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Global Structured Finance Counterparty Methodology

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Introduction

This report describes KBRA's rating methodology used to assess counterparty risk in structured finance transactions. KBRA defines structured finance counterparty risk as the risk that KBRA's rating on a transaction's securities may be affected by a change in a structured finance transaction counterparty's credit profile.

Several types of counterparties are utilized in structured finance transactions, including derivative counterparties, credit and liquidity support providers, transaction service providers, account banks, and issuers of permitted investments. The risks that counterparties may pose to a transaction can be financial or operational in nature and can range from minor to significant. The more material the counterparty's performance is to the credit quality of the transaction, the more likely the ratings of the transaction's securities will be dependent upon (and limited by) KBRA's assessment of the counterparty's creditworthiness. In determining creditworthiness, KBRA will generally rely on its own ratings or credit assessments although KBRA may rely on other publicly assigned ratings.

In certain instances, the rated securities may be entirely dependent upon a counterparty's performance, such as in a transaction where a third party guarantees all interest and principal payments on the rated securities. In this instance, the ratings on the most senior tranche of securities would likely not be higher than KBRA's rating or credit assessment on the counterparty; however, KBRA may choose to perform an analysis that partially or entirely excludes the support provided by the counterparty to determine if the securities can maintain their ratings on a stand-alone basis. This methodology would generally not apply to a transaction where a counterparty was directly responsible for the full payment of principal and timely payment of interest on the securities because in such a scenario the ratings would likely be limited solely to the counterparty's creditworthiness. Instead, this methodology addresses circumstances where a counterparty is utilized to mitigate a portion but not all of the overall risk present in the transaction.

This document was updated since its publication date, most recently on February 18, 2025, to update the document format. These updates had no impact on the overall methodological framework or outstanding ratings.



This methodology serves as a general framework for KBRA's approach to evaluating counterparty risks in structured finance transactions; however, it does not address all possible transaction structures and the attendant risks. KBRA's approach to any given structured finance transaction will seek to address counterparty risks, including risks not specifically discussed in this methodology, on a case-by-case basis. Additional and more specific considerations may be relevant to KBRA's analysis depending upon, among other things, the specific asset class being rated, credit enhancement present in the transaction unrelated to support provided by counterparties, the transaction structure, the forms and domiciles of the relevant entities, and the governing law of the transaction documents. This methodology is not intended to provide exhaustive guidance regarding potential counterparty risk but rather set forth a general overview of the basic counterparty considerations relevant to structured finance transactions.

It is important to note that KBRA applies judgment in the application of all of its methodologies. This may result in certain aspects of the methodology not being employed or being modified during our analytical process where deemed appropriate.

Financial Counterparties

In a structured finance transaction, the issuer may attempt to mitigate financial and liquidity risks by contracting with a creditworthy counterparty to provide additional credit enhancement. KBRA refers to such counterparties as "Financial Counterparties". KBRA divides Financial Counterparties into the following two categories which are discussed in greater detail below: (1) Derivative Counterparties and (2) Credit and Liquidity Support Providers. While this section addresses the most prevalent sources of Financial Counterparty risk, KBRA acknowledges that a transaction may feature additional layers of Financial Counterparty risk that will be assessed on a case-by-case basis.

Derivative Counterparties

Derivatives are often utilized in structured finance transactions to mitigate risks caused by certain asset and liability mismatches. Derivatives can take various forms, including foreign currency swaps, interest rate swaps, interest rate caps or floors, total return swaps or credit default swaps. While derivatives may reduce the overall risk profile of the transaction, to the extent debt service on the rated securities is dependent upon payments from a derivative counterparty, whether in the form of direct counterparty payments to the securityholders or indirect payment coverage on the assets collateralizing the rated securities, KBRA will assess the creditworthiness of such derivative counterparty and incorporate such assessment into its analysis.

Credit and Liquidity Support Providers

Transaction sponsors or their affiliates may be incentivized to provide various forms of credit enhancement, in lieu of cash reserves, such as in the form of a letter of credit or a revolving credit line, to support the overall liquidity requirements of a transaction, particularly in instances where cash flows may be volatile because the number of assets in the securitized pool is small or obligor payments are relatively sporadic. Alternatively, sponsors or their affiliates may contract with third parties, typically financial institutions, to provide such support. These types of credit support come in different forms with the overall creditworthiness of the support providers varying substantially.

