach in the S&P Criteria as "a soft or partial link" between the rating on structured transaction notes and a counterparty's rating, as opposed to a de-linking. *S&P Criteria*, at 1. S&P's approach, therefore, differs in that it establishes criteria it will use to reduce the credit risk exposure of a special purpose vehicle ("SPV") to hedge counterparties (and others) that have payment obligations to the SPV that must be considered in S&P's cashflow and credit analyses in relation to securities issued by the SPV.

<sup>2</sup> The Rating Agency Criteria generally assume documentation of hedge transactions using a 1992 International Swaps and Derivatives Association, Inc. ("ISDA") Master Agreement (each, a "Master Agreement") and either a 1994 ISDA Credit Support Annex (New York law) or 1995 ISDA Credit Support Annex (English law) (in either such case, a "Credit Support Annex"). Unless otherwise specified, capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the Master Agreement or Credit Support Annex, as the case may be.

<sup>3</sup> The S&P Criteria states that it applies to structured finance transactions and certain U.S. public finance transactions having a long-term rating of AAA. *S&P Criteria*, at 1. Certain aspects of the S&P Criteria also apply to asset-backed commercial paper and U.S. public finance commercial paper programs having a short-term rating of A-1+. *Id.*

counterparty will actively seek an appropriately-rated replacement counterparty to assume its obligations to the SPV under the hedge documents. Noticeably absent from the S&P Criteria is any discussion regarding the applicability of Master Agreement default events.

Finally, the Fitch Criteria also takes an approach that emphasizes swift mitigating actions that should be taken upon the ratings downgrade of a hedge counterparty to a hedge transaction with an SPV. However, it also describes certain of Fitch's preferences and expectations for default events in Master Agreements executed between hedge counterparties and SPVs and the collateral posting mechanics in any related Credit Support Annexes.

A comparison of some of the more significant Rating Agency Criteria provisions follows.

### **I. Priorities of Payment**

As Moody's notes, "[t]he seniority of payments to the [hedge counterparty] is a key tool in mitigating credit risk for the [structured finance] transaction."<sup>4</sup> In particular, the Moody's Criteria acknowledges that scheduled hedge transaction payments are typically made senior to payments on senior debt in both interest and principal waterfalls (but junior to taxes and senior expenses).<sup>5</sup> However, generally speaking, this should not be the case where a hedge counterparty has caused an early termination. Rather, if an early termination occurs with respect to which the hedge counterparty is the Defaulting Party or sole Affected Party, and the hedge transaction is "in-the-money" to the hedge counterparty, each of the Moody's Criteria and Fitch Criteria recommends that the termination payment payable by the SPV be subordinate to payments of principal and/or interest on the relevant notes under the relevant priority of payments.<sup>6</sup> However, Moody's and Fitch do not expect such subordination to apply to situations where a hedge terminates due to an event beyond the control of either party (such as an Illegality or Tax Event).<sup>7</sup>

The S&P Criteria does not address the priority of payments due from the SPV to the hedge counterparty.

### **II. Applicability of Events of Default and Termination Events**

The Moody's Criteria notes that the Master Agreement "is designed for hedges between large institutions that are able to look after their own interests" and that are able to provide timely notices, monitor their counterparties' circumstances, terminate hedge transactions, when appropriate, and calculate relevant termination amounts.<sup>8</sup> However, an SPV engaged in a structured finance transaction may not have the necessary resources to perform these functions and, therefore, the Moody's Criteria provides for some related modifications to the Master Agreement.

---

<sup>4</sup> *Moody's Criteria*, at 7.

<sup>5</sup> *Id.* at 16 (Table 2B). The Fitch Criteria also acknowledges that "[p]ayments from the SPV issuer to the [hedge] counterparty usually rank senior in the cash flow waterfall to the notes." *Fitch Criteria*, at 9.

<sup>6</sup> *Id.*; *Fitch Criteria*, at 12.

<sup>7</sup> Moody's states that, in such cases, payments should be senior in both interest and principal waterfalls. *Moody's Criteria*, at 16 (Table 2B). Similarly, Fitch expects that termination payments owed by the SPV to the hedge counterparty in connection with such events would be payable prior to or on parity with the most senior notes under the relevant priority of payments established in the structured finance transaction documents. *Fitch Criteria*, at 12.

<sup>8</sup> *Moody's Criteria*, at 9.

The Moody's Criteria requires that all ISDA-standard Events of Default generally should apply against a hedge counterparty and generally should not apply (or apply in only limited circumstances) to the SPV.<sup>9</sup> With respect to the Event of Default for Bankruptcy, in particular, Moody's requires that certain modifications be made to reflect that the SPV may be potentially "insolvent" from the beginning of the hedge transaction and to make inapplicable to the SPV certain other problematic clauses (e.g., the subclause that generally defines "Bankruptcy" to include a secured party taking possession of all or substantially all the assets of a party is made inapplicable to the SPV so that an SPV delivering its assets to an indenture trustee (or similar institution) acting as custodian does not thereby commit an immediate default).<sup>10</sup> The Moody's Criteria lists the ISDA-standard Termination Events as "optional" for both parties.<sup>11</sup>

The Fitch Criteria specifies its preferences as to which of the ISDA-standard Events of Default and Termination Events contained in a Master Agreement should be applied and/or modified to ensure that events that generally do not conform to those set forth in the underlying structured finance transaction documents do not inadvertently trigger an early termination against the SPV and that events relating to a hedge counterparty's creditworthiness apply against the hedge counterparty. In particular, the events of Breach of Agreement, Credit Support Default, Misrepresentation, Default under Specified Transaction, Cross Default, and Credit Event Upon Merger generally should not apply to the SPV, and Bankruptcy (if it applies at all) should be modified to conform with the equivalent definition in the underlying structured finance transaction documents.<sup>12</sup> The SPV should be permitted to terminate the hedge transaction for a Tax Event Upon Merger where it is the "burdened party" (i.e., payments made to it by the hedge counterparty are subject to withholding as a result of a party's merger event and the hedge counterparty is not required to gross up its payments).<sup>13</sup> Also, upon a Tax Event, Fitch expects the SPV to have the ability to terminate the hedge transaction if withholding were to apply to a hedge counterparty's payments due to a change in tax law and the hedge counterparty were not obligated to gross up such withheld amounts under the terms of the relevant Master Agreement.<sup>14</sup>

