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Implications of Financial Institution Downgrades on Global Structured Finance Markets

By Simon Mabin (Dubai), Neil Campbell (Hong Kong), Sean Crosky, Paul Matthews, Stephen Moller (London), David Bernstein, Anthony R.G. Nolan, Howard M. Goldwasser (New York)

On 21 June 2012 Moody's Investors Service (**"Moody's"**) downgraded the long term and short term ratings of 15 international financial institutions, some of the largest participants in the global structured finance market, with three large institutions being downgraded below single-A. The Moody's downgrades (the **"Moody's Downgrades"**) are possibly the most significant private sector downgrade since Standard & Poor's cut the credit ratings of a number of global financial institutions in December 2009. Despite the efforts of policymakers in several jurisdictions to lessen their importance, the credit ratings of participants in structured finance transactions are vitally important to the ratings of the asset-backed securities issued in those transactions. Financial institution rating downgrades in the past have resulted in a large number of transactions being restructured or terminated as a consequence of the effect of the downgrades on the structures.

This alert considers the impact that downgrades of financial institutions have had on structured finance transactions in recent years. We also highlight issues to consider and describe structures that may help to mitigate the effect on structured finance transactions of a rating downgrade of a transaction participant. This alert also considers the implications of the Moody's Downgrades on the market and highlights issues which may arise in structured finance transactions as a result of the Moody's Downgrades.

Potential Impact of the Moody's Downgrades on Structured Finance Markets

A key feature of structured finance transactions is the requirement that specified service providers or counterparties maintain a minimum rating (whether it be short term, long term or both) in order for the senior tranche of asset-backed securities issued in the transaction to maintain a high rating. The counterparties with required minimum ratings are generally those counterparties on whom the structure and noteholders have credit risk, although recent rating criteria have also focused on performance risk of certain parties (such as servicers). There may also be certain differences between criteria for different geographical markets, although broadly the criteria are the same and this alert does not distinguish between different geographical markets in its analysis.

As a general principle, the following entities in a transaction need to possess minimum ratings:

- account and deposit banks;
- Guaranteed Investment Contract ("GIC") providers and eligible investments;
- custodians;
- liquidity facility providers; and
- swap counterparties.

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Other parties may be required to maintain minimum ratings in order to perform their obligations in a transaction. For example, servicers in some transactions may be required to maintain minimum ratings levels in order to commingle collections on the securitised assets. Servicers without a specified rating are generally required to remit collections on securitised assets daily and lose the spread they would have otherwise been entitled to retain.

Since 2009, the rating agencies have downgraded a number of financial institutions that provide services to structured finance transactions, with the result that several of such transactions have required restructuring in order for their notes to retain their rating. In light of this history it is to be expected that the Moody's Downgrades will result in further restructuring of transactions. This may therefore be an opportune time to ask whether this process of restructuring ought to continue or whether, instead, rating agencies and policymakers should reconsider the role and importance of ratings in assessing what is required for the structural support of structured finance transactions globally. How do we balance the need to minimise credit risk with the need to limit concentration risk? How will the absence of appropriately rated swap counterparties limit the ability to issue securities to investors with varying rate preferences or affect the ability to hedge basis risk?

Efforts to address the impact of previous downgrades have been hindered because transactions differ widely in respect of the required ratings for service providers and others and the language in which those requirements are expressed. Not only does the language depend upon when documents were executed or last amended to conform with updated rating agency criteria, but also upon the semantics of the drafter responsible for the documents. Although in principle the provisions should be the same across transactions of a similar vintage involving the same rating agencies, this is not always the case. As such, each transaction, and the obligations of various parties in the relevant transaction, need to be considered on a case by case basis.

A relatively new development that further complicates efforts to address variability in ratings is that the role of credit ratings and of credit agencies has been changing, with ratings being de-emphasised for several purposes and the rating agencies being subject to enhanced restrictions (for example, Rule 17-g of the US Securities Exchange Act) that are designed to minimise conflicts of interest. For example, US banking regulators have been reducing the role of credit ratings for regulatory capital purposes and the Securities and Exchange Commission has proposed to remove ratings-based criteria for eligibility to issue asset-backed securities on a shelf registration statement. In Europe, the rating agencies have become subject to regulation under CRA Regulation I and II and further regulation is currently under debate. These developments, which are still ongoing to a degree, may affect the importance of ratings and the way in which rating agencies will address them.[1]

We will now consider the impact of credit rating downgrades on various facets of the structured finance market and consider issues which may arise as a result of the Moody's Downgrades.

