

# 17-cv-1224-LGS

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**United States District Court**  
*for the*  
**Southern District of New York**

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LEHMAN BROTHERS SPECIAL FINANCING, INC.,

*Appellant,*

—against—

BANK OF AMERICA NATIONAL ASSOCIATION, THE BANK OF NEW YORK MELLON NATIONAL  
ASSOCIATION, BNY MELLON CORPORATE TRUSTEE SERVICES LTD.,

*(Caption continued on the following pages)*

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ON APPEAL FROM THE UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF  
NEW YORK (CHAPMAN, J.)

IN RE: LEHMAN BROTHERS HOLDINGS INC., CASE NO. 08-13555, ADV. PROC. NO. 10-03547

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**BRIEF OF *AMICI CURIAE* SECURITIES INDUSTRY AND  
FINANCIAL MARKETS ASSOCIATION AND INTERNATIONAL  
SWAPS AND DERIVATIVES ASSOCIATION, INC. IN SUPPORT OF  
DEFENDANTS-APPELLEES AND AFFIRMANCE**

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*Trustee Defendants-Appellees,*

801 GRAND CDO SPC, F/A/O THE SERIES 2006-1, AS ISSUER, 801 GRAND CDO SERIES 2006-1 LLC, AS CO-ISSUER, 801 GRAND CDO SPC, F/A/O THE SERIES 2006-2, AS ISSUER, 801 GRAND CDO SERIES 2006-2 LLC, AS CO-ISSUER, ALTA CDO SPC, F/A/O THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, ALTA CDO LLC, FOR SERIES 2007-1, AS CO-ISSUER, ALTA CDO SPC, F/A/O THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS ISSUER, ALTA CDO LLC, FOR SERIES 2007-2, AS CO-ISSUER, BARTON SPRINGS CDO SPC, F/A/O THE SERIES 2005-1 SEGREGATED PORTFOLIO, AS ISSUER, BARTON SPRINGS CDO SERIES 2005-1 LLC, AS CO-ISSUER, BARTON SPRINGS CDO SPC, F/A/O THE SERIES 2005-2 SEGREGATED PORTFOLIO, AS ISSUER, BARTON SPRINGS CDO SERIES 2005-2 LLC, AS CO-ISSUER, BLUE POINT CDO SPC, F/A/O THE SERIES 2005-1 SEGREGATED PORTFOLIO, AS ISSUER, BLUE POINT CDO SERIES 2005-1 LLC, AS CO-ISSUER, CHERRY HILL CDO SPC, F/A/O THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, CHERRY HILL CDO LLC FOR SERIES 2007-1, AS CO-ISSUER, CHERRY HILL CDO SPC, F/A/O THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS ISSUER, CHERRY HILL CDO LLC FOR SERIES 2007-2, AS CO-ISSUER, COPPER CREEK CDO SPC, F/A/O SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, COPPER CREEK CDO LLC, AS CO-ISSUER, CROWN CITY CDO 2005-1 LIMITED, AS ISSUER, CROWN CITY CDO 2005-1 LLC, AS CO-ISSUER, CROWN CITY CDO 2005-2 LIMITED, AS ISSUER, CROWN CITY CDO 2005-2 LLC, AS CO-ISSUER, FREEDOM PARK CDO SERIES 2005-1 LIMITED, AS ISSUER, FREEDOM PARK CDO SERIES 2005-1 LLC, AS CO-ISSUER, FULLERTON DRIVE CDO LIMITED, AS ISSUER, FULLERTON DRIVE CDO LLC, AS CO-ISSUER, GREYSTONE CDO SPC, F/A/O THE SERIES 2006-1 SEGREGATED PORTFOLIO, AS ISSUER, GREYSTONE CDO SERIES 2006-1 LLC, AS CO-ISSUER, GREYSTONE CDO SPC, F/A/O THE SERIES 2006-2 SEGREGATED PORTFOLIO, AS ISSUER, GREYSTONE CDO SERIES 2006-2 LLC, AS CO-ISSUER, JEFFERSON VALLEY CDO SPC, F/A/O THE SERIES 2006-1 SEGREGATED PORTFOLIO, AS ISSUER, JEFFERSON VALLEY CDO SERIES 2006-1 LLC, AS CO-ISSUER, KINGS RIVER LIMITED, AS ISSUER, KINGS RIVER LLC, AS CO-ISSUER, LAKEVIEW CDO SPC, F/A/O THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, LAKEVIEW CDO LLC SERIES 2007-1, AS CO-ISSUER, LAKEVIEW CDO SPC, F/A/O THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS ISSUER, LAKEVIEW CDO LLC, F/A/O THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS CO-ISSUER, LAKEVIEW CDO SPC, F/A/O THE SERIES 2007-3 SEGREGATED PORTFOLIO, AS ISSUER, LAKEVIEW CDO LLC, F/A/O THE SERIES 2007-3 SEGREGATED PORTFOLIO, AS CO-ISSUER, PANTERA VIVE CDO SPC, F/A/O THE SERIES 2007-1, AS ISSUER, PANTERA VIVE CDO LLC, AS CO-ISSUER, PEBBLE CREEK LCDO 2007-2, LTD., AS ISSUER, PEBBLE CREEK LCDO 2007-2, LLC, AS CO-ISSUER, PENN'S LANDING CDO SPC, F/A/O THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, PENN'S LANDING CDO LLC, AS CO-ISSUER, PYXIS ABS CDO 2007-1 LTD., AS ISSUER, PYXIS ABS CDO 2007-1 LLC, AS CO-ISSUER, QUARTZ FINANCE PLC, SERIES 2004-1, AS ISSUER, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2005-21-C TRUST, AS ISSUER, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2006-1-C TRUST, AS ISSUER, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2007-4-C TRUST, AS ISSUER, RUBY FINANCE PLC, F/A/O THE SERIES 2005-1, CLASS A2-A9, AS ISSUER, SECURITIZED PRODUCT OF

RESTRUCTURED COLLATERAL LIMITED SPC, F/A/O THE SERIES 2007-1 FEDERATION A-1 SEGREGATED PORTFOLIO, AS ISSUER, SECURITIZED PRODUCT OF RESTRUCTURED COLLATERAL

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*Issuer Defendants-Appellees,*

– AND –

AIG, INC., AIG TAIWAN INSURANCE CO. LTD., ANZ INVESTMENT BANK, ANZ NOMINEES LIMITED, ATLANTIC CENTRAL BANKERS BANK, BALMORAL AUSTRALIA PTY LTD, BANCO CREDITO DEL PERU, BANK OF AMERICA NATIONAL ASSOCIATION, THE BANK OF NEW YORK MELLON, LONDON BRANCH, THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., BASIS CAPITAL PTY LIMITED, BASIS PAC- RIM OPPORTUNITY FUND LTD., BELMONT PARK INVESTMENTS PTY LTD, BIG HORN CDO 2007-1 COLLATERAL, BLUE MOUNTAINS CITY COUNCIL, BNY MELLON CORPORATE TRUSTEE SERVICES LTD., BRODERICK CDO 3, LTD., CARROLL 2 Cc/CARROLL HOLDINGS COMPANY AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, CATHOLIC DEVELOPMENT FUND FOR THE CATHOLIC DIOCESE OF BATHURST, CHEYNE CLO INVESTMENTS I LTD., CITIBANK, N.A., CITICORP NOMINEES PTY LTD., CITIGROUP GLOBAL MARKETS, INC., CITY OF ALBANY, CITY OF SWAN, CLASS V FUNDING III, CORP., CLASS V FUNDING III, LTD., CONTINENTAL LIFE INSURANCE COMPANY OF BRENTWOOD TENNESSEE, COUNTRY LIFE INSURANCE COMPANY, CREDIT SUISSE SECURITIES (EUROPE) LTD., CREDIT SUISSE SECURITIES (USA) LLC, DEUTSCHE BANK TRUST COMPANY AMERICAS, DIVERSEY HARBOR ABS CDO, INC., DIVERSEY HARBOR ABS CDO, LTD., EASTERN METROPOLITAN REGIONAL COUNCIL, ELLIOTT INTERNATIONAL, L.P., EUROMERICA ASESORIAS S.A., EUROCLEAR BANK S.A./N.V., FIRST NORTHERN BANK AND TRUST COMPANY, LOWER MURRAY WATER, FULTON STREET CDO CORP., G & F YUKICH SUPERANNUATION PTY LTD, GARADEX INC., GATEX PROPERTIES INC., GENERAL SECURITY NATIONAL INSURANCE, GENWORTH LIFE AND ANNUITY INSURANCE CO., GEOMETRIC ASSET FUNDING LTD., GOLDMAN, SACHS & Co., GOLDMAN SACHS INTERNATIONAL, GOSFORD CITY COUNCIL, GUOHUA LIFE INSURANCE Co., LTD., HAVENROCK II LIMITED, HHE PARTNERSHIP LP, JP MORGAN CHASE BANK, NATIONAL ASSOCIATION, JP MORGAN SECURITIES, PLC, KLIO II FUNDING CORP., KLIO II FUNDING LTD., KLIO III FUNDING CORP., KLIO III FUNDING LTD., KMCL CARROLL AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, LANCER FUNDING II LTD., LANCER FUNDING II, LLC, LEETON SHIRE COUNCIL, LEITHNER & COMPANY PTY. LTD, LGT

BANK IN LIECHTENSTEIN, LTD., LIFEPLAN AUSTRALIA FRIENDLY SOCIETY LTD., THE LIVERPOOL LIMITED PARTNERSHIP, LORELEY FINANCING (JERSEY) NO. 15 LIMITED, LYNDON LIVING INC., MAGNETAR CONSTELLATION FUND II LTD., MAGNETAR CONSTELLATION MASTER FUND III LTD., MAGNETAR CONSTELLATION MASTER FUND LTD., MANLY COUNCIL, MARINER LDC, MARSH & MCLENNAN MASTER RETIREMENT TRUST, MARSH & MCLENNAN COMPANIES, INC. STOCK INVESTMENT PLAN, MBIA, INC., MODERN WOODMEN OF AMERICA, INC., MONEYGRAM SECURITIES LLC, MORGAN STANLEY & CO., INCORPORATED, MORGANS FINANCIAL LIMITED, MULBERRY STREET CDO, LTD., NATIONAL NOMINEES LIMITED, NATIONWIDE HYBRID MAND/NATIONWIDE SF HYBRID AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, NATIONWIDE SUPERANNUATION AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, NATIXIS FINANCIAL PRODUCTS LLC, NEWCASTLE CITY COUNCIL, OHIO PUBLIC EMPLOYEE RETIREMENT SYSTEM, OSDF, LTD., OVERSEAS PROPERTY INVESTMENT CORPORATION, PANORAMA RIDGE PTY LTD, PARKES SHIRE COUNCIL, PCA LIFE ASSURANCE CO. LTD., PHL VARIABLE INSURANCE COMPANY, PHOENIX LIFE INSURANCE COMPANY, PINNACLE POINT FUNDING LTD., PINNACLE POINT FUNDING CORP., PRINCIPAL LIFE INSURANCE COMPANY, PUTNAM DYNAMIC ASSET ALLOCATION FUNDS – GROWTH PORTFOLIO, PUTNAM INTERMEDIATE DOMESTIC INVESTMENT GRADE TRUST, PUTNAM STABLE VALUE FUND, RGA REINSURANCE CO., SBSI, INC., SCOR REINSURANCE COMPANY, SECURITY BENEFIT LIFE INSURANCE CO., SENTINEL MANAGEMENT GROUP INC., SHENANDOAH LIFE INSURANCE COMPANY, SHINHAN BANK, SMH CAPITAL ADVISORS, INC., ST. VINCENT DE PAUL SOCIETY QUEENSLAND, STABFUND SUB CA AG, STANDARD LIFE INSURANCE COMPANY OF INDIANA, STANTON ABS I P.L.C., STANTON CDO I SA, STARLING STRATEGIES LTD., STATE STREET GLOBAL ADVISORS, STATE STREET BANK AND TRUST COMPANY, STATE STREET INTERNATIONAL IRELAND LIMITED, STRATEGIC GLOBAL (PUTNAM) MANAGED TRUST, STICHTING SHELL PENSIOENFONDS, STRUCTURED CREDIT OPPORTUNITIES FUND II, LP, SUSQUEHANNA BANK, TERWIN CAPITAL, LLC, TIERRA ALTA FUNDING I LTD., TIERRA ALTA FUNDING I, CORP., TOPDANMARK EDB A/S, TRICADIA CREDIT STRATEGIES MASTER FUND, LTD., U.S. BANK NATIONAL ASSOCIATION, UNICREDIT BANK AG, LONDON BRANCH, UNITING CHURCH IN AUSTRALIA PROPERTY TRUST (SA), VALEO INVESTMENT GRADE CDO LTD., WELLS FARGO BANK, NATIONAL ASSOCIATION, WHITEHAWK CDO FUNDING, LLC, WHITEHAWK CDO FUNDING, LTD., THE WINTER GROUP, ZAIS INVESTMENT GRADE LIMITED II, ZAIS INVESTMENT GRADE LIMITED V, ZAIS INVESTMENT GRADE LIMITED X, INDIVIDUALLY AND AS REPRESENTATIVES OF ALL OTHERS SIMILARLY SITUATED,

*Noteholder Defendants-Appellee*

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*Amici curiae* Securities Industry and Financial Markets Association (“SIFMA”) and International Swaps and Derivatives Association, Inc. (“ISDA”) respectfully submit this brief in support of the noteholder and trustee defendant-appellees (the “Appellees”) brief in response to the brief of Plaintiff-Appellant Lehman Brothers Special Financing Inc. (“LBSF”) concerning LBSF’s appeal from the order (the “Order”) of the United States Bankruptcy Court for the Southern District of New York dismissing Counts I through XIX of the Fourth Amended Complaint (the “Complaint”).