Fitch looks favorably upon each of the above-referenced events generally applying to the hedge counterparty (subject to the risks of the relevant transaction structure in the case of a Credit Support Default and/or Default under Specified Transaction).<sup>15</sup> With respect to a Tax Event Upon Merger, the Fitch Criteria states that the hedge counterparty generally should not be permitted to terminate the hedge where it is the burdened party.<sup>16</sup> Also, with respect to a Tax Event, Fitch expects that the hedge counterparty will often accept the risk of a change in tax law and, therefore, (i) be unable to terminate the hedge transaction if it must gross up its payments to the SPV and (ii) agree to accept less than a full payment from the SPV if a withholding tax is imposed on payments made by the SPV.<sup>17</sup>

<sup>9</sup> *Id.*

<sup>10</sup> *Moody's Criteria*, at 16 (Table 3A).

<sup>11</sup> *Id.* at 17 (Table 3B).

<sup>12</sup> *Fitch Criteria*, at 6-8.

<sup>13</sup> *Id.* at 7-8.

<sup>14</sup> *Id.* at 7.

<sup>15</sup> *Id.* at 6-8.

<sup>16</sup> *Id.* at 7-8.

<sup>17</sup> *Id.* at 7.

Exhibits 1 and 2 hereto provide a summary in table form of the applicability of Events of Default and Termination Events (including certain “Additional Termination Events” relating to events such as note redemption), as set forth in the Moody’s Criteria and the Fitch Criteria. (As noted above, the S&P Criteria does not (except as stated in the following paragraph) address the applicability of either Events of Default or Termination Events.)

Each of the Rating Agency Criteria also requires or expects the SPV to have the right to terminate the hedge transaction if a downgraded hedge counterparty fails to take acceptable remedial action within the applicable grace period (subject, in the case of the Moody’s Criteria, to certain conditions precedent, as discussed in greater detail below).

### **III. Eligible Hedge Counterparties<sup>18</sup>**

The Moody’s Criteria permits a hedge counterparty to enter into a hedge transaction with an SPV and continue to participate in that transaction without collateralizing its obligations so long as it maintains a long-term senior unsecured rating of at least A2 and a short-term rating of P-1 (or, if such hedge counterparty has only a long-term rating, at least A1) (the “Moody’s First Trigger Required Ratings”).<sup>19</sup> Unlike the S&P Criteria, which is discussed below, the Moody’s Criteria explicitly states that it “distinguishes a [hedge counterparty] by rating only, not by organizational type, domicile or other factor.”<sup>20</sup>

The S&P Criteria defines “eligible” hedge counterparties as those that have certain minimum ratings and agree up front to replace, guarantee or collateralize their obligations to the SPV at specified ratings triggers.<sup>21</sup> For an entity to continue to be eligible, it must satisfy one of the following:

- Any party with a short-term rating of at least A-1 (or a long-term rating of A+ or higher if it has no short-term rating);
- A bank, broker/dealer, insurance company, structured investment vehicle, or derivative product company with a short-term rating of A-2 (or a long-term rating of BBB+ to A if it has no short-term rating), provided that it collateralizes at the S&P First Trigger (as discussed below);
- An unrated subsidiary of a rated bank, broker/dealer, corporation, or insurance company, whose obligations are fully backed by an irrevocable and unconditional guarantee from an eligible entity having appropriate ratings to qualify itself as an eligible hedge counterparty; or
- An unrated subsidiary of a rated bank, broker/dealer, or insurance company that S&P deems as core or strategically important, provided that the group parent has a short-term rating of at least A-2 (or a long-term rating of BBB+ or above if it has no short-term rating), and the subsidiary collateralizes at the S&P First Trigger.<sup>22</sup>

Upon a ratings decline below A-1 (or below A+ if it has no short-term rating), a hedge counterparty other than a financial institution is deemed to be “ineligible” under the S&P Criteria.<sup>23</sup> A hedge

<sup>18</sup> Exhibit 3 hereto provides a summary in table form of the ratings required by each Rating Agency for a hedge counterparty to be “eligible” to enter into hedge transactions with an SPV, as well as the ratings relevant for the First Trigger and Second Trigger.

<sup>19</sup> *Moody’s Criteria*, at 6, 14 (Table 1).

<sup>20</sup> *Id.* at 6.

<sup>21</sup> *S&P Criteria*, at 5.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 6.

counterparty that is a financial institution becomes “ineligible” if its ratings decline below A-2 (or below BBB+ if it has no short-term rating), provided that any financial institution that is rated A-2 (or BBB+ to A if it has no short-term rating) remains eligible but must post collateral, as described below.<sup>24</sup>

Fitch believes that the risk of a hedge counterparty rated A or higher going into default over a very short period of time is so remote that it is consistent with a long-term risk of AAA.<sup>25</sup> Hence, assuming that the appropriate structural protections exist to rapidly address hedge counterparty downgrades to ratings below A, Fitch is amenable to having a hedge counterparty rated at least A support higher-rated structured finance transactions.<sup>26</sup> As such, the Fitch Criteria requires hedge counterparties to have a Fitch short-term rating of at least F1 and a Fitch long-term rating of at least A<sup>27</sup> in connection with structured finance transaction notes that are rated AA- or higher.<sup>28</sup>

#### **IV. Ratings Triggers, Remedies, and Collateralization**

The Rating Agencies have each taken, generally speaking, a two-step approach to document provisions required to address hedge counterparty rating downgrades, with certain permissible remedies (and periods in which they are to be effected) specified at higher rating levels (referred to herein as the “First Triggers” for each Rating Agency, as discussed below and in Exhibit 3), and other permissible remedies (and periods in which they are to be effected) specified at lower rating levels (referred to herein as the “Second Triggers” for each Rating Agency, as discussed below and in Exhibit 3). Simply put, these remedies are the replacement of the downgraded hedge counterparty by an appropriately-rated replacement hedge counterparty, the unconditional and irrevocable guaranty of the hedge counterparty’s obligations by an appropriately rated guarantor, or the collateralization of the hedge counterparty’s obligations in accordance with specified formulae.