Account Banks, Deposit Banks, GIC Providers, Custodians and Eligible Investments

In many transactions, the cash manager (or similar entity) is permitted to invest in certain investments, including bonds, money market funds and bank deposits. The credit risk on these investments is analysed in a similar way to that on the account bank or custodian. As such, the investments (or the entity into which the investment is being made) need to satisfy certain minimum criteria. A number of the financial institutions subject to the Moody's Downgrades

[1] *To view K&L Gates' Alert discussing some of the ways in which Congress sought to strengthen regulation and expand potential liability of credit rating agencies in the Dodd-Frank Act, click here.*

provide such services to the structured finance market. The Moody's Downgrades may mean that these entities are no longer available to offer eligible investments.[2]

Account banks, deposit banks, providers of GICs and other investment agents and custodians play fundamental roles in structured finance transactions. In the case of an account bank or GIC provider, they hold the income of the structure between payment periods and, in the case of a custodian, they hold the assets of the structure. The rating agencies rightly focus on these roles as a credit risk in the transaction. Like other rating agencies, Moody's has set a minimum rating for these entities in rated transactions rated Aaa by it, with its minimum custodian rating set at P-1 (short term). When the entity no longer satisfies this rating, the role in the transaction must be transferred to another appropriately rated entity within a given period (generally 30 days). The obligation to transfer varies across transactions, and depending on facts may fall on the downgraded entity, the issuing entity or the trustee.

The obligation to transfer the obligation to a new party may raise a number of issues. Generally the documentation for a structured finance transaction permits a transfer with the consent of the trustee so long as the new agreement is "substantially the same" as the existing agreement. The question arises as to when something is "substantially the same", as experience has shown that prospective transferees generally insist on modifying the documentation to conform to their approved forms. Sometimes these variations are minimal, and can be negotiated and agreed in a relatively short period. However, the variations may also be significant, including such matters as differences in limitation of liability language or indemnity provisions, and those differences may require extensive negotiation between the various parties to the transaction.

The issuer often has a limited ability to agree to amendments to the new agreement without the consent of the trustee. Although the trustee has certain discretion with regard to amendments, trustees generally seek the consent of the note holders to amendments that represent material differences, even where it has the power to agree to such modifications without note holder consent. Given the notice and quorum requirements for note holders meetings, this complicates the timing for any transfer and adds to the costs of the transfer.

In previous downgrades, the requisite timing of the transfer has also caused issues. Even where there is limited negotiation of the existing agreement with the new entity, it has been difficult to complete the transfer in the required time period. However, in a number of transactions, considerable time periods have been required to effect the transfer of the accounts from one entity to another entity. We have also had to structure around differences between various providers and consider whether another entity (such as the originator) may be able to provide some additional comfort to the new provider in order to minimise the extent of the amendments to the documents. The timing issue would only be compounded where a number of transfers are required through the downgrade of a major provider of these services in the structured finance market.

Even if a transfer is effected without problem, investors may be harmed by differences in the terms of an investment that can be obtained compared to the investment that had been offered by the downgraded entity. In the historically low interest rate environment of the past several years, the rate of interest being offered for GICs and other investment products for funds on deposit in accounts of the issuer is generally lower than that offered prior to 2008. Where a transaction has substantial amounts credited to low-yielding investments or in cash equivalents in its accounts during a payment period, the transfer may have an additional impact on the note holders by reducing the positive arbitrage between the assets and the liabilities of the securitisation structure.

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[2] *To view K&L Gates' Alert on "Key Insolvency Issues for Broker-Dealers, Custodial Banks and Counterparties to Repos, Swaps and Other Financial Contracts" (3 April 2008), click here.*

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The difference in pricing will often mean that the agreement is not "substantially the same" and will generally require note holder consent before being agreed to by the issuer and the trustee.

The removal of one of the major providers of account bank services in the structured finance market also raises the issue of concentration of credit risk with a more limited pool of entities. We have seen the difficulty in transferring accounts in structured finance transactions in previous downgrades, and the concern of market participants with too much risk lying with a limited number of entities. However, conversely the Moody's Downgrades will have this effect, unless the required ratings are modified going forward. This is of concern to investors, originators and any other participant in the structured finance market.