#### **PRELIMINARY STATEMENT**

This protracted and expensive proceeding is exactly the type that Congress intended to prevent when it enacted Bankruptcy Code safe harbor provisions completely insulating the right to terminate and liquidate swap agreements. That legislative balancing reflects Congress’s determination for swap agreements to be resolved promptly and with finality to safeguard market stability in the event that a significant financial market participant filed for bankruptcy.

Nearly nine years after Lehman’s bankruptcy filing, however, Lehman is still litigating whether its counterparties are permitted to terminate and liquidate swap agreements in the contractually agreed-upon manner. Instead of certainty and finality, participants in the multi-hundred trillion dollar swaps markets have

been left with precisely the uncertainty and costly litigation Congress sought to eliminate on the question whether swap agreements will be enforced as written.

This uncertainty has impacted not only transactions such as the Collateralized Debt Obligations (“CDOs”) at issue on this appeal, but also currency swaps and interest rate swaps that are widely used as hedges for commercial and financial transactions, and even the financing structures available to governmental housing agencies. *See Mich. State Hous. Dev. Auth. v. Lehman Bros. Derivative Prods. Inc. (In re Lehman Bros. Holdings Inc.)*, 502 B.R. 383 (S.D.N.Y. 2013). Indeed, the 2017 ISDA Derivatives Fact Sheet shows that 74% of the Interest Rate Differential market uses derivatives. *See ISDA Fact Sheet: Derivatives—Facts and Figures* (May 8, 2017), available at <http://www2.isda.org/about-isda/> (last visited June 15, 2017). A 2014 ISDA Research Study also confirms that 65% of over-the-counter interest rate derivatives market turnover involves an end user on one side and a reporting dealer on the other. *See ISDA Research Study: Dispelling Myths: End-User Activity in OTC Derivatives* (August 2014), available at <http://www2.isda.org/attachment/Njc2Nw==/ISDA-Dispelling%20myths-final.pdf> (last visited June 15, 2017).

Permitting Lehman to pursue its claims is also fundamentally at odds with market expectations. As Lehman alleges, it is suing over billions of dollars in

swap termination payments in connection with 47 different CDO transactions.

Compl. ¶ 2. Those transactions were structured and marketed—by Lehman—so that in the event of a Lehman default, the invested capital would be returned to the CDO investors. This structure was used to avoid triggering a payment obligation to Lehman that would wipe out billions of dollars in CDO investments in the event of a tactical default by Lehman under market conditions favorable to it, a Lehman bankruptcy, or certain other circumstances. Accordingly, the parties agreed that in the event of an early termination triggered by a Lehman default, the liquidation of the swap agreements would include the distribution of the collateral proceeds to the CDO investors. This is what the parties intended and what they contracted for. Those contracts should be enforced as written.

Lehman benefited, moreover, from the high credit ratings associated with this structure. Indeed, the credit rating agencies *required* this structure to award the CDOs their highest ratings. Without those ratings, the CDO investments would have been far more difficult to market. Lehman further benefited from the fact that the high ratings permitted it to enter into financing transactions at the lowest available market rates.

Enforcing the contractual priority of payment provisions at issue in this case would vindicate Congressional intent and send a clear message to the markets that they may rely on the Bankruptcy Code safe harbor provisions.

## STATEMENT OF INTEREST<sup>1</sup>

SIFMA is the voice of the U.S. securities industry. It represents the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

ISDA is the global trade association representing leading participants in the derivatives industry. ISDA was chartered in 1985, and comprises more than 850 member institutions from 68 countries on six continents. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives

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<sup>1</sup> Pursuant to Federal Rule of Bankruptcy Procedure 8017, SIFMA and ISDA state, consistent with Rule 8017(c)(4), that no party or party's counsel authored this brief in whole or in part; that no party or party's counsel contributed money that was intended to fund preparing or submitting the brief; and that no person other than *amici*, their members, and their counsel contributed money that was intended to fund preparing or submitting this brief.

market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas—reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure—is part of a strong commitment to ISDA's primary goals of building robust, stable financial markets, and a strong financial regulatory framework.

This appeal presents questions of significance to SIFMA, ISDA and their members concerning the functioning of the derivatives markets. ISDA's members and many of SIFMA's members—which included LBSF's parent Lehman Brothers Holdings, Inc. (“LBHI”) prior to its bankruptcy filing—are active participants in the derivatives markets who play a variety of roles in structured finance transactions. Some have sponsored and structured CDOs like those at issue here, while others have invested in notes and other instruments issued by such vehicles. Thus, SIFMA's and ISDA's members do not have a uniform financial interest in the outcome of this lawsuit. Indeed, should they one day find themselves in bankruptcy, certain of SIFMA's and ISDA's members might well benefit from rulings in this proceeding favorable to Lehman. SIFMA and ISDA nonetheless submit this brief as *amici curiae* supporting the position of the Appellees because they and their members seek the certainty, finality and assurances of market stability that the Bankruptcy Code safe harbor provisions were intended to provide.



## ARGUMENT

### I.

#### **LEHMAN’S CLAIMS CANNOT BE RECONCILED WITH THE BANKRUPTCY CODE SAFE HARBOR PROVISIONS ADDRESSING THE TERMINATION AND LIQUIDATION OF SWAP AGREEMENTS**

Congress has enacted safe harbor provisions for the very purpose of permitting financial market participants to enforce swap termination and liquidation provisions just like those at issue here without the cost and uncertainty of litigation—and thus promote the stability of the financial markets. Lehman’s claims in this lawsuit cannot be reconciled with those statutory safe harbors.

As early as 1982, Congress amended the Bankruptcy Code to add safe harbor provisions exempting payments made in securities, commodities, and forward contract trades from the bankruptcy avoidance powers (except in cases of actual fraud) and providing that rights to cause the “liquidation” of such contracts because of the debtor’s bankruptcy cannot be “stayed, avoided, or otherwise limited by operation of any provision of this title.” *See* 1982 Amendments to Bankruptcy Code, Pub. L. No. 97-222, 96 Stat. 235 (now codified, as amended, at 11 U.S.C. §§ 362(b)(6), 546(e), 555, 556); H.R. Rep. No. 97-420 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583. In the aftermath of a judicial decision that injected uncertainty as to the enforceability of repurchase agreements in bankruptcy, Congress acted again in 1984 to clarify that the Bankruptcy Code’s safe harbor protections extended to repurchase agreements. *See* 1984 Amendments to

Bankruptcy Code, Pub. L. No. 98-353, §§ 391-396, 98 Stat. 333 (now codified, as amended, at 11 U.S.C. §§ 362(b)(7), 546(f), 559); S. Rep. No. 98-65, at 47 (1983).

On both occasions, Congress sought to insulate the financial markets from the instability that could result if a bankruptcy prevented parties to financial contracts from enforcing their rights upon default. *See, e.g., In re Enron Creditors Recovery Corp.*, 422 B.R. 423, 429 (S.D.N.Y. 2009) (McMahon, J.) (“Congress opined that the safe harbor would prevent ‘the insolvency of one commodity or security firm from spreading to other firms,’ which could otherwise ‘threaten the collapse of the affected industry.’” (quoting H.R. Rep. No. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583)).

In 1990, Congress extended the safe harbor protections to swap agreements. Even then, in the swap markets’ infancy, Congress recognized that swap agreements “are a rapidly growing and vital risk management tool in world financial markets,” allowing financial institutions, corporations, and governments “to minimize exposure to adverse changes in interest and currency exchange rates.”<sup>2</sup> S. Rep. No. 101-285 (1990), *available at* 1990 WL 259288, at \*2; *accord* H.R. Rep. 101-484, at 2-3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224-225.

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<sup>2</sup> In the ensuing decades, the swap markets have only increased in size, complexity and importance, growing from an estimated \$1 trillion notional value of outstanding swaps transactions in 1989 to \$642.1 trillion in 2012. *Interest Swap: Hearing on S. 396 Before the Subcommittee on Courts and Administrative Practices of the Senate Committee on the Judiciary*, 101st Cong. 14 (1989); ISDA OTC Derivatives Market Analysis Year-End 2012, *available at* <https://www2.isda.org/functional-areas/research/studies/> (last visited June 9, 2017).

Echoing the concerns that drove Congress to act in 1982 and 1984, Congress had grown concerned about “volatility in the swap agreement markets resulting from the uncertainty over their treatment in the Bankruptcy Code.” H.R. Rep. No. 101-484, at 3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 225. As Senator Heflin explained, “[t]here is concern that if one of the parties to a swap agreement files for bankruptcy under the current Bankruptcy Code, the non-defaulting party is left with a substantial risk and, depending on the size of the swap agreement, could cause a rippling effect which would undermine the stability of the financial markets.” *Interest Swap: Hearing on S. 396 Before the Subcomm. on Courts and Administrative Practices of the Senate Comm. on the Judiciary*, 101st Cong. 1 (1989).

Accordingly, Congress enacted the 1990 Amendments to the Bankruptcy Code, which were designed to provide certainty to the over-the-counter derivatives markets by protecting swap transactions from the effects of bankruptcy. *See* 1990 Bankruptcy Amendments, Pub. L. No. 101-311, 104 Stat. 267; *see also* S. Rep. No. 101-285, at 1 (1990), *available at* 1990 WL 259288, at \*1 (the purpose of the bill is “to clarify U.S. bankruptcy law with respect to the treatment of swap agreements and forward contracts. ***The bill would provide certainty for swap transactions in the case of a default in bankruptcy. . . .***”) (emphasis added).

The addition of Section 560 to the Bankruptcy Code was a key element of this safe harbor protection. *See* 1990 Bankruptcy Amendments, Pub. L. No. 101-311, § 106, 104 Stat. 267. That provision was intended “to preserve a swap

participant's contractual right to terminate a swap agreement and offset any amounts owed under it in the event that one of the parties to the agreement files a bankruptcy petition." *See* H.R. Rep. No. 101-484, at 5 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 227. Through enactment of Section 560, Congress made clear that "the exercise of any such right shall not be . . . limited by operation of the Bankruptcy Code." *Id.* In other words, Section 560 "means that these contractual rights are not to be interfered with by any court proceeding under the [Bankruptcy] Code." S. Rep. No. 101-285 (1990), *available at* 1990 WL 259288, at \*9; *see also* 136 Cong. Rec. 13,153 (1990) (statement of Sen. DeConcini) ("The effect of the swap provisions will be to provide certainty for swap transactions and thereby stabilize domestic markets by allowing the terms of the swap agreement to apply notwithstanding the bankruptcy filing.").

Congress amended the Bankruptcy Code again in 2005, acting on recommendations of the President's Working Group on Financial Markets. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907(j), 119 Stat. 23; H.R. Rep. No. 10931, at 20 & n.79 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105. Two aspects of the 2005 amendments are particularly pertinent to the issues before the Court. First, Congress amended Section 560 to "clarify that the provisions of the Bankruptcy Code that protect . . . rights to terminate under swap agreements also protect rights of liquidation and acceleration." It did so by replacing "termination of a swap agreement" with the more expansive phrase "liquidation, termination, or acceleration of one or more swap agreements." *See* H.R. Rep. No. 109-31, at 193, 224 (2005), *reprinted in*

2005 U.S.C.C.A.N. 88, 190 (emphasis added). Second, the 2005 amendments significantly expanded the statutory definition of “swap agreement” to include “any security agreement or arrangement or other credit enhancement related to” a swap agreement. *See* 11 U.S.C. § 101(53B)(A)(vi). “This ensures that any such agreement, arrangement or enhancement *is itself deemed to be a swap agreement*, and therefore eligible for treatment as such for purposes of termination, liquidation, acceleration, offset and netting under the Bankruptcy Code.” *Id.* at 107 (emphasis added).

As with the earlier legislation, Congress emphasized that the 2005 amendments were “intended to reduce ‘systemic risk’ in the banking system and financial marketplace,” *i.e.*, “the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole.” H.R. Rep. No. 109-31, at 20 & n.78 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105-06. *Id.* at 20 n.78. Thus, “[f]or purposes of . . . section[] 560, . . . it is intended that the normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate . . . swap agreements . . . with the bankrupt or insolvent party.” *Id.* at 133.

Finally, in 2006, Congress enacted the Financial Netting Improvements Act. Among other provisions, the Act amended the safe harbor protections for swap agreements in Section 362(b)(17) to make clear that they “protect, free from the automatic stay, . . . self-help foreclosure-on-collateral rights, setoff rights and netting rights.” *See* H.R. Rep. No. 109-648 (2006), *available at* 2006 WL

6165926, at \*7; Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5, 120 Stat. 2692, 2697 (codified at 11 U.S.C. § 362(b)(17)). This amendment was intended to “strengthen[] and clarify[] the enforceability of early termination and close-out netting provisions and related collateral arrangements in U.S. insolvency proceedings,” in order to “reduce systemic risk in the financial markets.” H.R. Rep. No. 109-648 (2006), *available at* 2006 WL 6165926, at \*1-2.

The result of these Bankruptcy Code Amendments is a statutory scheme that: (1) permits swap participants to terminate and liquidate swap agreements according to their terms, notwithstanding the bankruptcy of a counterparty and notwithstanding any other provision of the Bankruptcy Code (Section 560); (2) permits swap participants to exercise their contractual rights under security agreements relating to swap agreements notwithstanding any automatic stay resulting from the bankruptcy filing of a counterparty (Section 362(b)(17)); and (3) prohibits the avoidance of transfers made in connection with a swap agreement (Section 546(g)).<sup>3</sup>

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<sup>3</sup> Congress focused its attention not only on swaps but also on other complex transactions that would pose risks to financial markets and the economy if bankruptcy laws were allowed to interfere with them. These include repurchase agreements (Sections 559, 101(47), 362(b)(7), 546(f)), securities contracts (Sections 555, 741(7), 362(b)(6), 546(e)), forward contracts (Sections 556, 101(25), 362(b)(6), 546(e)), commodities contracts (Sections 556, 761(4), 362(b)(6), 546(e)) and master netting agreements (Sections 561, 101(38A), 362(b)(27), 546(j)). All of these provisions reflect a common theme: parties to financial transactions that, if disrupted, would pose systemic risk to the economy are permitted to enforce the terms of their contracts notwithstanding the bankruptcy of a counterparty.