With respect to collateralization, the Rating Agencies acknowledge that it often takes a substantial amount of time to negotiate and execute a Credit Support Annex. As such, the Rating Agency Criteria generally require (or assume that) a Credit Support Annex will be drafted and approved by the hedge counterparty and the SPV by the closing date and, certainly, before each Rating Agency assigns its final ratings to the structured finance transaction. Yet this is where the similarities end, as each Rating Agency has taken a different approach in establishing the timing and implementation of the aforementioned remedies to hedge counterparty downgrades. This is particularly the case when it comes to the formulae used for collateral amounts to be posted by a downgraded hedge counterparty. As a result, most Credit Support Annexes used by SPVs in hedge transactions relating to structured finance transactions require that the ratings-based collateral calculations be made on each valuation date in accordance with each Rating Agency’s prescribed formulae, and that the downgraded hedge counterparty post collateral in accordance with the calculation resulting in the greatest amount of collateral.

<sup>24</sup> *Id.* at 5-6.

<sup>25</sup> *Fitch Criteria*, at 10.

<sup>26</sup> *Id.*

<sup>27</sup> Fitch indicates that in the rare case where a hedge counterparty has only a long-term rating by Fitch, and no short-term rating from Fitch, Fitch “may rely on its assessment of the long-term rating only.” *Fitch Criteria*, at 10.

<sup>28</sup> *Id.* Appendix 1 of the Fitch Criteria also sets forth minimum hedge counterparty ratings for structured finance transaction notes rated below AA-. *Id.* at 14 (App. 1).

**A. Moody's**

The Moody's Criteria sets forth three broad categories of possible hedge counterparty ratings and specifies the remedial obligations (if any) of hedge counterparties whose ratings fall within those broad categories. The first category is that of eligible counterparties, which is described above. The other two categories are as follows: (i) the hedge counterparty is rated A3 or P-2 (or, if the hedge counterparty has only a long-term rating, it is rated A2 or A3) (the "Moody's First Trigger"); and (ii) the hedge counterparty is either rated Baa1 or below (or has its ratings withdrawn) or rated P-3 (or, if the hedge counterparty has only a long-term rating, it is rated Baa1 or below (or has its ratings withdrawn)) (the "Moody's Second Trigger").<sup>29</sup>

Within 30 business days of a downgrade of a Moody's rating to the Moody's First Trigger, the hedge counterparty is required to either (i) post the "Moody's First Trigger Collateral Amount" (described below), (ii) obtain a guaranty from a guarantor rated not lower than the Moody's First Trigger Required Ratings, or (iii) transfer the hedge transaction at issue to a replacement hedge counterparty rated not lower than the Moody's First Trigger Required Ratings (or to a replacement hedge counterparty that does not satisfy the Moody's First Trigger Required Ratings but is rated at least P-2 and A3 (or at least A3 if it has no long-term rating), provided that any such replacement hedge counterparty immediately posts collateral in an amount equal to the Moody's First Trigger Collateral Amount).<sup>30</sup>

Within 30 business days of a downgrade of a Moody's rating to the Moody's Second Trigger, the hedge counterparty is required to post the "Moody's Second Trigger Collateral Amount" (described below).<sup>31</sup> Also, within 30 business days of a downgrade to the Moody's Second Trigger, the hedge counterparty is required to use commercially reasonable efforts to either (i) obtain a guaranty from a guarantor rated above the Moody's Second Trigger, or (ii) transfer the hedge transaction at issue to a replacement hedge counterparty rated above the Moody's Second Trigger.<sup>32</sup> If the hedge counterparty fails to obtain such a guaranty or effect such a transfer within the thirty business day period, the Moody's Criteria requires that it continue to use commercially reasonable efforts to either obtain an eligible guaranty or identify an eligible replacement hedge counterparty for so long as it remains rated below the Moody's Second Trigger.<sup>33</sup>

The Moody's Criteria requires that the SPV have the right to terminate the hedge transaction under either of the following circumstances: (i) the hedge counterparty is downgraded to the Moody's First Trigger and fails to take appropriate remedial action within the applicable grace period, or (ii) the hedge counterparty is downgraded to the Moody's Second Trigger and either (A) the hedge counterparty does not within the applicable grace period post the Moody's Second Trigger Collateral Amount and/or does not use commercially reasonable efforts to obtain an eligible guaranty or to locate an eligible replacement hedge counterparty, or (B) the applicable grace period has expired, the downgraded hedge counterparty has not obtained an eligible guaranty or transferred the hedge transaction to an eligible institution and at least one eligible institution has submitted a "live bid" to

<sup>29</sup> *Moody's Criteria*, at 6-7, 14 (Table 1).

<sup>30</sup> *Id.* at 7, 14 (Table 1), 15 (Table 2A).

<sup>31</sup> *Id.* If the hedge counterparty has previously been downgraded below the Moody's First Trigger, the hedge counterparty must post (or continue to post) the Moody's First Trigger Collateral Amount during the Moody's Second Trigger grace period (other than any portion of such grace period that falls within the applicable Moody's First Trigger grace period). *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 7, 15 (Table 2A).

replace the downgraded hedge counterparty. If, in the last of these situations, the SPV cannot terminate the hedge transaction because no live bid from an eligible institution is available, it will become entitled to declare an early termination and replace the downgraded hedge counterparty at such time (if any) as a live bid is provided and the downgraded hedge counterparty will remain obligated until that time to post the Moody's Second Trigger Collateral Amount.