If, because of the Moody's Downgrades, that which previously had been an eligible investment loses that status, it may not be possible to replace the formerly eligible investment with an investment that will generate as high a yield as the investment being replaced. That is particularly likely to be the case in today's very low interest rate environment. A possible way to deal with this is to keep the prior investment in effect but credit enhance that investment with a surety bond or other obligation of any entity that still has a sufficient rating (if that will satisfy the securitisation documents).

It is also noted that since the Moody’s Downgrades were announced, Moody’s has released for comment two proposals affecting how it assesses structured finance transactions. The first proposal supplements Moody's existing framework for de-linking swap counterparty risks by outlining an approach to assessing credit linkage to swap counterparties. The second proposal provides specific guidelines on how the choice of banks and eligible investments for the temporary use of cash affects Moody's analysis of structured finance transactions, other than asset backed commercial paper. It is expected that the proposals, if implemented, would result in a limited number of negative rating actions.

The Impact of Swap Counterparty Downgrades on Hedging in Structured Finance Transactions

Structured finance transactions typically include interest rate, FX or credit derivatives documented using ISDA master agreements. These transactions are designed with collateral triggers and early termination triggers that are planned to comply with derivatives counterparty criteria of the rating agencies rating the securities issued in that transaction. Those criteria are designed to enable the separation (or de-linkage) of the rating of such counterparties (or their credit support providers) from the structured finance products in respect of which they provide hedging. The derivatives counterparty criteria are designed to permit structured finance products to be rated higher than derivatives counterparties upon which their cashflows may depend. Derivative counterparty criteria vary between the agencies and also vary according to the nature of the relevant derivative and the target rating for the related structured finance product. The Moody's Downgrades implicate structured finance transactions because they have affected some of the major providers of derivatives in the structured finance market. Therefore, it is necessary to consider the impact of the Moody’s Downgrades – indeed, any downgrades of swap counterparties – on structured finance transactions in terms of increased credit support requirements and termination.

Generally the rating agency criteria for derivatives counterparties create three bands delineated by minimum rating requirements into which a counterparty may fall.

- A counterparty with a credit rating in the highest band can usually be a derivative counterparty without being required to provide additional credit support. Only a handful of structured finance market participants retain this status. This has clear pricing implications for new transactions and limits the options for the replacement of derivatives counterparties in outstanding transactions.

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- A counterparty whose credit rating falls in or to the middle band may be required to post collateral to support its obligations, depending on the value of its outward exposure on the derivatives contract. The recent downgrades have reduced the credit ratings of a significant number of structured finance market participants to this band. A requirement to post collateral can impose significant costs and liquidity constraints on derivatives counterparties, as was shown most dramatically in 2008 when collateral posting obligations triggered by a credit downgrade forced AIG into a situation that threatened the stability of the global financial system more acutely than did the collapse of Lehman Brothers. Where the implications of a structured finance vehicle holding posted collateral has not been fully anticipated in the transaction documentation (particularly in the case of older deals) other transaction parties may also be affected by this development. The negotiation and adoption of new credit support, bank account, custodial and security interest documentation may involve issues akin to the amendment and variation issues faced by issuers and trustees as described elsewhere in this alert. All parties will also be concerned to ensure that security arrangements and pre and post enforcement cashflow provisions appropriately govern and direct the utilisation of such collateral and its proceeds.

- Finally, counterparties rated in the lowest band cease to be eligible derivatives counterparties and must actively seek to transfer those roles to higher rated entities while also potentially being required to post increased amounts of collateral in the meantime. The transfer obligation raises many of the same considerations discussed above in relation to investment contracts, and also poses additional challenges related to the small and perhaps dwindling pool of willing and eligible potential replacement derivative counterparties. If the outgoing derivatives counterparty's position was in the money at the time of the downgrade or if market terms for the type of transaction in question have changed between the inception of the transaction and the date of the transfer, the structured finance transaction may incur significant costs that would ultimately be borne by the investors in the transaction.