As the Second Circuit and a number of other circuit courts around the country have recognized, these safe harbor provisions reflect a strong Congressional policy of safeguarding the financial markets from the disruptive effects of a counterparty's bankruptcy filing. *See, e.g., In re Bernard L. Madoff Investment Securities LLC*, 773 F.3d 411, 420 (2d Cir. 2014) (“the interpretation pressed by the Trustee risks the very sort of significant market disruption that Congress was concerned with”); *Official Comm. of Unsecured Creditors of Quebecor World (U.S.A.) v. Am. Life Ins. Co. (In re Quebecor World (U.S.A.))*, 719 F.3d 94, 100 (2d Cir. 2013) (holding that courts should apply the safe harbor provisions according to their plain meaning “as a means of ‘minimiz[ing] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries.’”), quoting *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011); *In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98, 120–21 (2d Cir. 2016) (quoting *Quebecor*); *Grede v. FCStone, LLC*, 746 F.3d 244, 253-54 (7th Cir. 2014) (“§546(e) reflects a policy judgment by Congress that allowing some otherwise avoidable pre-petition transfers in the securities industry to stand would probably be a lesser evil than the uncertainty and potential lack of liquidity that would be caused by putting every recipient of settlement payments in the past 90 days at risk of having its transactions unwound in bankruptcy court.”); *In re Nat'l Gas Distribs.*, 556 F.3d 247, 259 (4th Cir. 2009) (swap safe harbors serve a “policy of protecting financial markets and therefore favoring an entire class of instruments and participants”); *Thrifty Oil Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 322 F.3d

1039, 1050 (9th Cir. 2003) (“The legislative history of the Swap Amendments plainly reveals that Congress recognized the growing importance of interest rate swaps and sought to immunize the swap market from the legal risks of bankruptcy.”).

Both the words that Congress chose to use and the policy underlying that statutory language compel the conclusion that the Court should enforce the agreed upon priority of payment provisions at issue in this case. Lehman should not be permitted to perpetuate significant uncertainty in the financial markets by pursuing claims to re-write the terms of swap agreements contrary to the statutory language, Congressional intent and the intentions of the contracting parties. Instead, the safe harbor provisions should be construed in accordance with their plain meaning to uphold the broad protections that Congress intended to establish for the financial markets.

## II.

### **LEHMAN’S CLAIMS UNDERMINE MARKET EXPECTATIONS**

By the adversary proceeding below, Lehman seeks to avoid the enforcement of swap agreement terms that Lehman and its affiliates developed, marketed and sold to investors. It should not be permitted to so.

The issuer of each CDO at issue sold credit protection to LBSF on one or more “reference obligations” in the form of a credit default swap (“CDS”). *Id.* As Lehman openly acknowledges, security agreements entered into as part of each and every one of the transactions provide that in the event of a swap termination



triggered by a Lehman default, the CDO collateral proceeds are to be paid first to the noteholders. *Id.* ¶¶ 57, 61. At the same time, any swap termination amount payable to LBSF is subordinated to the payments to noteholders. *Id.* at 61.

As LBSF’s counsel has confirmed, “[t]hese transactions . . . were . . . largely structured by [LBSF] and its affiliates. . . .” Transcript of Hearing of Motion of Harrier Finance Limited, a.k.a Rathgar Capital Corporation, to Dismiss Adversary Proceeding at 22-23, *Lehman Bros. Special Fin., Inc. v. Harrier Fin. Ltd.* (Bankr. S.D.N.Y. Sept. 17, 2009) (Adv. Pro. No. 09-01241).<sup>4</sup> Indeed, Lehman entities routinely structured CDOs with LBSF serving as the CDS counterparty. Business Wire, *Fitch Monitoring Potential Implications of Lehman Bankruptcy on Global Synthetic CDOs*, Sept. 16, 2008 (hereinafter, *Fitch Monitoring*).<sup>5</sup> For example:

Lehman acted as swap counterparty in 69 Fitch-rated synthetic CDOs; 31 in Europe; 35 in Asia; three in the U.S. In many of these transactions, Lehman Brothers Special Financing Inc. acted as the buyer of credit protection from the CDO as CDS swap counterparty, and Lehman Brothers Holdings Inc. acted as a guarantor or credit support provider.

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<sup>4</sup> The Court may take judicial notice of this transcript. *Ryan v. Commodity Futures Trading Comm’n*, 125 F.3d 1062, 1063 (7th Cir. 1997); *Micula v. Government of Romania*, No. 15-MC-107, 2015 WL 4643180, at \*1 (S.D.N.Y. Aug. 5, 2015).

<sup>5</sup> Available at <http://www.businesswire.com/news/home/20080916006288/en/Fitch-Monitoring-Potential-Implications-Lehman-Bankruptcy-Global> (last visited June 9, 2017).

*Id.* This is precisely the structure at issue here.

The swap agreement term providing that noteholders would be paid before LBSF in the event that LBSF triggered the termination of the relevant CDS was a feature that Lehman built into many—possibly all—of these transactions to meet the requirements of both investors and credit rating agencies. *See, e.g., Fitch Monitoring* (“If an early termination is triggered where the swap counterparty is the defaulting party, the eligible securities are typically liquidated and used to repay the CDO notes before any swap termination payment is potentially due to [Lehman].”); *see also* Izabella Kaminska, *Europe’s ABS Currency-Swap Exposure*, *Financial Times*, Feb. 15, 2010 (“[S]aid swap termination payment is commonly subordinated to note payments if the termination payment results from the bankruptcy of the swap counterparty.”) (hereinafter, *Europe’s ABS Currency-Swap Exposure*)<sup>6</sup>; Kingsley T.W. Ong, *The ISDA Master Agreement: Insolvency Stalemate and Endgame Solutions for Hong Kong Liquidators*, 40 *Hong Kong L.J.* 337, 351 n.60 (2010) (requirement to pay noteholders before paying a defaulting swap counterparty is “market-standard in the securitization and structured finance industry;” its “primary objective . . . is to disincentivize default by a swap counterparty and ensure that the defaulting swap counterparty does not benefit

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<sup>6</sup> Available at <http://ftalphaville.ft.com/blog/2010/02/15/149331/europes-abs-currency-swap-exposure> (last visited June 9, 2017).

from its own default by continuing to be paid at a senior position in the waterfall.”).

The agreed upon contractual term providing that noteholders would be paid first in the event of an LBSF default was an important feature of the transactions, and was highlighted in the offering documents prepared by Lehman and its affiliates. It was also of particular significance to the ratings agencies assigning credit ratings to the notes.

Both Moody’s Investors Service and Fitch Ratings specifically described priority of payment provisions like those at issue as an important element that they considered in rating structured finance transactions such as these that are exposed to “hedge counterparty risk.” *See* Bill Harrington, Nicholas Lindstrom, & Edward Manchester, *Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions*, Moody’s Investors Service, May 25, 2006, at 8 (“To ensure sufficient Counterparty risk de-linkage, [a termination payment to the swap counterparty] should only be made . . . once all amounts senior thereto in the respective priority of payments have been made, particularly when the Counterparty is the Defaulting Party . . . . *See Table 2B* for the priority in which termination payments to the Counterparty should be made.”); *id.* at 16 (Table 2B, providing for swap counterparty to be paid after noteholders where the swap counterparty is the defaulting party) (copy attached as Exhibit A to the

Compendium of Rating Agency Criteria submitted herewith); *see also* Dr. Stefan Bund, Alessandro Cipolla, Andre Dahlkamp, Euan Gatfield, Alex Kung, & Jennifer San Cartier, *Counterparty Risk in Structured Finance Transactions: Hedge Criteria*, Fitch Ratings, Aug. 1, 2007, at 12 (“One way to provide additional protection to the noteholders in the event of a default by the counterparty is to make any termination payments owed by the SPV to the counterparty subordinate to any payments of interest and/or principal and the topping up of any reserve fund in the Structured Finance transaction’s priority of payments.”) (copy attached as Exhibit B to the Compendium of Rating Agency Criteria submitted herewith); *see also* Michael Drexler & Katrien van Acoleyen, *CDO Spotlight: Counterparty Risk In Structured Finance Transactions*, Standard & Poor’s, Mar. 7, 2005, at 1 (“[M]itigated credit risk” can be achieved “by structuring the transaction in such a way that it would terminate with no loss to investors if the counterparty did not comply with certain downgrade provisions.”) (copy attached as Exhibit C to the Compendium of Rating Agency Criteria submitted herewith).<sup>7</sup>

The reason for this credit ratings impact is straightforward. Absent a default by either party, the CDS typically would remain in existence for the term of the

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<sup>7</sup> The Court can take judicial notice of the matters attached as Exhibits A-C. *Muller v. State of Oregon*, 208 U.S. 412, 421 (1908); 21 B Kenneth W. Graham, Jr., *Federal Practice and Procedure, Federal Rules of Evidence*, §5103.2 (2d Ed.).

notes. The mark-to-market amount of the entire CDS would become payable only upon the early termination of the CDS.<sup>8</sup> *See, e.g., Europe's ABS Currency – Swap Exposure* (“Even though the swaps undergo mark-to-market gains and losses over the life of an ABS transaction, the fact that the notes are supposed to be hedged over the life of the transaction means gains and losses have no discernible ‘real-world consequence’ for noteholders.”). If, however, the CDS counterparty (*i.e.*, LBSF) or its credit support provider (*i.e.*, LBHI) were to default, and the CDS were terminated earlier than anticipated as a result, then the termination payment amount would be valued as of the early termination date. If the swap happened to be “in the money” to LBSF on a mark-to-market basis on that date, then the CDOs at issue would be left with the Hobson’s choice of leaving in place a swap with a defaulting counterparty that presumably would be unable or unwilling to meet its contractual obligation to make premium payments, or terminating and owing potentially very large sums to a counterparty that was not otherwise entitled to any payment at that time, and might never be.

The solution that the parties to these transactions agreed upon, and upon which the ratings agencies relied, was that if LBSF defaulted, it would be paid

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<sup>8</sup> Absent early termination, limited loss protection payments might or might not have come due to Lehman over the life of the transactions depending on the performance of the reference obligations and certain other conditions.

after the noteholders. This was the way that LBSF and other sponsors structured and marketed these transactions, this was the way the market—including SIFMA, ISDA and their members—expected them to operate, and this was the way the rating agencies rated the notes.<sup>9</sup>

As Judge Peck previously recognized, his contrary rulings in earlier cases upset the expectations of those who had invested hundreds of billions of dollars in this market by invalidating the agreed upon priority of payment provisions, thus literally upending the way these transactions were meant to unwind in the event of an LBSF default:

The Court recognizes that there is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective. The Court assumes that a bankruptcy affecting any of the Lehman entities was viewed as a highly remote contingency at the time that the Transaction Documents were being prepared. At that time, LBSF agreed to a subordination of its Swap Counterparty Priority in the hard-to-imagine event that it should be in default at some time in the future. *Capital was committed with this concept embedded in the transaction.*

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<sup>9</sup> Lehman benefited, moreover, from the high credit ratings made possible by the priority of payment provisions. This is so because the transactions may have been unmarketable—and certainly would have been more difficult to market—with lower ratings. Furthermore, the favorable credit ratings permitted Lehman to enter into financing transactions at the lowest available market rates.

*In re Lehman Bros. Holdings Inc.*, 422 B.R. 407, 422 n. 9 (Bankr. S.D.N.Y. 2010) (hereinafter, “*BNY I*”) (emphasis added). As Judge McMahon further observed in granting leave to appeal from *BNY I*: “Judge Peck’s interpretation of the Bankruptcy Code’s *ipso facto* provisions has potentially far-reaching ramifications for the international securities markets, and has triggered significant uncertainty in the financial community.” *Lehman Bros. Holdings Inc. v. BNY Corporate Trustee Servs. Ltd.*, 09-01242, 2010 WL 10078354, at \*9 (S.D.N.Y. Sept. 23, 2010) (hereinafter, “*BNY II*”).<sup>10</sup>

This “Shot Heard Around the CDO World” raises the specter of a massive redistribution of wealth from investors who bargained for payments in accordance with contractual priorities to the creditors of LBSF’s bankruptcy estate:

[U]nless the decision is overturned, Lehman Brothers Special Financing will likely receive a windfall of billions of dollars from various structured finance transactions contrary to the terms of the transactions and the intentions of the parties. ***Investors in highly rated structured notes who had not intended to take Lehman risk will suffer massive losses, and creditors of Lehman who did agree to take Lehman bankruptcy risk will instead be repaid.***

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<sup>10</sup> Of course, Judge Peck did not have the benefit of the Second Circuit’s subsequent decisions in *Madoff*, *Quebecor*, *Tribune* and *Enron*, all of which make clear that the safe harbors are to be interpreted in accordance with their plain meaning and in light of Congress’s goal of preventing market disruptions.

James G. Rumball, *A New Threat for Structured Finance Transactions: Flip Clauses Enforceable?*, available at

<http://www.mondaq.com/canada/x/95668/Investment+Strategy/A+New+Threat+For+Structured+Finance+Transactions+Flip+Clauses+Enforceable> (last visited June 9, 2017) (emphasis added); *see also* David B. Stratton & Michael J. Custer, *Shot Heard Around the CDO World: Flip Clauses Found To Be Unenforceable Ipso Facto Provisions*, 29 Am. Bankr. Inst. J. 30, 31 (2010) (observing that the Bankruptcy Court’s rulings have created “significant uncertainty with respect to the enforceability in bankruptcy of flip clauses or similar market-standard subordination provisions in CDO transactions.”).