Determination of required collateral amounts under the Moody's Criteria may be complex, as the determining party must take into account numerous factors, including whether daily or weekly collateral posting applies, the type of hedge transaction (e.g., a single currency swap, cross currency swap, etc.) and whether DV01 will be relevant for calculations. For illustrative purposes, assume that a Moody's First Trigger Collateral Amount must be determined for a single-currency swap for which weekly posting applies. In accordance with the Moody's Criteria, the formula for this calculation is as follows:

$$\text{Max}[0, \text{MtM}^{34} + \text{Min}[25 * \text{DV01}, 4\% * \text{hedge notional}]]^{35}$$

However, the parties may elect to post collateral without reference to a DV01. In such a case, assuming the determination of the above-referenced swap, the Moody's Criteria provides an alternative formula:

$$\text{Max}[0, \text{MtM} + \text{hedge notional} * \text{potential increase percentage}^{36}]^{37}$$

Moody's Second Trigger Collateral Amounts are determined largely in the same manner as Moody's First Trigger Collateral Amounts, but with different specified percentages to be applied against the hedge notional amount and specified amount to be applied against the DV01 (if applicable).<sup>38</sup>

The Moody's Criteria provides detailed Valuation Percentages for collateral, based on numerous factors, including the denomination of the Credit Support Amount, the type of collateral posted, the remaining maturity of the collateral posted, the frequency of collateral posting and whether the collateral is being posted to satisfy a Moody's First Trigger Collateral Amount requirement or Moody's Second Trigger Collateral Amount requirement. For example, where a Credit Support Amount is U.S. dollar denominated and weekly posting applies, if U.S. dollar denominated fixed rate U.S. Treasury debt having a remaining maturity of six years is delivered to satisfy a Moody's First Trigger Collateral Amount requirement, then the applicable Valuation Percentage would be 100%; if

<sup>34</sup> This is defined as the mid-market value of the hedge transaction. *Moody's Criteria*, at 19 (Table 4A-1), fn 3.

<sup>35</sup> *Id.* at 19 (Table 4A-1).

<sup>36</sup> This potential increase percentage is essentially an estimate by Moody's of the potential increase in the mid-market valuation of a hedge transaction and depends on the weighted average life of that transaction. For the Moody's First Trigger Collateral Amount, these potential increase amounts are set forth in the Moody's Criteria, at 20 (Table 4A-2). As the Moody's Criteria notes, this table (and the corresponding one relating to Moody's Second Trigger Collateral Amounts) was "derived by assigning conservative estimates of DV01 to each yearly increment of weighted average life" of a hedge transaction. *Id.* at 11.

<sup>37</sup> *Moody's Criteria*, at 19 (Table 4A-1). For illustrative purposes, assume weekly posting applies to a single-currency swap transaction having (i) a weighted average life of between nine and 10 years, (ii) a notional amount of US\$100,000,000, and (iii) a mark-to-market in favor of the SPV of US\$5,000,000. In such a case, using the relevant potential increase percentage found in Table 4A-2, the collateral amount to be posted by the hedge counterparty would be calculated as follows:  $\text{Max}[0, \text{US\$5,000,000} + \text{US\$100,000,000} * 2.2\%] = \text{US\$7,200,000}$ .

<sup>38</sup> *Id.* at 21 (Table 4B-1).

that same collateral were posted under the same circumstances to satisfy a Moody's Second Trigger Collateral Amount requirement, then the applicable Valuation Percentage would be 95%.<sup>39</sup>

The Moody's Criteria also addresses the risk of an SPV receiving less than a full payment (or of being required to gross up a payment) as a result of applicable withholding taxes. Among other things, Moody's requires that the relevant Master Agreement reflect that (i) the SPV is not obligated to gross up its payments to the hedge counterparty for any withholding or deduction, and (ii) the hedge counterparty must always gross up its payments to the SPV for any withholding or deduction (at least to the extent that such a withholding or deduction arises for reasons other than a Change in Tax Law).<sup>40</sup>

One aspect of the Moody's Criteria that is unique to Moody's is its modification of the ISDA-standard termination payment calculation measure. In particular, where the hedge counterparty is the Defaulting Party or the sole Affected Party (other than in connection with an Illegality or Tax Event), Moody's requires that, instead of indicative Market Quotations being sought to calculate the termination value for the hedge transaction, "live bids" reflecting an amount an eligible replacement hedge counterparty is actually willing to pay (or receive) to execute a replacement hedge transaction with the SPV (on terms that are at least as beneficial to the SPV in all material respects) should be sought.<sup>41</sup> The hedge counterparty itself may (and, if requested by the SPV, must) attempt to obtain live bids.<sup>42</sup> If two or more live bids are obtained, then the SPV may accept only the one that is most beneficial for the original hedge counterparty.<sup>43</sup> If replacement occurs on or before the Early Termination Date, then the live bid amount actually either paid or received by the replacement hedge counterparty will constitute the Settlement Amount for purposes of unwinding the original hedge transaction.<sup>44</sup> If replacement does not occur on or before the Early Termination Date and at least one live bid is available, the live bid that is most beneficial to the original hedge counterparty will constitute the Settlement Amount for purposes of unwinding the original hedge transaction.<sup>45</sup> Finally, if replacement does not occur on or before the Early Termination Date and no live bid is available, then the Settlement Amount will be calculated in accordance with the Loss methodology.<sup>46</sup> Moody's motivation in requiring this modification is to encourage the replacement of the hedge counterparty and a smooth transition to the replacement hedge counterparty.<sup>47</sup>

<sup>39</sup> *Moody's Criteria*, at 26 (Table 5C).