Limited versus Significant Financial Counterparty Risk

KBRA will first evaluate the transaction structure and review the operative documents to determine the extent to which the rated securities are exposed to the creditworthiness of a Financial Counterparty. In some structured finance transactions, the rated securities' exposure to a Financial Counterparty's risk may be low or moderate ("Limited Counterparty Risk"). Examples of Limited Counterparty Risk include, among other things: servicer advances to cover delinquent obligor payments or property protection expenses that the servicer deems recoverable; or the requirement that an asset seller must repurchase assets from an issuer if certain representations or warranties relating to the assets were breached. In such instances, KBRA will generally review the overall transaction terms and structure to determine the level of risk introduced by the inclusion of the Financial Counterparty and whether such risk is sufficiently mitigated taking into account the proposed rating levels on the transaction's securities.



In other structured finance transactions, the ratings dependency on the Financial Counterparty is significant (“Significant Counterparty Risk”). Significant Counterparty Risk relates to situations where the transaction’s ratings are meaningfully (but not 100%) exposed to a Financial Counterparty’s creditworthiness. Examples of Significant Counterparty Risk include, among other things: utilizing an interest rate hedge to address an interest rate mismatch between a substantial portion of the transaction’s collateral and the rated securities; utilizing a currency hedge in a transaction where all or a substantial portion of the payments by the obligors on the underlying assets are denominated in one currency and the distributions on the rated securities are payable in another currency; or retaining a liquidity support provider to make interest payments on the rated securities in the event of temporary interest shortfalls.

Requirements Relating to Significant Counterparty Risk

In the event that a structured finance transaction includes Significant Counterparty Risk, KBRA generally expects a Financial Counterparty to have credit characteristics commensurate with the ratings or credit assessments listed in Figure 1.

Figure 1: Minimum Financial Counterparty Rating or Credit Assessment in Transactions with Significant Counterparty Risk

If Highest Rated Tranche is:	Minimum Financial Counterparty Long-Term Senior Unsecured Debt Rating or Credit Assessment	Minimum Financial Counterparty Short-Term Senior Unsecured Debt Rating or Credit Assessment
AAA (sf) to AA- (sf)	A-	K1
A+ (sf) to BBB- (sf)	BBB-	K3
BB+ (sf) to BB- (sf)	BB-	B

If a structured finance transaction includes Significant Counterparty Risk and the relevant counterparty’s rating or credit assessment is below the minimum Financial Counterparty ratings or credit assessments, as applicable, set forth in Figure 1, KBRA will evaluate the deal-specific credit enhancement and other transaction features to determine if there are sufficient mitigants to the risk of including such counterparty. In addition, KBRA’s initial analysis and/or ongoing surveillance may partially or entirely exclude the support or enhancement provided by a counterparty to determine if the transaction’s rated securities are able to maintain ratings on a stand-alone basis.

Triggers Relating to Significant Financial Counterparties

In addition to reviewing the creditworthiness of any Financial Counterparties in a structured finance transaction containing Significant Counterparty Risk, KBRA will review the transaction documents to confirm there are appropriate triggers addressing potential future rating downgrades of such Financial Counterparties. Such provisions may have multiple remedies upon a rating downgrade, including that the Financial Counterparty must either post collateral in the full amount of its potential obligations under the applicable agreement to which the Financial Counterparty is a party, find a replacement counterparty that meets the minimum required ratings for the Financial Counterparty at the transaction’s closing, obtain a guarantee from a Financial Counterparty which meets the minimum required ratings for the Financial Counterparty at the transaction’s closing, or a combination of these remedies. To the extent our analysis and ratings significantly rely on a Financial Counterparty, it is an important consideration in KBRA’s analysis that the agreements to which the Financial Counterparty is a party provide for sufficient time periods in which such remedial actions must occur. KBRA would generally expect that the transaction documents require such remedial actions to occur in a reasonable time frame, which is typically within 90 days, although KBRA will review transactions on a case-by-case basis to analyze whether in certain circumstances either shorter or longer time periods are appropriate.