Not surprisingly, “[t]he outcomes of the court cases in favor of Lehman will have clear rating implications for synthetic CDOs and other similar securitizations.” *Lehman Win Could Spark Downgrades*; *see also id.* (“If Lehman ultimately succeeds in its claim, Fitch will cap its ratings of notes sold from CDOs backed by CDSs to the rating of the CDS counterparty, when the counterparty could be subject to U.S. bankruptcy proceedings, Fitch said.”). This ratings impact is not limited, moreover, to CDOs, but “could have implications . . . for global structured finance transactions generally due to the widespread use of the subordination provisions within securitization structures . . . .” *Id.* This may include, for instance, transactions involving currency swaps and interest rate swaps



that are widely used to hedge commercial and financial transactions. *Europe's ABS Currency-Swap Exposure*.

SIFMA and ISDA are concerned about the disruption of the market and the concomitant losses to investors who will not receive what they bargained for if Lehman prevails on its appeal. This result is particularly inappropriate because Lehman's claims are legally unfounded, as discussed in Part III, *infra*.

### III.

#### LEHMAN'S CLAIMS ARE LEGALLY UNFOUNDED

Lehman's claims are not only irreconcilable with both Congressional intent and market expectations; they are legally untenable.

##### **A. The Parties' Agreement Regarding The Priority Of Payments Is Enforceable Pursuant To The Plain Meaning Of The Bankruptcy Code**

Section 560 provides that the contractual rights to terminate and liquidate a swap agreement "shall not be stayed, avoided, or otherwise limited by operation of any provision" of the Bankruptcy Code. The plain meaning of this provision is that the priority of payment provisions are enforceable even if they could otherwise be construed as prohibited *ipso facto* clauses (which they cannot for the reasons set forth in the noteholder appellees' brief).

**1. The Noteholders' Rights To Settlement And Payment Of Termination Amounts In Accordance With The Terms Of The Swap Agreements Are Expressly Preserved By Section 560 Of The Bankruptcy Code**

Section 560 of the Bankruptcy Code provides in pertinent part:

The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

This provision expressly permitted the CDOs to terminate their swap agreements with LBSF, and permitted the CDO trustees to liquidate the parties' positions by determining the amounts due and distributing those amounts to the contractually specified parties.

As discussed above, as originally enacted, Section 560 addressed only the "termination" of swap agreements. Pub. L. No. 101-311, § 106(a), 104 Stat. 267, 268 (1990). As part of the 2005 amendments, however, Congress revised Section 560 to include "liquidation" of swap agreements in the safe harbor. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, at § 907(j)(1), 907(o)(10).

There is a plain meaning of "liquidate" that is consistent across legal dictionaries, financial dictionaries and general dictionaries. Black's Law

Dictionary defines “liquidate” to mean “[t]o settle (an obligation) by payment or other adjustment; to extinguish (a debt).” *Black’s Law Dictionary* 1014 (9th ed. 2009). As used in the financial community, “liquidate” means “[t]o discharge, to pay off, to convert into cash by selling.” L. Davids, *Dictionary of Banking and Finance* 129 (1978). In general usage, “liquidate” means “to settle or pay (a debt): to liquidate a claim.” *The Random House Dictionary of the English Language* 1121 (2d ed. unabridged 1987); accord *Merriam-Webster’s Collegiate Dictionary* 726 (11th ed. 2004) (“to settle (a debt) by payment or other settlement”).

The swap agreements set forth the agreement of the CDOs, LBSF, the noteholders and the trustees regarding the amount, priority, and source of the payments to be made to the noteholders and LBSF upon a termination of the CDS resulting from LBHI’s bankruptcy. Specifying the amount, priority, and source of payments of a debt is part of the process of settling a debt and thus of “liquidating” the related agreement. Accordingly, the plain meaning of Section 560 is that the parties are entitled to enforce the contractual priority of payment provisions following termination of the CDS. Lehman is not entitled to rewrite or ignore these provisions.

Lehman takes the position that the safe harbor “does not include making payment.” Appellant’s Brief at 29. This position is irreconcilable with the goals of the safe harbor protections and the legislative history described in Part I above.

Congress enacted the safe harbors specifically to mitigate systemic risk and ensure that the bankruptcy of one market participant would not have a ripple effect that caused the bankruptcy of other participants. Under Lehman’s proposed interpretation of the safe harbor protections, a swap participant would be prohibited from making any payment from the cash proceeds of the liquidation process, and the cash proceeds would be frozen pending further court proceedings. But if a swap participant cannot use the cash generated during the liquidation process, then the likelihood of a ripple effect increases dramatically. A swap participant with frozen cash that it cannot access is far more likely to encounter financial difficulties, resulting in precisely the systemic risk that Congress sought to prevent. Lehman’s proposed interpretation increases, rather than reduces, systemic risk and therefore cannot be squared with legislative intent.

**2. The Bankruptcy Code Defines “Swap Agreement” To Include Related Security Agreements**

Section 101(53B)(A)(vi) of the Bankruptcy Code defines “swap agreement” broadly to include “any security agreement or arrangement or other credit enhancement *related to* any agreements or transactions referred to” in the preceding provisions of the definition of “swap agreement.” (Emphasis added.) Thus, under the plain meaning of Section 101(53B), the priority of payments provisions at issue constitute part of a “swap agreement.” This is true whether the priority of payments provisions are set forth on the face of the “schedule” or

“confirmation” in respect of the CDS at issue, are incorporated therein by reference, or appear exclusively in the indenture in respect of the relevant CDO. By definition, the indentures—which govern the liquidation of “the Collateral and/or proceeds from the Collateral that secures the Issuers’ respective payment obligations both to the LBSF and the Noteholders” (Compl. ¶ 57)—constitute security agreements related to the CDS. Thus, the priority of payment provisions set forth in those indentures are safe harbored.

The Supreme Court has repeatedly stated that the Bankruptcy Code is to be interpreted according to its plain meaning: “It is well established that ‘when the statute’s language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.’” *Lamie v. U.S. Trustee*, 540 U.S. 526, 534 (2004) (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A.*, 530 U.S. 1, 6 (2000)); see also, e.g., *Quebecor*, 719 F.3d at 100; *Enron*, 651 F.3d at 334. The provisions of Section 101(53B) could hardly be clearer that security agreements related to swap agreements are included in the term “swap agreements.”<sup>11</sup>

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<sup>11</sup> As the leading bankruptcy commentator has observed: “The *Lehman* decision [in *BNY I*] is questionable because the priority-shifting provisions were contained in the security arrangement for the subject swap agreement and, thus, were a swap agreement under Bankruptcy Code section 101(53B)(A)(vi).” 5 *Collier on Bankruptcy* ¶ 560.02 at 560-6 n. 2 (16th ed. 2010).

The inclusion of security agreements in the definition of “swap agreement” is not an accident. When Congress in 1990 added the provisions to the Bankruptcy Code that deal with the treatment of swap agreements, the definition of “swap agreement” did not expressly include security agreements. Pub. L. No. 101-311, § 101(2), 104 Stat. 267 (1990). As discussed above, Congress modified Section 101(53B) as part of the 2005 amendment to add a separate clause to the definition of “swap agreement” that expressly includes security agreements. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907(a)(1)(E), 119 Stat. 23, 172-73 (2005). The legislative history confirms the obvious conclusion that Congress intentionally broadened the scope of this provision:

The definition [of swap agreement] also includes any security agreement or arrangement, or other credit enhancement, related to a swap agreement, including any guarantee or reimbursement obligation related to a swap agreement. This ensures that any such agreement, arrangement or enhancement is itself deemed to be a swap agreement, and therefore eligible for treatment as such for purposes of termination, liquidation, acceleration, offset and netting under the Bankruptcy Code . . . .

H.R. Rep. No. 109-31, pt. 1, at 129 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 190.

Each CDS and the related indenture together constitute a “swap agreement” under Bankruptcy Code Section 101(53B). Accordingly, the priority of payment provisions are safe harbored, and should be enforced according to their terms.

**3. The *Ipsa Facto* Provisions Of Sections 365(e)(1), 541(c)(1) And 363(l) Have No Applicability To Transactions Protected By Section 560**

Section 560 of the Bankruptcy Code provides that the contractual rights to terminate and liquidate a swap agreement “shall not be stayed, avoided, or otherwise limited by operation of any provision” of the Bankruptcy Code. The plain meaning of this provision is that the “*ipso facto*” provisions of Section 365(e)(1), 541(c)(1) and 363(l) of the Bankruptcy Code do not trump the trustees’ contractual rights to terminate and liquidate the swap agreements with LBSF pursuant to the terms of those agreements.

Furthermore, Section 362(b)(17) of the Bankruptcy Code—which, as noted above, is part of a package of statutory provisions designed to ensure the stability of financial markets—provides that the Section 362(a) automatic stay does not prohibit “the exercise by a swap participant or financial participant of *any contractual right* (as defined in section 560) *under any security agreement* or arrangement or other credit enhancement forming a part of or related to any swap agreement. . . .” (Emphasis added.) The indentures are security agreements that form a part of, and relate to, swap agreements. Congress expressly stated in

Section 362(b)(17) that bankruptcy would not limit the ability of swap participants to enforce *any* contractual right under a security agreement relating to a swap agreement. Similarly, Section 362(o) provides that “[t]he exercise of rights not subject to the stay . . . pursuant to paragraph . . . (17) . . . shall not be stayed by any order of a court . . . .” Thus, Sections 365(e)(1)(B), 541(c)(1)(B) and 363(l) cannot operate to bar the operation of the priority of payment provisions.

**B. Contract Rights Triggered By LBHI’s Bankruptcy Filing Could Not Violate The Bankruptcy Code’s *Ipsa Facto* Prohibitions As To LBSF**

The Bankruptcy Code’s *ipso facto* provisions never even came into play for transactions in which the CDS was terminated before LBSF itself filed for bankruptcy.

A number of courts have recognized that the *ipso facto* prohibitions apply only to contract termination or modifications resulting from a bankruptcy filing by a party to the contract. *See BNY II*, 2010 WL 10078354, at \*7 (“[P]rior cases in this and other circuits appear to assume—albeit in circumstances that are factually distinguishable—that the Bankruptcy Code’s *ipso facto* provisions invalidate clauses that condition an event of default on the contracting party’s *own* bankruptcy filing.”), citing *In re Chateaugay Corp.*, No. 92 Civ. 7054 (PKL), 1993



WL 159969, at \*5 (S.D.N.Y. May 10, 1993) and *In re EBC I, Inc.* 356 B.R. 631 640 (Bankr. D. Del. 2006).<sup>12</sup>

While Judge Peck ruled to the contrary in *BNY I*, he recognized that no other court has ever held that Sections 365(e)(1)(B) and 541(c)(1)(B) prohibit the enforcement of contract provisions that refer to the bankruptcy of a non-party to the contract. 422 B.R. at 422. Like other aspects of *BNY I*, moreover, this ruling has caused significant uncertainty. *See id.* at 419 (“Opening up the subject to cases filed by debtors other than the counterparty itself has the potential of opening up a

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<sup>12</sup> *See also, e.g., Lyons Savings & Loan Association v. Westside Bancorporation, Inc.*, 828 F.2d 387, 393 n.6 (7th Cir. 1987) (“Section 365(e) of the Bankruptcy Code invalidates *ipso facto* or bankruptcy termination clauses which permit one contracting party to terminate or even modify an executory contract or unexpired lease in the event of the bankruptcy **of the other contracting party.**”) (emphasis added); *In re Cole*, 226 B.R. 647, 652 (9th Cir. BAP 1998) (“An ipso facto clause is a provision in an executory contract . . . that results in a breach solely due to the financial condition or the bankruptcy filing **of a party**”) (emphasis added); *In re IT Group, Inc., Co.*, 302 B.R. 483, 488 (D. Del. 2003) (right of first refusal is not an *ipso facto* clause because “the right of first refusal is triggered by any transfer . . . and not by a member filing for bankruptcy”); *I.T.T. Small Business Finance Corp. v. Frederique*, 82 B.R. 4, 6 (E.D.N.Y. 1987) (“An ‘ipso facto’ or ‘bankruptcy clause’ is a contractual provision which expressly states that **upon a borrower’s filing of a bankruptcy petition**, the creditor may accelerate payment. . . .”) (emphasis added); *In re Sapolin Paints, Inc.*, 5 B.R. 412, 417 (Bankr. E.D.N.Y. 1980) (addressing enforceability of “bankruptcy clauses, i.e., a clause in a lease which permits its termination on resort **by the lessee** to the protection of the bankruptcy laws”) (emphasis added). *See also* 1 D. Epstein, S. Nickles, & J. White, *Bankruptcy* § 5-12 at 467-68 (1992) (“The term ‘*ipso facto*’ was used to refer to those clauses that provided that the contract or lease terminated instantly, or ‘*ipso facto*’ upon the filing of a bankruptcy petition **by one of the parties.**”) (emphasis added).

proverbial can of worms that may lead to speculation as to the nature and degree of the relationship between the debtors that is needed in order to properly apply the provision.”); *see also* 1 *Collier on Lending Institutions & Bankruptcy Code* ¶ 3.03 at 2(b)(i) (2015) (“[B]ecause the [*BNY I*] court refused to define what sort of entities are ‘sufficiently close to mandate that the bankruptcy of one debtor entity necessarily would lead to the protection of property interests’ of another, the door is also open for a much more sweeping reading allowing a broad swath of nondebtor entities to take advantage of a protection that courts have traditionally read as belonging to the debtor.”).

Furthermore, the policy behind Sections 365(e)(1)(B) and 541(c)(1)(B) further supports the conclusion that the statutes are limited to the bankruptcy of a contracting party. One commentator has expressed the policy behind Section 365(e)(1) as follows: “If those types of provisions were enforceable, then a debtor-in-possession would forfeit valuable contract rights by applying for reorganization under the Bankruptcy Code.” Martin J. Bienenstock, *Bankruptcy Reorganization* 460 (Practising Law Institute) (1987) (footnote omitted). Here, LBSF did not forfeit contract rights by applying for reorganization. While there may be an adverse effect on LBSF as a result of the termination of the swap agreements, that effect—even if it could be characterized as a forfeiture of contract rights, which it is not—did not occur as a result of LBSF filing for bankruptcy. Rather, it occurred

because a third party—LBHI—filed for bankruptcy. The payment provisions at issue do not discourage LBSF from filing for bankruptcy: the treatment of LBSF under the payment provisions in these circumstances is identical whether or not LBSF files for bankruptcy. Refusing to enforce these payment provisions under these circumstances thus will not further the goals of the Bankruptcy Code.