Derivatives counterparties will be keen to ensure they satisfy their contractual obligations to the fullest of their abilities to try to avoid triggering default or other termination provisions of their contracts. Varying standards of bespoke contractual terms developed over the years can make this a daunting and precarious task, and as in other contexts discussed in this alert, the negotiation and adoption of new documentation for an existing transaction can raise significant issues for issuers and trustees and incur costs that reduce the return to investors . In some cases the practical difficulties of arranging a replacement derivative counterparty (or the inability to make such arrangement at an economically acceptable cost) will prevent a replacement taking place but, despite the efforts of the downgraded counterparty, may not excuse such a failure. In many transactions a failure by a derivative counterparty to replace itself upon downgrade will result in the subordination of termination payments that may be due to that counterparty.[3] An ongoing

[3] *Although beyond the scope of this article, the enforceability of such "flip clauses" in bankruptcy has been hotly contested, with courts in the United States and England adopting quite different approaches. See, e.g. re: Lehman Brothers Holdings Inc., et al.(Lehman Brothers Special Financing Inc. v BNY Corporate Trustee Services Limited (Adversary Proceeding No. 09-01242 (Bankr. S.D.N.Y. 2011); Belmont Park Investments PTY Limited (Respondent) v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc (Appellant) [2011] UKSC 38. See also In re: Lehman Brothers Holdings Inc., et al.(Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Limited, and Wells Fargo Bank, N.A(Adversary Proceeding No. 09-01032 (Bankr. S.D.N.Y. 2011). See also In*

failure to replace (notwithstanding the efforts of the relevant counterparty) may also affect the rating of related securities. We note however the current rating agency initiatives to more fully assess the actual impact on the ratings of related securities of non-compliance with rating criteria in these circumstances.

For simplicity, references to a counterparty's rating in this section include the rating of any guarantor of that counterparty's relevant derivative obligations. Arranging a guarantee from a suitably rated guarantor may accordingly enable a derivative counterparty to improve its banding and reduce or avoid potential additional obligations accordingly. As an alternative to a guarantee some transactions have involved the intermediation of a suitably rated derivatives counterparty between the transaction and a lower rated market participant. However, the limited pool of potential intermediaries and related cost implications limit the practicality of this alternative.

Looking beyond the immediate action required in relation to the recent downgrades we note that various downgrades over recent years had severely decreased the universe of willing and eligible structured finance derivatives counterparties. The experience of recent participants is also unlikely to encourage new entrants for some time. Increased costs and restricted choice in the structured finance hedging market is therefore likely to inhibit the development of the structured finance market for the foreseeable future.

Impact of a Downgrade on Transaction Liquidity

One other participant in the structured finance market who has been directly impacted by downgrades over the past few years is the liquidity facility provider. When a liquidity facility provider no longer satisfies the required minimum rating, the issuer either needs to find a new provider or needs to make a standby drawing of the entire facility. In the current market, it is almost impossible for an issuer to find a replacement provider at a similar cost to the existing provider, and as such, the issuers have been required to draw on the liquidity facilities. Whilst there may be some effect on the remaining facilities following the Moody's Downgrades, a large number of the banks who traditionally provided these facilities in the structured finance market have already been subject to downgrades by one or more rating agencies which have resulted in their facilities being fully drawn as standby drawings.

Impact of a Downgrade on CLO Transactions

While most of the press coverage on the Moody's Downgrades has focused on the impact that the downgrades would have on collateral posting in swap transactions, the CLO community is concerned about how the downgrades might impact the ability of CLOs to acquire loans on a participation basis, rather than by direct assignment. For example, as Moody's noted, most CLOs impose concentration limits on the amount of participation interests that the CLO issuer can purchase from any single selling bank. If the selling bank's credit rating is high – typically, Aa3 or better – the CLO's governing documents usually allow the issuer to purchase 10-20% of its assets in the form of participation interests from a single selling bank. However, once the selling bank's rating drops to A3 or below (or sometimes A2 if its short-term rating its below P-1), the CLO issuer is prohibited from purchasing more participation interests from the seller. Even though a CLO issuer is not obligated to sell its participations when that happens, it would not be permitted to buy more. The Moody's Downgrades pushed the ratings of many major banks below the "participation ratings" threshold. According to some estimates that may leave only two banks as eligible sellers if the ratings triggers apply at the holding company level and four if applied at the bank level.