With respect to the posting of collateral, requirements may vary depending on the type of derivative contract or liquidity support provided. Further, the types of collateral required to be posted often depend upon the duration of the required posting and the potential for market value changes in the collateral. To offset this market value or credit risk, guidelines in the transaction documents should generally specify the types of acceptable collateral along with market value haircuts. KBRA will review the counterparty collateral posting provisions and related documentation for each transaction to determine whether they are sufficient to maintain the ratings on the rated securities in the event that collateral must be posted.

KBRA is cognizant of the fact that derivative contracts for structured finance transactions may have minimum rating requirements (including downgrade triggers) for the Financial Counterparties that are based on Financial Counterparty ratings from other NRSROs. When the downgrade trigger is based upon the ratings of another NRSRO, KBRA may conduct an internal assessment of the creditworthiness of the replacement Financial Counterparty to ensure that, in KBRA's view, the creditworthiness of such Financial Counterparty combined with the remedies in the documentation will allow the transaction's rated securities to maintain their ratings.

KBRA may also review additional structural and legal elements of a transaction when evaluating the risks a Financial Counterparty introduces, including consideration of the specific asset class being rated. These elements may include, among other things, the transaction structure, the forms and domiciles of the relevant entities, and the governing law of the transaction documents. Generally, KBRA expects derivative transactions to be prepared in accordance with market standard documentation, utilizing standard forms from the International Swaps and Derivatives Association and other related documents.

Transaction Service Counterparties

Structured finance transactions often include counterparties that are essential to servicing the issuer's assets, managing the issuer's limited purpose operations, and ensuring that funds which must ultimately be paid to investors are adequately segregated. Such counterparties may include servicers, custodians managing or maintaining possession of the physical collateral, special servicers performing workouts or otherwise handling defaulted assets, trustees, and paying agents. KBRA refers to such counterparties as "Transaction Service Counterparties". KBRA will evaluate the Transaction Service Counterparties to ensure that such parties do not pose significant credit risk, taking into account the proposed rating levels considered for the rated securities in the transaction.

Transaction Service Counterparties can generally be divided into the following three categories which are discussed in greater detail below: (1) servicers, (2) trustees and securities administrators, and (3) account banks and custodial institutions. While this section addresses the most prevalent sources of Transaction Service Counterparty risk, KBRA recognizes that a transaction may feature additional layers of Transaction Service Counterparty risk that will need to be assessed on a case-by-case basis. Furthermore, many risks related to Transaction Service Counterparties are specific to certain asset classes, especially with respect to risks posed by servicers, master servicers and/or special servicers, and the reader is encouraged to review KBRA's methodologies concerning the specific asset class being evaluated in order to understand how KBRA would analyze Transaction Service Counterparty risk in a given transaction.

Servicers

The servicer is traditionally responsible for collecting payments from obligors to the extent payments are not sent directly to a lockbox or specified trust account, overseeing the issuer's assets and, in certain instances, providing servicer advances. Servicers may directly collect all payments due with respect to performing assets in the collateral pool and initiate special servicing transfers when necessary. The extent of the servicer's role depends heavily on the specific asset class and readers should review KBRA's methodologies concerning the specific asset class being evaluated to understand how KBRA would analyze servicer risk in a given transaction.



Operational risk arises due to the transaction's dependence upon the servicer's ability to fulfill its contractual obligations to service the collateral pool. A disruption in the servicer's operations may result in, among other things, fewer collections on the underlying assets than expected, thus decreasing the amount of funds available to make payments on the securities. The overall depth of the servicer's experience and quality of its operations coupled with the extent of services being provided will determine the level of operational risk.

In addition to operational risk, a potential financial risk that could result from the servicer's collection practices is commingling risk, particularly where the servicer is not a highly rated depository institution. This occurs when the servicer collects payments from obligors or other proceeds from the collateral and holds such amounts in its own account prior to depositing the funds into a segregated account held on behalf of the issuer. In the event the servicer is subject to any financial disruption or becomes subject to a bankruptcy or insolvency proceeding, all funds held in the servicer's own account could become part of the servicer's bankruptcy estate and unavailable for distribution to the securityholders. To mitigate commingling risk, payments from obligors can be routed directly into a trust account or a separate account maintained by a highly rated third party in the name of the issuer. In some cases, a lockbox account is established and is controlled by a trustee on behalf of the issuer instead of by the servicer. However, for some asset classes, this arrangement is not practicable, and the length of time the payments are held by the servicer can be minimized by having overnight or frequent cash sweeps to an account controlled by a trustee on behalf of the issuer. Typically, cash sweeps from a servicer account to a trustee-controlled account occur within two to three business days of receipt of funds by a servicer. To the extent that deposits are not held by a highly rated depository institution and commingling risk will exceed three consecutive business days, KBRA will review the proposed time period and consider the impact it may have on the ratings assignment on a case-by-case basis.