**C. There Is No Violation Of The *Ipso Facto* Prohibitions Because Nothing Has Been Taken From LBSF**

The purpose of the *ipso facto* prohibitions is to prevent property from being taken from the debtor as a result of its bankruptcy filing. Even if a CDS was terminated after LBSF filed for bankruptcy, the contractual priority of payment provisions at issue do not take anything away from LBSF.

In these transactions, the investors invested money with the applicable CDO. LBSF agreed to make premium payments to the CDO. The CDO, in turn, agreed to make payments to LBSF if LBSF suffered specified losses. If losses did not occur, then at the termination of the transaction, the remaining funds would be returned to the investors.

Here, the transactions terminated earlier than expected and the parties are disputing who was entitled to receive the remaining funds.

LBSF does not allege that there was any failure to pay it for covered losses incurred through the termination date. Moreover, LBSF has not paid any premiums after the termination date. Thus, if the contractual priority of payment

provisions are not enforced and LBSF is permitted to recover on its claims, LBSF will receive a windfall. It will receive a post-termination payment, but it will not make any of the required post-termination payments. LBSF will be getting something for nothing.

The *ipso facto* prohibitions are designed to protect debtors from forfeitures resulting from their bankruptcy filing. They are not supposed to provide debtors with windfalls. Enforcing the contractual priority of payment provisions will not cause LBSF to suffer a forfeiture. Refusing to enforce them will provide LBSF with an illegitimate windfall.

\* \* \*

The basic ISDA swap agreement architecture—all written against the backdrop of the Bankruptcy Code safe harbor provisions—depends on the enforceability of swap agreements as written, including provisions triggered by the debtor's bankruptcy. Permitting a party whose bankruptcy was itself a default under the agreement to recover under the contract, while at the same time disregarding the liquidation mechanism that was intended to apply in the event of bankruptcy, would make no commercial sense, and would turn the parties' agreements on their head.

The central reasons that ISDA developed standard termination provisions as part of its architecture were to avoid disputes or litigation over valuation and to

facilitate agreement upon a methodology for efficiently resolving defaulted transactions. Congress similarly enacted the safe harbor provisions for the termination and liquidation of swap agreements to promote certainty and finality. If debtors could now set aside agreed-upon contractual provisions in bankruptcy, the contractual foundations underpinning substantial portions of the derivatives markets could be upended. At a minimum, such an approach would invite litigation and delay before the safe harbor could be relied on—precisely as has happened in this case—fundamentally undermining the certainty and finality the safe harbors were designed to provide. Such delay is neither appropriate nor necessary in light of the plain language of the Bankruptcy Code safe harbor provisions.

SIFMA and ISDA urge the Court to apply the Bankruptcy Code safe harbor provisions as written, and to affirm the Bankruptcy Court’s decision dismissing with prejudice Counts I through XIX of the Complaint, in keeping with both Congressional intent and market practice.

### **CONCLUSION**

Lehman’s claims cannot be squared with Congressional language or intent and defy market expectations. The Court should affirm the Bankruptcy Court’s decision dismissing with prejudice Counts I through XIX of the Complaint.

Dated: New York, New York  
June 16, 2017

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**CERTIFICATE OF COMPLIANCE**

Based on the word counting device used in my computer program, I hereby certify that:

1. This brief contains 8,152 words and therefore complies with the limitations requested by the *amici curiae* on June 2, 2017 (Dkt. 21 at 2).
2. This brief complies with the typeface requirements of Fed R. Bankr. P. Rule 8015(a)(5) and the type style requirements of Fed. R. Bankr. P. Rule 8015(a)(6), because the brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010 in 14-point Times New Roman type style.

Dated: New York, New York

June 16, 2017

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# **EXHIBIT A**



## STRUCTURED FINANCE

## Rating Methodology

# Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions

## Moody's Methodology

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**SUMMARY**

Moody's Investors Service ("Moody's") has revised the framework that it will apply when reviewing hedges in connection with highly-rated structured finance cashflow transactions ("cashflow transactions").

In general, where a hedge counterparty (a "Counterparty") agrees at the outset to adhere to rating triggers and remedies that are of a nature substantially as specified in this Framework, Moody's opinion is that that this would substantially mitigate the impact of Counterparty exposure on the expected loss of the cashflow transaction. As such, the contribution of the Counterparty to the expected loss of the cashflow transaction need not be modeled and the Counterparty credit risk is effectively "de-linked" from the credit risk of the cashflow transaction.

This Framework sets out the criteria that Moody's will take into account in determining whether to de-link the Counterparty risk. Certain aspects of this framework need not be applied where a cashflow transaction retains linkage to the ratings of a Counterparty. In this case, the linkage is disclosed in our reports.

The framework is organized as follows:

- *Table 1* contains the Moody's ratings pertaining to:
  - the minimum level for an institution to provide a hedge to a cashflow transaction without posting collateral; and
  - rating triggers, upon the occurrence of which the Counterparty must take certain actions to further de-link its credit risk from that of the transaction.
- *Tables 2A & 2B* set out the main contractual sanctions applicable to a Counterparty for failure to perform the applicable action(s) upon being downgraded to a given trigger level; the timing for delivery of certain documents; certain necessary amendments to hedge documentation; and the guidelines for payment of hedge periodic and termination payments.
- *Tables 3A & 3B* set out guidelines for application, disapplication and modification of hedge events of default and termination events.
- *Tables 4A-1 to 4B-3* list the respective collateral amounts to be posted by a Counterparty with ratings at the First Trigger and Second Trigger.
- *Tables 5A, 5B, 5C & 5D* list the Valuation Percentages applicable to posted collateral for liabilities issued by a cashflow transaction in Euro, U.K. sterling, U.S. dollars and Australian dollars, respectively.

The Framework (i.e. *Tables 1-5* taken together) supplants Moody's previous framework, as contained in "Swaps in European Term Securitizations", May 21, 2002 and "Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions", October 23, 2002.

**The Framework is merely intended to explain the circumstances under which Moody's will de-link the credit risk of a Counterparty from the credit**



**Moody's Investors Service**

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risk associated with a cashflow transaction when assessing such a cashflow transaction and is not intended for any other purpose. In particular, the Framework is not intended to be legal or tax advice or advice on how to draft transaction documentation to any person (including any Counterparty or SPV) and it does not take into account the specific requirements of any person. Such persons should take their own legal and tax advice when structuring, negotiating and documenting such transactions.

<sup>1</sup> Marlow Gereluk contributed to the publication.

## FRAMEWORK FOR DE-LINKING COUNTERPARTY RISKS FROM STRUCTURED FINANCE CASHFLOW TRANSACTIONS

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# FRAMEWORK FOR DE-LINKING COUNTERPARTY RISKS FROM STRUCTURED FINANCE CASHFLOW TRANSACTIONS

## I INTRODUCTION

Moody's has revised its framework for substantially mitigating the expected losses added by a hedge counterparty ("Counterparty") to those of a structured finance cashflow transaction ("cashflow transaction") involving a special purpose vehicle (an "SPV")<sup>2</sup>. This framework is intended for use where Moody's has assigned initial ratings of **Aaa**, **Aa1**, **Aa2** and/or **Aa3**<sup>3</sup> to the liabilities of a cashflow transaction without having modeled the additional expected losses associated with the Counterparty.

Most aspects of this framework are not intended for use where a cashflow transaction retains linkage to the expected losses of a Counterparty, although certain components, such as those relating to Events of Default, tax provisions and priority of termination payments, may apply. Linkage of a cashflow transaction to a Counterparty is disclosed in Moody's reports.

As previously, the framework uses the Moody's rating of a Counterparty to place it into one of three categories, each of which carries distinct obligations. The revisions simplify these three categories and specify how the respective obligations associated with each category are to be carried out. The revisions include:

- standardized categories of ratings;
- removal of watch language in assigning rating categories;
- execution of all ISDA documentation incorporating the framework at close, including a Collateral Support Agreement ("CSA") that incorporates collateral amounts and valuation percentages;
- clarification of the position of periodic and termination payments made by a cashflow transaction to a Counterparty;
- amendments to standard ISDA language where necessary to address certain operational limitations of cashflow transactions and also to maximize likelihood of obtaining replacement;
- application of Additional Termination Events and Events of Default to both a Counterparty and a cashflow transaction; and
- elimination of Rating Agency Confirmation by Moody's prior to a Counterparty obligation being activated.

## II PURPOSE OF FRAMEWORK

The framework should enable an eligible counterparty to assess the cost of providing a hedge to a cashflow transaction as accurately as possible. The framework also seeks to limit these costs to only those which cannot be avoided in de-linking the credit risk of a Counterparty from a cashflow transaction, as these costs are borne ultimately by the cashflow transaction itself. For instance, a Counterparty reserves against its potential obligation to post collateral or to arrange its own replacement and will incorporate the cost of doing so into its bid for a hedge. But where these obligations are not specified, a Counterparty must add an uncertainty factor into its bid or even refrain from bidding altogether. Either outcome will result in a cashflow transaction paying more for its hedge without receiving any additional benefit.

Unnecessary costs may also accrue at close wherever a Counterparty is obliged to re-establish the framework when bidding on otherwise similar hedges. This may occur if the framework is not sufficiently precise, or if it is not applied equally to all counterparties. Lastly, operational costs may be larger than necessary for both a Counterparty that has experienced a downgrade and a cashflow transaction if the Counterparty obligations must first be established before procedures can be implemented to meet them.

To eliminate these distortions, the framework specifies Counterparty obligations upfront and does not contemplate their being supplanted in the future by "other such remedies as may be agreed at a later date". Alternatives to this framework will be considered at closing where the relevant provisions are already in place, rather than being left open-ended for future specification.

<sup>2</sup> Excludes synthetic transactions, such as credit default swaps and synthetic CDOs, inflation swaps and other contracts supported by ISDA documentation, including but not limited to GICs, where the contract serves a more integral role than hedging payment mismatches between assets and liabilities.

<sup>3</sup> A follow-up paper will address criteria for liabilities with lower ratings.



## **Address Differences Between Cashflow Transactions and Other Hedge Market Participants**

Moody's observes that the form of agreement generally used to document hedges has been created for use by institutional market parties<sup>4</sup> that trade derivative products much more actively than cashflow transactions. SPVs typically do not have the resources or capacity to carry out many of their rights and obligations unassisted under these hedge agreements. Further, the agents of these SPVs and their debtholders (such as trustees) may not always have the mandate or resources to fully protect the interests of the cashflow transaction under the hedges. Therefore, "market standard" contractual terms in hedges involving institutional market parties are not always appropriate for hedges with cashflow transactions. The framework uses market standards wherever possible and adjusts them where necessary to address the limited capacities of an SPV. The principal adjustment occurs with respect to a Counterparty paying for its own replacement; several others follow from the potential time needed for replacement to occur and reliance on the Counterparty to discharge this and certain other tasks.

Major participants in the hedge market typically trade a portfolio of hedges that is marked-to-market on a daily basis and re-balanced frequently. These institutions maintain trading lines with multiple participants and are indifferent between maintaining any single hedge with an existing counterparty, assigning it to a new one and terminating it altogether to pursue an alternative hedging strategy. Hedge documentation addresses deterioration in the credit risk of a counterparty through collateral and termination provisions based on rating or other credit measures. But institutions are also free to negotiate a hedge termination at any time and most have the resources to do so. As a result, credit risk in the hedge market is generally viewed as existing over a very short horizon and many participants accept collateral amounts, valuation percentages and assignment provisions commensurate with this view.

In contrast, a cashflow transaction typically executes one or only a few hedges over its life and is tied much more closely to an individual Counterparty. Persistent mismatches are generally identified at close and offset by hedges that are expected to remain in place for their scheduled lives<sup>5</sup> without requiring the cashflow transaction to make any unforeseen payments. Few resources exist to address hedging issues after close, but any interruption in a hedge will expose the cashflow transaction to market risk and, if it continues over a payment date, may trigger irrevocable changes in the capital structure as well. Unforeseen costs would accrue even if a cashflow transaction was able to terminate the original hedge at mid-market while simultaneously entering into an identical hedge with a new Counterparty, in the likely event that the terms of the two transactions did not offset each other completely. A replacement bid by a new Counterparty would be expected to add costs for funding, conforming to this framework and facing the cashflow transaction, as well as dealing spreads, to the mid-market valuation.

### ***Replacement Drives the Framework, but Cannot Be Guaranteed***

The framework intends for the original Counterparty to arrange and pay for its replacement, where its ratings have reached the Second Trigger (**Baa1** or below and/or **P-3** or are withdrawn). Counterparties ask for at least 30 business days to effect replacement, to include as many eligible parties as possible, but counsel that more time may be required in individual cases. Further, there is no assurance that each cashflow transaction requiring replacement will obtain it, as no mechanism exists to oblige an eligible institution to bid on any single hedge, let alone each one provided by a major institution. Instead, an eligible institution would be expected to examine each hedge separately, decide which warranted bids, price those accordingly and pass on the remainder.

Many aspects of the framework are intended to maximize the likelihood of replacement occurring. The Second Trigger is set at a level which is high enough to ensure that a Counterparty begins replacing itself where possible, prior to the emergence of potential inhibitors to its ability to do so. The collateral amounts and valuation percentages at the Second Trigger incorporate 30 additional business days into their measurement periods, to provide sufficient resources and time for the SPV to pay a replacement bid directly, should that be necessary. And the definition of Market Quotation is amended to enable replacement to occur wherever at least one eligible bidder is ready to step into an existing hedge. Moody's believes that these provisions, taken together with the other sanctions applicable upon loss of Second Trigger, will provide sufficient incentive for the Counterparty to replace itself in as many cases as possible. In the remaining cases where the original Counterparty cannot be replaced imme-

<sup>4</sup> The 1992 Master Agreement (Multicurrency - Cross Border) published by the International Swaps and Derivatives Association, Inc. (the "ISDA agreement") is the form of agreement generally used by the market for hedges in cashflow transactions. This report focuses on hedges which are evidenced by this form of agreement; the use of the 2002 Master Agreement (Multicurrency - Cross Border) for hedges in cashflow transactions will be the subject of an upcoming report.