<sup>40</sup> *Id.* at 29. In lieu of these asymmetric obligations to gross up, it is also acceptable for the SPV and trustee to receive satisfactory legal opinions at closing confirming that, under current law, no withholding applies to any payments made by or due to the SPV under the hedge transaction. *Id.*

<sup>41</sup> *Id.* at 9-10 and 16 (Table 2B).

<sup>42</sup> *Id.* at 10 and 16 (Table 2B).

<sup>43</sup> *Id.* at 10.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 9 (stating "the primary concern is not to be 'compensated' for the termination of the hedge, but rather simply to have such amount as is necessary to pay a replacement [hedge counterparty] to assume the role of the original [hedge counterparty]").

**B. S&P<sup>48</sup>**

As noted above, the S&P Criteria puts an emphasis on a downgraded hedge counterparty posting collateral. The collateral remedies applicable to a hedge counterparty under the S&P Criteria depend on whether it continues to be eligible or becomes ineligible. An eligible hedge counterparty that is a financial institution remains “eligible” but must collateralize if it is downgraded to A-2 (or to BBB+ or A if it has no short-term rating) (the “S&P First Trigger”).<sup>49</sup> Collateral posting at the S&P First Trigger is called “un-stressed collateral posting” and results in the hedge counterparty being required to cover at least 100% of its mark-to-market exposure within 10 local business days of the related rating event.<sup>50</sup> In contrast, a non-financial institution hedge counterparty that is downgraded to below A-1 (or below A+ if it has no short-term rating), and a financial institution hedge counterparty that is downgraded to below A-2 (or below BBB+ if it has no short-term rating) (the “S&P Second Trigger”), becomes an “ineligible” hedge counterparty.<sup>51</sup> Collateral posting by ineligible hedge counterparties at the S&P Second Trigger is called “stressed collateral posting” and results in (i) the downgraded hedge counterparty being required to cover at least 125% of its mark-to-market exposure within 10 business days of the related rating event and (ii) the hedge counterparty being required to use commercially reasonable efforts to either (A) replace itself with an eligible hedge counterparty having appropriate ratings or (B) find an appropriately-rated guarantor, in either case within 60 calendar days of the related rating event.<sup>52</sup> An ineligible hedge counterparty’s failure to procure a replacement or guarantor within the specified period of time must be documented as a termination option in favor of the SPV and, therefore, is typically reflected in the Master Agreement as an Additional Termination Event.<sup>53</sup>

In accordance with the S&P Criteria, collateral posted in the form of eligible securities instead of cash is subject to market-value haircuts, or base overcollateralization rates (“BORs”).<sup>54</sup> The rating of the issuer, type of issuer and weighted average life (“WAL”) of the eligible security are factors in determining the applicable BOR.<sup>55</sup> A broad range of eligible securities are included in the S&P Criteria, including sovereign and corporate bonds, as well as structured securities (e.g., student loan and auto ABS, CDOs, and CMBS).<sup>56</sup> Nevertheless, the most common securities posted by financial institutions—U.S. Treasuries and Agencies having a WAL of up to 10 years—have BORs of between 102% and 108%.<sup>57</sup>

<sup>48</sup> It is important to keep in mind that the collateralization guidelines set forth in the S&P Criteria are not intended to replace the guidelines for credit derivative counterparties to terminating de-linked structures (most commonly, synthetic CDOs), which S&P has stated it intends to address in more detail separately. *S&P Criteria*, at 5. Rather, the S&P Criteria’s application to such structures is limited to establishing the minimum rating of the hedge counterparty to AAA-rated transactions (i.e., a short-term rating of at least A-1 (or a long-term rating of A+ or higher if it has no short-term rating)). *Id.*

<sup>49</sup> *S&P Criteria*, at 5.

<sup>50</sup> *Id.* at 6, 11-12 (App. II).

<sup>51</sup> *Id.* at 6.

<sup>52</sup> *Id.* at 6 and 9 (App. I, Table 2).

<sup>53</sup> *Id.* at 6.

<sup>54</sup> The haircuts set forth in the S&P Criteria assume weekly mark-to-market frequency. S&P notes that these rates may differ from the overcollateralization rates applicable to market-value structured finance transactions (e.g., market-value CDOs, SIVs, SIV-lites, and extendible CP programs), which would have transaction-specific overcollateralization rates based on the relevant pool size, diversification, and liquidation horizon. *Id.* at 13 (App. III).

<sup>55</sup> Table 4 in Appendix III of the S&P Criteria sets forth three broad categories of eligible securities that may be posted and their applicable BORs.

<sup>56</sup> *S&P Criteria*, at 13 (App. III, Table 4).

<sup>57</sup> *Id.* BORs of other securities vary more widely (for example, a AA U.S. corporate bond with a WAL of ten years has a BOR of 115% and a BBB credit card ABS with a WAL of seven years has a BOR of 140%). *Id.*

BORs are stressed by an additional 25% for hedge counterparties that become ineligible.<sup>58</sup> Stressed collateral posting is intended by the S&P Criteria to be onerous. To illustrate this point, consider the collateral posting requirements of a hedge counterparty that is downgraded to BBB at a time when it is out of the money to an SPV on a single transaction by US\$4,000,000. Assuming it elects to post U.S. Treasuries having a WAL of less than five years, the hedge counterparty must post eligible securities having a value of US\$6,375,000 to meet the stressed collateralization amount required by the S&P Criteria.<sup>59</sup>