Trustees and Securities Administrators

The typical role of a trustee or securities administrator is to hold the transaction's collateral in trust for the benefit of the securityholders. The trustee or securities administrator can coordinate with the issuer to operationally manage the cash accounts with the account banks and custodian. The trustee or securities administrator often also creates and distributes detailed reports of collateral performance and payments required to be made pursuant to the transaction documents. Generally, KBRA would expect a trustee or securities administrator in a structured finance transaction containing securities rated investment grade by KBRA to have an investment grade rating or investment grade credit assessment.

Account Banks and Custodial Institutions

An issuer will typically need to have several accounts established in a structured finance transaction in which to deposit principal or interest collections received on the underlying collateral, and for maintaining adequate reserves for interest payments and transaction expenses. Depending on the asset class and relevant jurisdictions, the transaction may use either account banks or trust and custodial institutions. Since such account banks or trust and custodial institutions are responsible for holding funds that the securityholders are or may be entitled to, securityholders are exposed to the credit risk of such institutions. As a result, KBRA may review such institutions to make sure their creditworthiness is appropriate for the rating levels being considered for the transaction's securities.

With respect to account banks and trusts or custodial institutions, the risk to the transaction can be material depending on both the relative amount of collections held at such institution and the amount of time such collections remain on deposit. To the extent a structured finance transaction contains securities rated investment grade by KBRA and funds related to such transaction are expected to be held at an account bank or trust or custodial institution for an extended period of time, KBRA generally expects such account banks and trust or custodial institutions to have an investment grade rating or investment grade credit assessment. Nevertheless, KBRA will review each transaction on a case-by-case basis to analyze whether the investors' exposure to an account bank's or trust or custodial institution's creditworthiness is sufficiently limited to mitigate the risk of an account bank or trust or custodial institution having a rating or credit assessment below investment grade.



Permitted Investments

The transaction documents for structured finance transactions typically permit either the issuer or its service providers to invest cash deposited in trust accounts in specified investments often identified in the transaction documents as “permitted investments” or “eligible investments.” KBRA generally expects that any “permitted investment” would be required to mature no later than the maturity date of the rated security.

With respect to “permitted investments” that mature in 90 days or less, KBRA generally expects a structured finance transaction with securities rated investment grade to restrict “permitted investments” to investments in securities, deposits, funds, guaranteed investment contracts or entities with a short-term senior unsecured debt rating or credit assessment of at least K3 or its long-term equivalent.

With respect to “permitted investments” that mature in 91-365 days, KBRA generally expects: (i) a structured finance transaction with securities rated in the two highest investment grade rating categories by KBRA (i.e. AAA (sf) or AA (sf)) to restrict “permitted investments” to investments in securities, deposits, funds, guaranteed investment contracts or entities with a short-term senior unsecured debt rating or credit assessment of at least K1 or its long-term equivalent, and (ii) a structured finance transaction with the highest rated tranche of securities having a rating in the two lowest investment grade categories (i.e. A (sf) or BBB (sf)) to restrict “permitted investments” to investments in securities, deposits, funds, guaranteed investment contracts or entities with a short-term senior unsecured debt rating or credit assessment of at least K3 or its long-term equivalent.

With respect to “permitted investments” that mature in more than one year, KBRA generally expects a structured finance transaction to restrict “permitted investments” to investments in securities, deposits, funds, guaranteed investment contracts or entities with a long-term senior unsecured debt rating or credit assessment of at least as high as the highest KBRA-rated security relating to the transaction.

To the extent “permitted investment” guidelines in a transaction diverge from these standards, KBRA will evaluate such “permitted investment” guidelines on a case-by-case basis to determine if the increased risk of potential investment losses is mitigated by the overall structure.

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