<sup>5</sup> Governing documents of most cashflow transactions enable an existing hedge to be adjusted, or new one entered into, if modeling shows the expected losses of rated liabilities to be unimpaired by the proposed change.

diately following its downgrade to the Second Trigger, it continues to provide the hedge and seek replacement, while posting the Second Trigger Collateral Amount, until either replacement occurs or the hedge runs off.

### III APPLICATION OF FRAMEWORK

The principal features of the revised framework (hereafter "framework") are contained in *Tables 1-5*, beginning on page 14.

The framework was developed for hedges denominated in major currencies, including Australian, Canadian, New Zealand and U.S. dollars, euro, Danish krone, Swedish krona, Norwegian krone, Swiss franc, U.K. sterling, and, in some circumstances, Japanese yen. Adaptation of the framework will be required for hedges denominated in other currencies, such as those of emerging market countries, where underlying assumptions regarding market liquidity, volatility, potential currency controls, etc. differ from those used here.

Moody's intends for this framework to be used as widely as possible across most types of cashflow transactions, rating centers and the universe of counterparties. This universe now includes money-center, regional and investment banks, as well as specialized entities such as insurance subsidiaries and, in limited instances, highly-rated derivative product companies. Other types of institutions may also provide hedges to rated transactions; the framework will apply equally to them. Existing rated transactions may choose to adopt this framework, if permitted to do so by their governing documents.

#### **A Caveat Regarding the Framework**

The broad application of this framework necessitates mention of a caveat pertaining to rating stability of cashflow transactions whose Counterparty has been downgraded. This framework mitigates the expected losses of the vast majority of hedges as of their close, but cannot contemplate each combination of market risk, collateral sufficiency, likelihood of obtaining replacement and Counterparty performance that may emerge post-close. Moody's will continue to monitor such cashflow transactions and will assess whether rating actions are warranted in individual cases, even if the Counterparty is fully compliant with all obligations detailed here. However, both the incidence and severity of any rating actions should be much less pronounced than if this framework were not in place.

### IV RATING CATEGORIES

This framework distinguishes a Counterparty by rating only, not organizational type, domicile or other factor. Ratings are grouped into one of three categories, each of which confers distinct obligations intended to substantially mitigate the expected losses associated with its respective range of ratings. Changes in ratings are recognized following publication of an upgrade, downgrade or withdrawal, but not by being placed on a watchlist.

*Table 1* lists the three possible categories into which the rating of a Counterparty will fall. A Counterparty must have a long-term rating<sup>6</sup>, as this addresses its expected loss over the same horizon as that of a rated transaction. However, the information contained in a short-term rating, where one exists, is not ignored. A **P-1** rating will defer a First Trigger from being reached until a long-term rating equals **A3**, compared with **A2** in the absence of a short-term rating. Conversely, a short-term rating of **P-2** or **P-3** obliges a Counterparty to assume the obligations associated with the First or Second Trigger, respectively, even if its long-term rating does not.

*Tables 2A & 2B* list the Counterparty obligations associated with each category. Upon entering a hedge, a Counterparty would execute agreements necessary for it to perform its obligations, including those activated upon its rating reaching either the First Trigger or Second Trigger, such as a Schedule to Master incorporating provisions consistent with this framework, a credit support annex, and, where necessary to support the Counterparty's rating above the First Trigger at time of closing, letters of credit or guarantees<sup>7</sup>. None of these obligations may be contingent upon issuance of Rating Agency Confirmation by Moody's prior to being activated. At this stage, a Counterparty should either have ratings above the First Trigger, or be prepared to post collateral immediately. In contrast, a Counterparty with a rating below the Second Trigger providing any new hedges would be inconsistent with the assumption that it brings no additional expected losses to the cashflow transaction. In addition to not providing any new hedges, such a Counterparty should seek replacement or equivalent for each hedge already on its books.

<sup>6</sup> Long-term rating refers to a senior unsecured rating.

<sup>7</sup> The framework contemplates possible use of a guarantee by the Counterparty after close, as an acceptable remedy should the Counterparty be downgraded to either the First Trigger or Second Trigger. Such a guarantee may never be needed, and thus is not expected to be in place at Close.

Following a grace period of 30 business days after each of the Counterparty and any guarantor of the Counterparty has reached the “First Trigger” rating level, the Counterparty should post the First Trigger Collateral Amount listed in *Table 4A-1*, unless and until it (or its guarantor) is upgraded above the First Trigger, replacement occurs or a suitable guarantee is provided by a sufficiently-rated guarantor. At this level, a failure by the Counterparty to post the required collateral should constitute an Additional Termination Event under the hedge.

Upon each of the Counterparty and any guarantor of the Counterparty reaching the “Second Trigger” rating level, the Counterparty must use commercially reasonable efforts to, as soon as reasonably practicable, replace itself or procure a sufficiently-rated guarantor of its obligations under the hedge. In addition, following a grace period of 30 business days, the Counterparty should post the Second Trigger Collateral Amount listed in *Table 4B-1* (which will represent an increase from First Trigger Collateral Amount), unless and until it (or its guarantor) is upgraded above the Second Trigger, replacement occurs or a suitable guarantee is provided by a sufficiently-rated guarantor. The Second Trigger Collateral Amount must be posted so as to be in place if needed to fund replacement. Accordingly, failure to post the Second Trigger Collateral Amount should constitute an Event of Default under the hedge, rather than an Additional Termination Event. The latter would not provide a Counterparty with sufficient incentive to post the second Trigger Collateral Amount, as refusal to do so would simply result in a potential termination of the hedge — a less costly outcome than meeting its obligation to replacing itself.

## **V PAYMENT PRIORITIES**

*Tables 2A & 2B* also address the seniority of payments made by a cashflow transaction to a Counterparty. The seniority of payments to the Counterparty is a key tool in mitigating credit risk for both the Counterparty and cashflow transaction. Payments to a counterparty are generally senior to all rated debt. For this reason, it is usually important that payments to the Counterparty are not accelerated or increased solely due to reasons pertaining to the Counterparty.

### **Periodic Hedge Payments**

The SPV is usually required to make regular periodic payments to the Counterparty under the hedge. The SPV can usually make these payments to the Counterparty intra-period, as and when the SPV is scheduled to receive such funds, depending upon the payees who would normally rank senior to the Counterparty.

In all other cases, periodic hedge payments should usually be made on rated debt interest payment dates, in accordance with the priority of payments. Periodic hedge payments to a counterparty may be made from both interest proceeds and principal proceeds and are generally senior to all rated debt.<sup>8</sup>

### **Collateral Posting and Return while Hedge in Effect**

An SPV or its arranger should establish a separate collateral account at closing, secured to its Trustee, for the sole purpose of holding collateral that may be posted at a later date, should the ratings of the Counterparty be downgraded to one of the triggers in this framework.

Interest may be payable by the cashflow transaction to the Counterparty in respect of cash amounts posted to the cashflow transaction. However, the amount payable should either be (a) an amount equal to the amount actually earned on such amounts; or (b) an amount equal to the contractual rate of interest that the cashflow transaction is contractually entitled to receive on such amounts from its own bank account. An amount equal to all distributions received on securities posted to the cashflow transaction may also be payable to the Counterparty.

Calculation should generally be made in the same currency as that of the rated liabilities, particularly for cross-currency hedges addressing mismatches between assets and liabilities. However, for certain single-currency hedges addressing asset mismatches only, calculation may be made in the currency of the hedge itself, even where different from that of the rated liabilities.

The threshold for transferring collateral to the cashflow transaction should be set at zero whenever collateral is required to be posted, and minimum transfer amounts and return amounts should be set at USD 100,000 or its equivalent. As the cashflow transaction does not have the capacity to make calculations of the hedge mid-market valuation, DV01, etc., the Counterparty should usually be required to calculate collateral requirements. For the same reasons, demands for collateral should be “deemed” to occur either daily or weekly, consistent with the Collateral Amounts and Valuation Percentages specified in the CSA (assuming that additional collateral is payable under the credit support documentation).

<sup>8</sup> Some cross-currency hedges, by their nature, may result in payments to the counterparty being pari-passu with those of senior debt



Movements of collateral, either into or out of the separate collateral account, occur directly with the Counterparty outside the general payment waterfall, as instructed by the Calculation Agent (as mentioned above, generally the Counterparty itself).

### **Hedge Termination Payments**

The ISDA agreement states that if the hedge terminates early, a termination payment will be payable by one party to the other. The party that is "in-the-money" is usually entitled to a payment from the party that is "out-of-the-money", regardless of the reasons for the early termination, net of unpaid amounts under the hedge<sup>9</sup>. This payment is calculated as the sum of: (a) the net of all unpaid amounts owing by the parties to each other, and (b) the mark-to-market ("MtM") of the hedge as at the Early Termination Date. Note that each of (a) and (b) may be positive or negative with respect to the cashflow transaction.

If the termination payment is negative for the cashflow transaction, it is required to make a payment to the Counterparty. This payment can be substantial, and is usually expected to be paid out of interest proceeds and, if necessary, principal proceeds of the cashflow transaction. To ensure sufficient Counterparty risk de-linkage, this payment should only be made on rated debt payment dates, and only once all amounts senior thereto in the respective priority of payments have been made, particularly when the Counterparty is the Defaulting Party or sole Affected Party. See *Table 2B* for the priority in which termination payments to the Counterparty should be made. In addition, where the MtM component of the hedge is negative (i.e. payable by the SPV to the Counterparty) and is subordinated to noteholders, it should not be set-off against any unpaid amount owing by the Counterparty to the SPV<sup>10</sup>. However, if replacement occurs, the amount received from the replacement Counterparty in consideration for entering into the replacement hedge is applied in satisfaction of the MtM payment and paid to the original Counterparty outside the waterfall of payments.

### **Collateral Return Following Hedge Termination**

Collateral due back to the Counterparty following a termination (in excess of that which is necessary to cover any net unpaid amount<sup>11</sup> owing to the SPV and any amount paid by the SPV to enter into a replacement hedge) may be paid or transferred back directly to the Counterparty, outside the general payment waterfall.

### **Replacement Receipts**

It is generally acceptable for amounts paid by a replacement Counterparty to be made directly to the outgoing Counterparty to the extent of any payment due to such outgoing Counterparty.

## **VI EVENTS OF DEFAULT AND TERMINATION EVENTS**

The ISDA agreement provides for two main ways for parties to terminate the related hedges: "Events of Default" and "Termination Events".

Events of Default are intended to allow the non-defaulting party to terminate the hedge where there is a fundamental failure in respect of the other party; where the "Defaulting Party" is unable to perform one or more of its fundamental obligations under the hedge. At common law, a party generally only has the right to sue for damages when the other breaches its obligations. The ISDA Event of Default mechanics were intended to instead allow the non-Defaulting Party to simply terminate the agreement, rather than be forced through costly and uncertain court proceedings.

Termination Events are intended to allow one or both parties to the hedge to terminate the hedge where both parties are still able to perform their obligations, but it has become undesirable for one or both parties to continue with the hedge. These circumstances usually arise from changes in law or changes in circumstances of the parties, making it costly or prohibitive to continue with the hedge.

Both Events of Default and Termination Events result in a potential early termination of the hedge and a termination payment arising under s. 6(e) of the ISDA agreement. However, there are many differences between Events of Default and Termination Events, including:

- Events of Default entitle the non-Defaulting Party to stop paying the Defaulting Party immediately (s. 2.(a)(iii)).

<sup>9</sup> A party is "in-the-money" in a hedge at a given time to the extent that it has inherent value in the hedge; i.e., the present value of all future expected receipts to which it is entitled under the hedge is greater than the present value of all future expected payments that it is required to make under the hedge, calculated at then-current rates. Conversely, a party is "out-of-the-money" to the extent that the present value of future receipts is less than the present value of future payments at then-current rates.

<sup>10</sup> This bifurcation of payments is not required if the ISDA Credit Support Annex (English law) is used.

<sup>11</sup> Without regard to any deemed unpaid amount under paragraph 6 of the ISDA Credit Support Annex (English law).



This is not the case for Termination Events.

- Events of Default may cause the non-Defaulting Party to cross-default under other hedge or debt obligations; therefore, parties will generally take obligations which, by non-performance, cause an Event of Default much more seriously.
- Under s. 11 of the Master Agreement, the non-Defaulting Party is entitled to be compensated for its reasonable out-of-pocket expenses incurred in connection with enforcing its rights under the hedge in connection with an Event of Default by the Defaulting Party. This is not the case for Termination Events.

The ISDA agreement is designed for hedges between large institutions that are able to look after their own interests. Such institutions have the resources to provide timely notices, monitor Counterparty circumstances and calculations and to terminate the hedge when it is advisable to do so. However, when one of the parties to a hedge is an SPV in a cashflow transaction, that SPV may not have adequate resources to do these things, but instead rely upon the Counterparty's calculations, notices and goodwill. It is therefore necessary to amend certain of the Events of Default and Termination Events accordingly to reflect these realities.

All ISDA-standard Events of Default should generally apply to the Counterparty. The Breach of Agreement Event of Default should apply to the Counterparty, since it has many vital non-financial obligations under the hedge, including (a) the obligation to maintain all authorizations; (b) the obligation to comply with all applicable laws; (c) the obligation to calculate the ongoing collateral owing to the cashflow transaction (if the Counterparty has been downgraded at least to the First Trigger); and (d) the obligation to make other calculations for the purposes of the hedge. Also, the time and expense of suing the Counterparty would usually be inconsistent with the ratings provided to the cashflow transaction.