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Additional Implications of a Downgrade on Structured Finance Investors

Ultimately the effect of a downgrade on financial institutions that participate in structured finance transactions is borne by the investors in those transactions, either in terms of additional costs or in terms of seeing their notes downgraded.

The requirements under the criteria for entities performing certain roles to transfer these roles on downgrade may involve additional costs depending upon how the documentation is drafted. Alternatively, requiring the transfer of the accounts (in particular, where the account is structured as a GIC account) or eligible investments of the issuing vehicle may mean that the income from these assets is less than originally anticipated (although it should be stressed that the income from such investments and accounts is generally not part of the modelled cash flows for structured finance transactions). All of these factors can have an impact on the position of investors in a transaction.

Where a replacement service provider counterparty is not available, such as where providers of swaps to structured finance transactions are unable to find a replacement counterparty, the rating agencies generally downgrade the relevant asset-backed securities if the obligation is not transferred to an appropriately rated entity in a timely manner. Such a rating downgrade could impact investors in a variety of ways. For example, note holders that are are only permitted to hold asset-backed securities with a certain rating (such as insurance companies in many jurisdictions) or that obtain punitive regulatory capital treatment of asset-backed securities below a certain rating level (as banks under Basel II and III) would likely liquidate their positions or be required to strengthen their balance sheets following the downgrade. Such requirements could exacerbate market pressures by forcing sales of holdings at fire sale prices or requiring recapitalization dilution of existing shareholders.

Downgrades of service providers or counterparties may also place the directors of issuing vehicles in structured finance transactions in complicated positions. Under the relevant transaction documents they may have an obligation to transfer accounts etc. within a certain period after the downgrade. However, there may be only a limited universe of entities (or, in some cases, no entity) who are willing to perform the role and they may require significant amendments to the documents. This in turn may mean that the consent of the investors is required to the amendment, which may result in the issuing vehicle not being in compliance with its obligations under the documentation. The increased difficulty in finding suitable replacement entities within the structured finance market and the additional tightening of the replacement language in the documentation will only exacerbate these issues.

Future Implications

The Moody’s Downgrades represent the most recent example of ongoing strains as the financial markets struggle with the aftermath of the 2008 crisis and with new shocks emanating from Europe and elsewhere. Because of the size and global reach of the institutions involved there can be little doubt that the Moody’s Downgrades will have generally similar implications for transactions and investors in markets as diverse as New York, London, Dubai and Hong Kong. It is very possible that the Moody's Downgrades will not be the last word, and that further downgrades could affect the structured finance markets, whether they are instigated by Moody's or another rating agency. These will raise a variety of questions.

One issue which needs to be addressed is the effect of the Moody’s Downgrades - or similar downgrades - on structured finance transactions whose senior debt is rated below Aaa by Moody’s. A number of transactions have had their debt downgraded over the last few years for a variety of reasons (including deterioration of assets as well as counterparty risk), and it may be that the effect on the market, if limited to Aaa rated transactions, is less than initially expected. We understand that Moody's intends to issue clarification on Aa rated transactions and the effects of

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the Moody's Downgrades on such transactions. This clarification may affirm the ability of existing parties to maintain their positions in structured finance transactions, or it may indicate that Aa rated transactions should follow the Aaa rating criteria.

A key unanswered question is how downgrades will affect structured finance investors in light of the ongoing recalibration of the importance of ratings as measurements of credit risk.

The answer to this conundrum will have material implications far beyond the confines of structured finance, including government bond markets, sovereign debt ratings and, ultimately, the stability of an interlinked global financial system.

Authors:

Simon Mabin
simon.mabin@klgates.com
+971.4.427.2730
Dubai

Neil Campbell
neil.campbell@klgates.com
+852.2230.3577
Hong Kong

Sean Crosky
sean.crosky@klgates.com
+44.(0).20.7360.8169
London

Paul Matthews
paul.matthews@klgates.com
+44.(0).20.7360.8214
London

Stephen Hans Moller
stephen.moller@klgates.com
+44.(0).20.7360.8212
London

David W. Bernstein
david.bernstein@klgates.com
+1.212.536.4029
New York

Anthony R.G. Nolan
anthony.nolan@klgates.com
+1.212.536.4843
New York

Howard M. Goldwasser
howard.goldwasser@klgates.com
+1.212.536.4809
New York

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