**C. Fitch**

Fitch’s approach is based on the existence of structural mitigants that address ratings downgrades of hedge counterparties to levels below either F1 or A (the “Fitch First Trigger”). In particular, the Fitch Criteria provides that upon any such downgrade one of the following actions be taken within 30 calendar days: (i) replacement of the hedge counterparty with a rated entity having ratings of at least F1 and A, as described above, (ii) arrangement of an unconditional guarantee of the hedge counterparty’s obligations by a rated entity having ratings of at least F1 and A, as described above, or (iii) collateral posting by the hedge counterparty to cover the potential replacement cost of the hedge transaction.<sup>60</sup> Where a hedge counterparty is downgraded to either below F2 or BBB+ (the “Fitch Second Trigger”), Fitch prefers that a replacement or guarantee be effected instead of collateral posting.<sup>61</sup> Once a hedge counterparty is rated below investment grade, Fitch expects that counterparty to be replaced (or its obligations to be guaranteed) and, until such action is taken, for the requisite amount of collateral to be posted.<sup>62</sup>

Appendix 3 of the Fitch Criteria specifies “Advance Rates” (or haircuts) that are to be applied to the most common collateral, namely, certain fixed-rate government bonds. These Advance Rates are intended to cover movements in a collateral security’s market value over time. Essentially, Advance Rates account for the risk of change to the market value of a collateral security in the time it takes to calculate and post the initial collateral and thereafter to find a substitute hedge counterparty to replace the downgraded hedge counterparty (for calculation purposes, Fitch assumes that the calculation, posting and replacement process will take four weeks to complete).<sup>63</sup> The longer the remaining maturity of the collateral, the greater the impact of the relevant Advance Rate on the collateral amount required. For instance, with respect to notes rated AAA, assuming weekly collateral posting,<sup>64</sup> U.S. government bonds maturing in one year or less have an Advance Rate of

<sup>58</sup> *Id.* at 13 (App. III).

<sup>59</sup> Because the S&P Criteria relies on stressed and unstressed BORs—as opposed to the more standard Valuation Percentages—in making collateral valuation determinations, calculations such as this (which appears in Appendix II of the S&P Criteria) differ from traditional determinations under the Credit Support Annex. If the ineligible hedge counterparty referenced above must collateralize 125% of the mark-to-market and the relevant BOR of 102% is stressed by 25%, it would have to post eligible securities having a value determined in accordance with the following formula:

$$\text{Collateral Amount Required (Stressed)} = \text{US\$5,000,000} * 127.5\% = \text{US\$6,375,000}$$

<sup>60</sup> *Fitch Criteria*, at 10.

<sup>61</sup> *Id.* at 10-11.

<sup>62</sup> *Id.* at 11.

<sup>63</sup> *Id.* at 12.

<sup>64</sup> The Fitch Criteria notes that Advance Rates will be determined by Fitch on a case-by-case basis where daily collateral valuation and posting exist. *Fitch Criteria*, at 18 (App. 3).

99.5, whereas U.S. government bonds maturing in between ten and fifteen years have an Advance Rate of 92.7.<sup>65</sup>

The Fitch Criteria notes that, unlike a replacement of a hedge counterparty or a guarantee of its obligations, each of which result in the hedge counterparty's creditworthiness being restored to at least a pre-downgrade level, collateral posting relates to potential losses upon the hedge counterparty's default.<sup>66</sup> As a result, the amount of collateral posted must be in an amount sufficient to ensure that any potential loss amount is virtually zero.<sup>67</sup> The Fitch Criteria generally seeks to accomplish this by determining the collateral amount that a downgraded hedge counterparty must provide according to the following formula:

$$CA = \max[MV + VC * N; 0]^{68}$$

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

The use of a VC component in the determination of collateral requirements is unique to Fitch and is described in the Fitch Criteria. In short, the VC is the value at risk of the hedge transaction, which necessarily depends on the hedge transaction type and its weighted average life ("WAL"). Appendix 2 of the Fitch Criteria specifies the VCs for the most common hedge transaction types, assuming weekly collateral posting.<sup>69</sup> For example, in connection with notes rated AA- or higher, a U.S. dollar denominated interest rate swap having a WAL of one year would have a VC of 0.6, whereas a U.S. dollar denominated interest rate swap having a WAL of 10 years would have a VC of 7.0.<sup>70</sup>

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

<sup>65</sup> *Id.* at 19 (App. 3). Advance Rates for U.S. agency debt are calculated by applying a multiplier of 0.99 to the applicable U.S. government bond rate. *Fitch Criteria*, at 18 (App. 3). For instance, assuming weekly posting and AAA notes, the Advance Rate for U.S. government debt maturing in between one and three years is 98.2; the Advance Rate for U.S. agency debt having the same characteristics in these circumstances is the product of 0.99 and 98.2, or 97.22. *Id.*

<sup>66</sup> *Id.* at 11.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* Note that the VC is to be adjusted by a factor of 105% for balance-guaranteed swaps under which the notional amount is not predetermined according to a fixed schedule (or by fixed boundaries) to account for differences in perceived hedge market value that may exist due to market participants' different views of a hedge's amortization profile. *Id.* For illustrative purposes, assume weekly posting applies to a U.S. dollar denominated interest rate swap transaction having (i) a WAL of nine years (with respect to notes rated AA- or better), (ii) a notional amount of US\$100,000,000, and (iii) a mark-to-market in favor of the SPV of US\$5,000,000. In such a case, using the relevant VC found in Appendix 2, the collateral amount to be posted by the hedge counterparty would be calculated as follows:  $\max[US\$5,000,000 + US\$100,000,000 * 6.4\%; 0] = US\$11,400,000$ .

<sup>69</sup> The Fitch Criteria notes that VCs corresponding to daily collateral posting will be provided by Fitch on a case-by-case basis. *Id.* at 15 (App. 2).

<sup>70</sup> *Id.* at 16 (App. 2).