Similarly, the Misrepresentation Event of Default should usually apply to the Counterparty, since if the Counterparty does not have the capacity and authority to enter into the hedge, the cashflow transaction will likely suffer an economic loss. Also, even though the SPV might be able to sue the Counterparty for misrepresentation at common law, a court might view the disapplication of Misrepresentation against the Counterparty as evidence that these representations in s. 3(a)-(d) were intended to have no force and effect. In any event, the expense and time involved in a lawsuit are usually inconsistent with the ratings of debt instruments in cashflow transactions.

The Failure to Pay or Deliver Event of Default will generally apply to both the SPV and the Counterparty. So will the Bankruptcy Event of Default; however, it should be amended to reflect the fact that: (a) the SPV is potentially "insolvent" from the very start of the transaction; and (b) substantially all of the SPV's assets are subject to a security interest in favor of the trustee and are often held by a custodian. Further, the "soft" aspects of Bankruptcy should not apply to the SPV. It is usually more appropriate for the Counterparty to rely upon an Additional Termination Event which applies (with the SPV as Affected Party) when there has been an irrevocable acceleration of the rated debt or a redemption of the Notes (other than due to normal course structural features, e.g. paydown of rated debt to cure coverage tests in cashflow CDOs).

## **VII AMENDED ISDA TERMINATION PAYMENT CALCULATION MEASURE**

Consistent with the principle of substantial mitigation of Counterparty risk, it is imperative that no material gap in hedge coverage arises as a result of an action giving rise either to an Event of Default by the Counterparty or an Additional Termination Event where the Counterparty has been designated as sole Affected Party. From the perspective of the cashflow transaction, therefore, 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 Counterparty to assume the role of the original Counterparty in providing it. Ideally, replacement will occur through novation, so that the hedge will not be interrupted even as the original Counterparty bows out in favor of its replacement. To maximize the likelihood of the hedge continuing in these circumstances, the framework suggests adjustments to the termination payment calculation measure that incorporate the concept of "live bids", rather than representative ones, and that will result in a successful Market Quotation where there is at least one eligible party under this framework that has submitted a "live bid".

However, provision must also be made for cases where no replacement is available, but the hedge has been impaired as a result of an action giving rise either to an Event of Default by the Counterparty or an Additional Termination Event where the Counterparty has been designated as sole Affected Party. In these cases, a material gap in hedge coverage will have arisen or be imminent, and this gap will grow if the hedge continues with the original Counterparty. Should the SPV decide that its best option under these circumstances is to terminate

the impaired hedge, even though it cannot be replaced, the mark-to-market component of a termination payment will revert to "Loss".

In this regard, the following amendments should be made in the related hedge agreement to the termination payment calculation measure where the Counterparty is the Defaulting Party or sole Affected Party (except termination for Illegality or Tax Event)<sup>12</sup>:

- "Live bids" to be made for a hedge on terms that are at least as beneficial (in all material respects) for the SPV as the current one, including rating triggers, credit support documentation and other components of this framework, to be determined by SPV, acting in a commercially reasonable manner.
- A "live bid" represents the amount which an eligible institution is willing to pay or receive to execute a replacement hedge with the cashflow transaction.
- Counterparty may also obtain "live bids", and must attempt to do so if required by the SPV.
- All "live bids" from eligible institutions considered, whether sourced by Counterparty or SPV.
- At any time at which two or more "live bids" are available, the SPV is entitled to accept only the "live bid" that is the most beneficial for the outgoing Counterparty.
- Where replacement occurs on or before the Early Termination Date, the actual replacement price paid to or by the new Counterparty is used to determine the "mark-to-market" component of a termination payment, even if only one "live bid" is obtained.
- Where replacement does not occur on or before the Early Termination Date and at least one "live bid" is available, the "live bid" that is the most beneficial for the outgoing Counterparty is used to determine the "mark to market" component of a termination payment.
- Where replacement does not occur on or before the Early Termination Date and no "live bid" is available, revert to "Loss".

### **Additional Termination Event at Second Trigger**

Under the framework, a Counterparty with ratings at or below the Second Trigger seeks replacement with an eligible party or a guarantee of its hedge obligations, using "commercially reasonable" efforts to do so. Consistent with the goal of securing replacement in as many instances as possible, the framework also contemplates a parallel search for a replacement Counterparty by an SPV. As such, an SPV may declare an Additional Termination Event at any time beginning 30 business days after initial downgrade of a Counterparty's rating to the Second Trigger, provided at least one eligible institution is willing to submit a "live bid" to replace the hedge.

This Additional Termination Event may not be declared solely because a Counterparty has been downgraded to the Second Trigger. In the absence of an eligible party willing to submit a "live bid" to replace a hedge, or where no eligible parties that had expressed a willingness to submit "live bids" actually did so, the original Counterparty continues to provide the hedge, post the Second Trigger Collateral Amount and use "commercially reasonable" efforts to seek replacement or a guarantee. If, at some later date, the Counterparty has not obtained replacement or a guarantee and at least one "live bid" is submitted from an eligible institution, the SPV may at that time declare an Additional Termination Event, using the amended Market Quotation termination payment calculation measure, as described in preceding section.

The Additional Termination Event at the Second Trigger is unique among those using the amended Market Quotation termination payment calculation measure in that it may not revert to "Loss". The reasoning is that, while a Counterparty with ratings at the Second Trigger brings additional expected losses to the cashflow transaction, its downgrade alone does not cause a material interruption in hedge coverage. Rather, the Second Trigger Collateral Amount mitigates the additional expected losses and will be available should a material gap in hedge coverage arise later, while the ongoing obligation of the Counterparty to seek replacement or obtain a guarantee, combined with the Additional Termination Event at the Second Trigger, hold out the potential for replacement in the future.

### **Where SPV is Defaulting Party, Affected Party or Termination following Illegality or Tax Event**

- Market Quotation without above adjustments

<sup>12</sup> Tables 3A & 3B list Events of Default and Termination Events as applicable to Counterparty and SPV

## VIII COLLATERAL AMOUNTS

Tables 4A-1 & 4B-1 list the collateral amounts for the First Trigger and Second Trigger, respectively. The collateral amount represents the potential value of a hedge over the relevant measurement period and is assembled from components routinely calculated by a Counterparty.

The collateral amount will vary for each hedge, depending on its type, remaining life and Counterparty rating. For any given hedge, a collateral amount will be greater for a Counterparty with ratings associated with the Second Trigger, compared with the First Trigger.

Calculation is made from the point of view of the cashflow transaction, in the same currency as its rated liabilities on at least a weekly basis. The collateral amount has a floor of zero whenever negative, i.e. the potential value of the hedge represents a liability, not an asset, to the cashflow transaction. At each such calculation date, the Counterparty posts no collateral.

### Starting Point - Mid-Market Valuation of Hedge

The starting point in determining the potential value of a hedge over its relevant measurement period is its mid-market valuation at time of calculation. Typically, a Counterparty calculates the mid-market value of a hedge on a daily basis for many purposes, such as recording P&L, agreeing the value of the hedge with its end-users and posting collateral. Counterparty discretion in making these calculations is sharply curtailed both by its own internal controls and the liquid nature of many types of hedges.

#### Valuation of Transaction-Specific Hedges

An exception exists with respect to hedges with whose payment terms will vary in tandem with characteristics of the cashflow transaction itself ("transaction-specific hedges"). For instance, the hedge notional may be tied to the outstanding assets or liabilities or the pre-payment characteristics of either, rather than being established at close. Balance-guaranteed hedges, where the notional of the hedge adjusts over time to account for principal amortization, prepayments and defaults experienced on the asset side fall into this category, as do PIKING swaps, hedges using band analysis and certain types of liquidity swaps, among others. Calculating a mid-market value for these transaction-specific hedges necessarily requires considerable resources and subjective judgment, with the result being more of a risk assessment unique to the Counterparty preparing it and less a valuation around which assessments by other parties will converge. The Second Trigger Collateral Amounts mitigate the range of valuations associated with transaction-specific hedges through a higher estimate of potential increase over the measurement period, rather than adjusting or scrutinizing the mid-market valuation itself.

### Second Step - Potential Increase of Mid-Market Valuation of Hedge

The potential increase of the hedge valuation over the relevant measurement period is added to the initial mid-market valuation to produce the potential value of a hedge over its relevant measurement period. The framework uses "DV01", an estimate of the change in the mid-market value of a hedge resulting from a one basis point change in the swap curve, to measure the potential increase. The DV01 is primarily sensitive to the remaining amortization of a hedge, but also incorporates sensitivity to the swap coupon or spread above LIBOR or other index. The risk department of a Counterparty routinely measures a DV01 in conjunction with a mid-market valuation to assess portfolio risk. Different methods may be employed to measure a DV01, with each producing a slightly different outcome. However, as these differences are generally not significant, the framework relies on the measure routinely prepared by the Counterparty, rather than specifying a standard DV01 calculation.

A Counterparty may need to make operational adjustments to enable its risk department to share the DV01 at each Calculation Date with its collateral department, but the cost of doing so should be offset by the efficiencies gained in measuring the potential increase for each hedge individually. However, the framework also provides tables<sup>13</sup> of the potential increase of a hedge by its weighted average life, to allow a Counterparty to calculate the collateral requirement without reference to DV01. These tables were derived by assigning conservative estimates of DV01 to each yearly increment of weighted average life.

The potential increase of an interest-rate swap is measured here by multiplying its DV01 by a specified number of basis points. DV01 is also used to estimate the potential increase of an interest-rate option, such as a cap, floor or swaption, although the multiplier increases to address the additional contributor of implied volatility. While a second risk measure, such as Vega, may address the impact of implied volatility more directly, the use of DV01 alone, when paired with a higher multiplier, serves several purposes. It simplifies the formula to deter-

<sup>13</sup> Please see Tables 4A-2, 4B-2 & 4B-3.



mine the potential increase of a hedge with optionality, limits the risk measures that a Counterparty transmits to its collateral department and increases the estimate of potential increase for a hedge with optionality, compared to a similar one without optionality.

The range of valuations associated with a transaction-specific hedge is also addressed through increasing the number of basis points multiplied by the DV01, compared to a hedge that is not transaction-specific.

The potential increase for a cross-currency hedge is treated primarily as a function of currency exposure, expressed as a percentage of the hedge notional of that leg denominated in the same currency as that of the rated liabilities of the cashflow transaction. The interest rate risk associated with cross-currency hedges is addressed by using a lower multiplier to DV01 than for straight interest rate hedges. The reasoning is that interest rate risk is a second-order impact that is only partially correlated with currency risk. As with single-currency hedges, a cross-currency hedge either with optionality, such as a cap, floor or swaption, or one that is transaction-specific, will use a higher multiplier for DV01 than a similar hedge without such features.

### **Estimating Potential Increases of Hedge Valuations**

The potential increases for different types of hedges are obtained using an application of Moody's Market Value CDO Methodology<sup>®14</sup>. This application employs the Black-Scholes option pricing formula to calculate the expected loss of an individual type of hedge over a specified period of time. The approach is parametric and based on a two-state Markov model that recognizes volatility as tending to occur in clusters, rather than occurring randomly. An additional modification is made, to incorporate the expected loss of the Counterparty itself. Inputs include:

- market volatility of hedge type as estimated from historic data;
- number of days in relevant measurement period;
- Counterparty rating; and
- target rating of senior liabilities issued by cashflow transaction.

### **First Trigger Collateral Amounts**

The First Trigger Collateral Amount is determined by summing two components:

- the mid-market value of the hedge; and
- the potential increase of the hedge over the relevant measurement period.

Here, the relevant measurement period equals the interval between posting dates<sup>15</sup> plus the number of days allowed for a cure period, generally five business days in total for daily posting and nine business days in total for weekly posting. No additional days are added to the measurement period, as the ratings associated with the First Trigger suggest a high likelihood that a Counterparty will meet each collateral call. This high likelihood of Counterparty performance constrains the First Trigger Collateral Amount in an additional way, as Moody's methodology credits it as a partial offset to market risk of the hedge.

### **Second Trigger Collateral Amounts**

Second Trigger Collateral Amount is increased, compared with the First Trigger Collateral Amount, to compensate both for a longer measurement period and for the higher expected losses of ratings in this group. Essentially, the risk of Counterparty non-performance is no longer trivial when compared to the expected losses of the cashflow transaction, with the result that the Second Trigger Collateral Amount must be sufficient to pay for a replacement hedge, if necessary. Moody's Market Value CDO Methodology picks up this additional risk in two ways:

- the relevant measurement period expands by an additional 30 business days, compared with the First Trigger, to allow enough time for the SPV to arrange replacement, if necessary; and
- the lower rating of the Counterparty offsets the potential increase of a hedge to a much smaller degree, compared to ratings at the First Trigger.

Additional costs may accrue to a cashflow transaction as a result of Counterparty non-performance that are outside the scope of pure market risk and thus cannot be estimated using Moody's Market Value CDO Methodology<sup>®</sup>. Accordingly, the Second Trigger Collateral Amount also:

- expands the hedge types to include transaction-specific hedges, to mitigate variations in their valuation; and
- considers the next net coupon payment owed by the Counterparty, to protect the rated liabilities against

<sup>14</sup> See *Moody's Special Report "Moody's Rating Methodology: an Alternative Approach to Evaluating Market Value CDOs"*, December 5, 2002.

<sup>15</sup> Taking account of the difference between the valuation time and the time of transfer.

Counterparty non-performance that may persist over a payment date<sup>16</sup>.

Finally, the Second Trigger Collateral Amount must be sufficient to pay for a replacement hedge in the likely case where the amount needed to do so varies from mid-market valuation. No additional provision is made for the potential gap replacement bid and mid-market valuation, instead, it is borne by the adjustments already mentioned here.

## **IX VALUATION PERCENTAGES FOR REPRESENTATIVE INSTRUMENTS**

Tables 5A, 5B, 5C, 5D and 5E list Valuation Percentages for instruments commonly posted as collateral. Cash includes euros, U.K. sterling, U.S. dollars, Australian dollars and Japanese yen. Bonds include U.S. Treasuries and Agencies, Euro-Zone government bonds, U.K. Gilts, Australian government bonds and Japanese government bonds, both fixed-rate and floating-rate. These instruments represent various types of permissible collateral, not an exhaustive list. Moody's will supply Valuation Percentages for certain other forms of collateral using the same methodology employed here<sup>17</sup>.