#### **D. Collateral Posting Mechanics**

In addition to providing detailed guidelines as to eligible collateral types and haircuts, the Moody's Criteria also sets forth numerous expectations with respect to the mechanics of collateral posting, including the following: (i) the SPV arranger should establish a separate account at closing for the sole purpose of holding collateral posted by a hedge counterparty, (ii) interest on cash collateral should be either the amount the SPV actually earns on such cash or the contractual rate it is entitled to receive on such cash from its own bank account; (iii) the hedge counterparty's "Threshold" (or, simply, its permitted amount of uncollateralized exposure) for collateral posting to occur should be zero and its "Minimum Transfer Amount" (or, simply, the nuisance amount which a collateral deficiency under the hedge transaction must exceed before additional collateral must be posted) should be US\$100,000 (or its equivalent); (iv) the hedge counterparty should calculate the collateral requirements at either a daily or weekly frequency; and (v) movements into and out of the SPV's collateral account should occur directly with the hedge counterparty outside the priority-of-payments waterfall of the structured finance transaction, as instructed by the Valuation Agent.<sup>71</sup>

The Fitch Criteria also addresses certain mechanics of collateral posting. In particular, Fitch expects the market valuation of a hedge transaction and the value of any posted collateral to be determined at least weekly and collateral to be delivered, at the latest, on the day (presumably, one business day) following any valuation date on which a deficiency exists.<sup>72</sup> Moreover, where a hedge counterparty elects to remedy its downgrade by posting collateral, the Fitch Criteria states that it expects the mark-to-market calculations, as well as the correct and timely posting of collateral, to be verified by an independent third party.<sup>73</sup> The Fitch Criteria requires that a downgraded hedge counterparty should not have to meet any Threshold to post collateral and expresses a preference for a Minimum Transfer Amount of US\$25,000 (or its equivalent).<sup>74</sup> Finally, the Fitch Criteria states that the collateral should be held in an account either in the name of or pledged to the SPV and that Fitch will review the legal opinion regarding the enforceability, ranking and perfection of the security interest created over the collateral.<sup>75</sup>

#### **VI. Conclusion**

Despite their varied approaches, the Rating Agencies each provide a timeframe for a downgraded hedge counterparty to an SPV in a structured finance transaction to either replace, guaranty, or collateralize in order to maintain relatively comparable rating levels. Each of the Rating Agencies notes directly its strong preference for replacement at the first sign of trouble and, at least with respect to the S&P Criteria, the terms of collateralization are substantively intended to compel assignment by a hedge counterparty downgraded below the Second Trigger. A structured finance transaction that fails to implement a specified remedy within the permitted grace period should anticipate a negative reaction by the Rating Agencies. The Fitch Criteria, in particular, is quite clear in this regard. It states that if such a period expires without any of the specified remedial actions being taken, it will put the affected tranches of the related structured finance transaction on "Rating Watch Negative" and determine whether the credit enhancement available to the notes at issue

<sup>71</sup> *Moody's Criteria*, at 7-8. Although the Moody's Criteria states that collateral amount should be determined by the "Calculation Agent" (see *Moody's Criteria*, at 8), this reference is clearly intended to be to the "Valuation Agent."

<sup>72</sup> *Fitch Criteria*, at 12.

<sup>73</sup> *Id.* at 11.

<sup>74</sup> *Id.* at 13.

<sup>75</sup> *Id.* at 12.

and/or the quality of the underlying portfolio warrants an affirmation of the ratings on the notes or, rather, a downgrade of such ratings.<sup>76</sup>

## Contact Us

If you have any questions in connection with this memorandum, please contact:

**James Croke**

212-506-5085

[jcroke@orrick.com](mailto:jcroke@orrick.com)

**Peter Manbeck**

212-506-5095

[pmanbeck@orrick.com](mailto:pmanbeck@orrick.com)

**Sharad Samy**

44 207-422-4679

[ssamy@orrick.com](mailto:ssamy@orrick.com)

**Nikiforos Mathews**

212-506-5257

[nmathews@orrick.com](mailto:nmathews@orrick.com)

[www.orrick.com](http://www.orrick.com)

---

<sup>76</sup> *Id.* at 13.

**Exhibit 1 – Applicability of Events of Default<sup>77</sup>**

<b>Master Agreement Event</b>	<b>Moody's</b>		<b>Fitch</b>		<b>S&amp;P</b>
	<b>Hedge Counterparty</b>	<b>SPV</b>	<b>Hedge Counterparty</b>	<b>SPV</b>	
Failure to Pay or Deliver (§5(a)(i))	Apply	Optional <sup>78</sup>	Not Addressed	Not Addressed	n/a
Breach of Agreement (§5(a)(ii))	Apply	Disapply	Apply	Disapply	n/a
Credit Support Default (§5(a)(iii))	Apply	Apply <sup>79</sup>	Apply	Disapply	n/a
Misrepresentation (§5(a)(iv))	Apply	Disapply <sup>80</sup>	Apply	Disapply	n/a
Default under Specified Transaction (§5(a)(v))	Disapply <sup>81</sup>	Disapply	Disapply	Disapply	n/a
Cross Default (§5(a)(vi))	Optional	Disapply	Apply	Disapply	n/a
Bankruptcy (§5(a)(vii))	Apply	Optional <sup>82</sup>	Apply	Disapply <sup>83</sup>	n/a
Merger Without Assumption (§5(a)(viii))	Apply	Optional	Not Addressed	Not Addressed	n/a

<sup>77</sup> Applicability relates to the relevant party being the “Defaulting Party.” The applicability delineation set forth in this Exhibit may describe only a “preference” of the relevant Rating Agency. For additional details relating to Moody’s position on the applicability of these events, see the Moody’s Criteria, at 8-9 and 18 (Table 3A) and 19 (Table 3B). For additional details relating to Fitch’s position on the applicability of these events, see the Fitch Criteria, at 5-8.

<sup>78</sup> Although this Event of Default is listed as “Optional,” common market practice is to make it applicable.

<sup>79</sup> Moody’s permits this Event of Default to apply against the SPV only in connection with its obligation to return excess collateral amounts. *Moody’s Criteria*, at 17 (Table 3A).

<sup>80</sup> Moody’s permits this Event of Default to apply against the SPV only in connection with “good housekeeping” representations, such as those relating to capacity and authority of the SPV, and only if such representations are supported by an appropriate legal opinion at closing. *Id.* at 17 (Table 3A), fn 6.

<sup>81</sup> However, Moody’s permits this Event of Default to apply if the parties have executed more than one Master Agreement. *Id.* at 17 (Table 3A). Similarly, Fitch expects it to apply where there is more than one hedge with the same counterparty hedging different classes of notes (presumably under a separate Master Agreement). *Fitch Criteria*, at 7.

<sup>82</sup> Although this is listed as “Optional,” this Event of Default typically applies against the SPV, subject to certain modifications. *Moody’s Criteria*, at 17 (Table 3A), fn 7.

<sup>83</sup> The Fitch Criteria notes that where this Event of Default is made applicable to the SPV, it should be modified such that it is defined consistently with the definition of “Bankruptcy” set forth in the underlying structured finance documents. *Fitch Criteria*, at 7.

**Exhibit 2 – Applicability of Termination Events<sup>84</sup>**

<b>Master Agreement Event</b>	<b>Moody's</b>		<b>Fitch</b>		<b>S&amp;P</b>
	<b>Hedge Counterparty</b>	<b>SPV</b>	<b>Hedge Counterparty</b>	<b>SPV</b>	
Illegality (§5(b)(i))	Optional	Optional	Not Addressed	Not Addressed	n/a
Tax Event (§5(b)(ii))	Optional <sup>85</sup>	Optional	Disapply	Apply	n/a
Tax Event Upon Merger (§5(b)(iii))	Optional	Optional	Disapply	Apply	n/a
Credit Event Upon Merger (§5(b)(iv))	Optional	Optional	Apply	Disapply	n/a
Additional Termination Events (§5(b)(v))	Apply <sup>86</sup>	Apply <sup>87</sup>	Apply <sup>88</sup>	Apply	n/a

<sup>84</sup> Applicability generally relates to the relevant party being the “Affected Party.” The applicability delineation set forth in this Exhibit may describe only a “preference” of the relevant Rating Agency. For additional details relating to Moody’s position on the applicability of these events, see the Moody’s Criteria, at 8-9 and 18 (Table 3B). For additional details relating to Fitch’s position on the applicability of these events, see the Fitch Criteria, at 5-8.

<sup>85</sup> If this event applies against a hedge counterparty, Moody’s requires certain modifications to the provision to be made. See *Moody’s Criteria*, at 18, fn 2.

<sup>86</sup> As set forth above, Moody’s permits the SPV to terminate upon either (i) a failure by the hedge counterparty to post collateral after breaching the First Trigger, or (ii) a failure by the hedge counterparty to replace itself or procure an appropriate guarantee within 30 calendar days of breaching the Second Trigger, provided that at least one eligible party has provided a live bid. See *Moody’s Criteria*, at 18.

<sup>87</sup> Moody’s permits the hedge counterparty to terminate in whole (or, in some case, in part) upon the occurrence of specified redemption and acceleration events. See *Moody’s Criteria*, at 18 (Table 3B). Moody’s may also, on a case-by-case basis, permit the hedge counterparty to terminate if the SPV, without obtaining the hedge counterparty’s consent, executes additional hedge agreements with other counterparties or makes materially adverse changes to the structured finance transaction documents. *Id.*

<sup>88</sup> The Fitch Criteria notes that, although Breach of Agreement and Misrepresentation should not apply to the SPV, if the parties provide for it, breach of certain agreements and representations may result in a default in the underlying documents, leading to an acceleration or other enforcement action which, in turn, could provide the hedge counterparty with a right to terminate as an Additional Termination Event. See *Fitch Criteria*, at 6-7.

**Exhibit 3 – Ratings for Eligible Counterparties and First Trigger and Second Trigger Ratings<sup>89</sup>**

	<b>Fitch</b>	<b>Moody's</b>	<b>S&amp;P (Financial Institutions)<sup>90</sup></b>
Eligible Counterparties	At least F-1 and A	At least P-1 and A2 (or, if party only has a long-term rating, a long-term rating of at least A1)	At least A-2 (or, if party only has a long-term rating, a long-term rating of at least BBB+), subject to First Trigger collateral posting requirements for parties rated A-2 (or BBB+ or A if such party only has a long-term rating)
First Trigger	Below either F-1 or A	Below either P-1 or A2 (or, if party only has a long-term rating, below A1) <sup>91</sup>	At A-2 (or, if party only has a long-term rating, if such rating is either BBB+ or A)
Required Action Required Within:	30 calendar days	30 business days	10 business days
Second Trigger	Replacement or guarantee at below F2 or BBB+	Replacement or guarantee (and, in the interim, collateralization) at below P-2 or A3	Collateralization and either replacement or guarantee at below A-2 (or, if party only has a long-term rating, below BBB+)
Required Action Required Within:	30 calendar days	30 business days	10 business day for additional collateral 60 calendar days to guaranty or replace

<sup>89</sup> References to the “First Trigger” and “Second Trigger” rating levels in this table do not in and of themselves reflect a requirement by one or more Rating Agencies for a hedge counterparty to effect particular remedies. Rather, they merely reflect the ratings levels at which, in accordance with the Rating Agency Criteria, a hedge counterparty that has executed a hedge transaction with an SPV in connection with a structured financing must take specified affirmative steps to mitigate a ratings downgrade. As discussed in greater detail above, depending the Rating Agency Criteria, these steps may differ in their substance and in the timing in which they are to be effected.

<sup>90</sup> For purposes of clarity, the S&P ratings set forth in this table are only relevant for hedge counterparties that are financial institutions, which is typically the case.

<sup>91</sup> As Moody’s notes, “A P-1 [short-term] rating will defer a First Trigger from being reached until a long-term [senior unsecured] rating equals A3, compared with A2 in the absence of a short-term rating.” *Moody’s Criteria*, at 6.