The Valuation Percentages which follow are also obtained using an application of Moody's Market Value CDO Methodology<sup>18</sup>, as described in the previous section.

As with the collateral amounts, both the number of business days exposure and the rating of a Counterparty combine to produce lower Valuation Percentages for the Second Trigger, compared with the First Trigger. At the First Trigger, the expected loss of the Counterparty is sufficiently low as to offset partially or even fully the market risk of the asset posted as collateral. Furthermore, the high probability that the Counterparty will continue to post limits measurement to the interval between posting dates plus any cure periods. As a result, many of the First Trigger Valuation Percentages in Tables 5A, 5B, 5C, 5D and 5E = 100%.

Valuation Percentages at the Second Trigger are considerably lower, owing primarily to the longer measurement period that must be considered. The growing likelihood that a Counterparty rated below the Second Trigger may at some point fail to post expands the time interval being measured by an additional 30 Business Days, the time potentially needed to arrange replacement. While a cashflow transaction may terminate a hedge immediately following a Counterparty failure to cure, it is not obligated to do so. Where possible, a rated transaction will likely defer terminating an existing hedge until the point where it simultaneously enters into a replacement hedge, to retain access to collateral that may be required to pay for the replacement. Additionally, higher expected losses associated with the lower ratings of a Counterparty below the Second Trigger offset the market risk of the collateral to a much lesser degree than at the First Trigger.

No further adjustments are made to Valuation Percentages for collateral posted in the same currency as that of the liabilities of the cashflow transaction being hedged. But collateral denominated in a currency separate from that of the rated liabilities is exposed to an additional market risk, that of the currency pair itself. In this instance, the Valuation Percentage of the collateral currency per liability currency is also obtained, and applied to that of the respective collateral type<sup>19</sup>.

<sup>16</sup> Please also see "V Payment Priorities - Collateral Return Following Hedge Termination" for mechanism enabling cashflow transaction, under certain circumstances, to retain collateral equal to unpaid amounts.

<sup>17</sup> Data needed include price history for proposed collateral and for currency of collateral per currency of liabilities, where the two currencies differ.

<sup>18</sup> See Moody's Special Report "Moody's Rating Methodology - An Alternative Approach to Evaluating Market Value CDOs", December 5, 2002.

<sup>19</sup> For certain single-currency hedges addressing asset mismatches only, collateral may be posted in the currency of the hedge itself without application.

**X "THE FRAMEWORK"**

*Table 1*  
**Counterparty Obligations by Rating Category**

The following table sets out the three rating categories and associated obligations pertaining to a Counterparty whose risk is de-linked from a cashflow transaction at its close.

If a Counterparty's ratings (or the ratings of its guarantor) are above the First Trigger, it may provide a hedge to a cashflow transaction or assume an existing hedge requiring replacement, in either case without posting collateral, although it must agree to take corresponding action prescribed below, upon its ratings (and the ratings of its guarantor, if any) being downgraded to a trigger level.

For example, if an unguaranteed Counterparty has only a long-term rating<sup>1</sup> that is downgraded to **A2** or both a long-term and a short-term rating, and its long-term rating is downgraded to **A3** or its short-term rating is downgraded to **P-2**, it should be contractually obligated to take the steps corresponding to the "First Trigger". If that Counterparty's long-term rating is downgraded to **Baa1** or below or, if it also has a short-term rating that is downgraded to **P-3** or below, that Counterparty should be contractually obligated to take the steps corresponding to the "Second Trigger". If a Counterparty's rating(s) are subsequently upgraded to **A1** or above (where it has only a long-term rating) or **A2** or above and **P-1** (where it has both long-term and short-term ratings), it is no longer required to post any collateral at all, replace itself or procure a sufficiently rated guarantor for its obligations.

<b>Hedges in Cashflow Transactions (USD, CAD, AUD, NZD, DKK, EUR, CHF, SEK &amp; GBP) <sup>2</sup></b>		
<b>Rating Categories Where Counterparty has Only a Long-Term Rating<sup>1</sup></b>	<b>Counterparty Obligations by Rating Category (apply for so long as Counterparty Rating corresponds to respective Trigger)</b>	<b>Rating Categories Where Counterparty has Both Long and Short-Term Ratings<sup>1</sup></b>
<b>Aaa</b>	1. Enter into ISDA documentation at Close, including Schedule & CSA.  2. Provide new hedge to cashflow transaction or assume existing hedge requiring replacement, in either case without posting collateral.  3. If upgraded above First Trigger, cease performing First Trigger obligations.	<b>Aaa &amp; P-1</b>
<b>Aa1</b>		<b>Aa1 &amp; P-1</b>
<b>Aa2</b>		<b>Aa2 &amp; P-1</b>
<b>Aa3</b>		<b>Aa3 &amp; P-1</b>
<b>A1</b>		<b>A1 &amp; P-1</b>
<b>A2</b>	<b>"FIRST TRIGGER"</b>  1. Obtain guarantee, replace self OR post First Trigger Collateral Amount <sup>3</sup> .  2. If upgraded above Second Trigger, cease performing Second Trigger Obligations.	<b>A2 &amp; P-1</b>
<b>A3</b>		<b>A3 OR P-2</b>
<b>Baa1 &amp; Below<sup>4</sup></b>	<b>"SECOND TRIGGER"</b>  Obtain guarantee or replace self, AND, in interim, post Second Trigger Collateral Amount <sup>5</sup> .	<b>Baa1 &amp; Below<sup>4</sup></b> OR <b>P-3</b>

<sup>1</sup> Long-term rating refers to senior unsecured rating.  
<sup>2</sup> Other currencies, such as those of Emerging Market domiciles, may have different rating triggers and sanctions.  
<sup>3</sup> See Table 4A-1 for First Trigger Collateral Amount.  
<sup>4</sup> Includes withdrawn ratings.  
<sup>5</sup> See Table 4B-1 for Second Trigger Collateral Amount.

Table 2A  
**Counterparty Obligations, SPV Remedies and Timing**

CRITERIA	STANDARD
<b>Timing for CSA</b>	Closing.
<b>Priority of Periodic Payments to Counterparty</b>	Senior in both interest and principal waterfalls to all rated debt. Junior to tax and senior expenses.
<b>Ratings Above First Trigger</b>	Provide hedge without posting collateral. Assume existing hedge requiring replacement without posting collateral.
<b>First Trigger</b>	
SPV notifies Counterparty?	No. Counterparty obligations automatic following publication by Moody's of change in rating of Counterparty to First Trigger levels. <sup>1</sup>
Days for Counterparty to post collateral.	30 Business Days ("BDs") following publication by Moody's of such downgrade to post First Trigger Collateral Amount. Counterparty may, at any time, avoid posting collateral by transferring the hedge to a replacement counterparty rated above the Second Trigger or obtaining a guarantee from a guarantor rated above the First Trigger. If a replacement counterparty is rated at or below the First Trigger at the time of replacement, it must post First Trigger Collateral Amount with no grace period.
SPV remedy if Counterparty fails to post collateral.	Additional Termination Event @option of SPV, Counterparty = sole Affected Party.
External verification of mark?	No. First Trigger Collateral Amount does not distinguish transaction-specific hedges.
<b>Second Trigger</b>	
SPV notifies Counterparty?	No. Counterparty obligations automatic following publication by Moody's of change in rating of Counterparty to Second Trigger levels.
Days for Counterparty to act.	Post Second Trigger Collateral Amount within 30 BDs following publication by Moody's of such downgrade. If First Trigger grace period has elapsed, post First Trigger Collateral Amount during Second Trigger grace period. Counterparty may, at any time, avoid posting Second Trigger Collateral by transferring the hedge to a replacement counterparty rated above the Second Trigger or obtaining a guarantee from a guarantor rated above the Second Trigger. Ongoing obligation to seek guarantee or replacement, as soon as reasonably practicable, using "commercially reasonable efforts" to do so.
External verification of mark?	No. Instead, Second Trigger Collateral Amount increases for transaction-specific hedges.
SPV remedies if Counterparty fails to take required action.	Event of Default @option of SPV, if collateral not posted or Counterparty fails to use commercially reasonable efforts to obtain replacement or a guarantee. Additional Termination Event beginning 30 BDs following publication by Moody's of such downgrade at option of SPV, using amended ISDA termination payment calculation measure & Market Quotation, BUT ONLY WHERE <u>at least</u> one eligible Counterparty submits "live bid" to replace original Counterparty. (Please note - No Additional Termination Event exists in absence of eligible party submitting "live bid". Without at least one such "live bid", the original Counterparty continues to provide the hedge, begins posting the Second Trigger Collateral Amount and replacement is still sought. If at some future date, at least one eligible party submits a "live bid" and the ratings of the Counterparty remain at or below the Second Trigger, an Additional Termination Event may be declared @option of SPV <sup>1</sup> , using amended ISDA termination payment calculation measure & Market Quotation.)

1. Moody's is continuing to explore whether, in certain transactions identified at close, the Trustee should be required to appoint a broker to support a parallel search by the SPV for replacement. In due course, this additional criteria may be added to this framework



*Table 2B*  
**Termination - Amended Market Quotation and Payment Priorities**

**Amended ISDA Termination Payment Calculation Measure**

**Where Counterparty Defaulting Party or Sole Affected Party (except for Illegality or Tax Event)<sup>1</sup>**

"Market Quotation"<sup>2</sup>

- "Live bids" to be made for hedge on terms that are at least as beneficial (in all material respects) for the SPV as the current one, including rating triggers, credit support documentation and other components of this framework, to be determined by SPV, acting in a commercially reasonable manner.
- A "live bid" represents the amount which an eligible institution is willing to pay or receive to execute a replacement hedge with the cashflow transaction.
- Counterparty may obtain "live bids" too, and must attempt to do so if required by the SPV.
- All "live bids" from eligible institutions considered, whether sourced by the Counterparty or SPV.
- At any time at which two or more "live bids" are available, the SPV is entitled to accept only the "live bid" that is the most beneficial for the outgoing Counterparty.
- Where replacement occurs on or before the Early Termination Date, the actual replacement price paid determines the "mark-to-market" component of a termination payment, even if only one "live bid" is obtained.
- Where replacement does not occur on or before the Early Termination Date and at least one "live bid" is available, the "live bid" that is the most beneficial for the outgoing Counterparty is used to determine the "mark to market" component of a termination payment.
- Where replacement does not occur on or before the Early Termination Date and no "live bid" is available, revert to Loss.

**Termination Payment Calculation Measure**

**Where SPV is Defaulting Party, Affected Party or Termination for Illegality or Tax Event**

Market Quotation without above adjustments.

**Priority of Termination Payments to Counterparty**

- |                               |  |
|-------------------------------|--|
| A. General Rule:              | A: Senior in both interest and principal waterfalls to all rated debt.<br>Junior to tax and senior expenses.   |
| B. Exception to General Rule: | B. Where Counterparty is Defaulting Party or sole Affected Party:<br>Subordinate in waterfall to all rated debt; <sup>3</sup> AND<br>No recourse to funds that may subsequently be applied to pay principal on rated debt. |
| C. Exception to Exception:    | C. Senior in both interest and principal waterfalls where hedge termination arises from Tax Event or Illegality.   |

1. Tables 3A & 3B list Events of Default and Additional Termination Events as applied to a Counterparty and SPV.

2. Note that "Market Quotation" should usually be selected as the payment measure.

3. Note that replacement receipts from a replacement Counterparty and any collateral posted under the CSA (in excess of that which is necessary to cover any amount paid by the SPV to enter into a replacement hedge and any net unpaid amount owing to the SPV) may be paid or transferred directly to the original Counterparty outside the priority of payments



Table 3A  
**Events of Default - Applicability to Counterparty & SPV<sup>1</sup>**

EVENT OF DEFAULT	COUNTERPARTY	SPV
Failure to Pay or Deliver (s. 5(a)(i))	Apply	Optional
Breach of Agreement (s. 5(a)(ii))	Apply	Disapply
Credit Support Default (s. 5(a)(iii)) <sup>2,3</sup>	Apply <sup>4</sup>	May apply only with respect to return of excess collateral to Counterparty, otherwise Disapply <sup>5</sup>
Misrepresentation (s. 5(a)(iv))	Apply	Disapply, except where noted below <sup>6</sup>
Default under Specified Transaction (s. 5(a)(v))	Apply only where more than one swap agreement	Disapply
Cross Default (s. 5(a)(vi))	Optional	Disapply
Bankruptcy (s. 5(a)(vii))	Apply	Optional <sup>7</sup>
Merger without Assumption (s. 5(a)(viii))	Apply	Optional

1. Section references are to the 1992 ISDA Master Agreement.
2. CSA generally designated a credit support document, to enable this Event of Default to cover failure both by Counterparty to post required collateral and SPV to return excess collateral.  
FOR AVOIDANCE OF DOUBT, the framework does not contemplate any other governing document of a cashflow transaction, such as an Indenture, to be designated a credit support document.
3. Application is necessary for credit support documents governed by the laws of New York. While application is not technically necessary where collateral is provided via an English-law credit support annex, application allows for an Event of Default to be called e.g. if the Counterparty challenges the validity of the credit support annex.
4. Where Counterparty fails to post required collateral, the SPV, or its Trustee or other agent, delivers notice to Counterparty specifying Event of Default.
5. Generally, the only obligation of the SPV under the CSA is to return excess collateral to the Counterparty. The framework does not contemplate any other action, or failure to act, by SPV giving rise to this Event of Default, whether related to the CSA or other governing document.
6. Apply only to representations by SPV regarding corporate "good housekeeping", such as those relating to "capacity and authority" and "security interest", PROVIDED THAT, an opinion regarding each such representation is provided at closing by the Issuer.
7. If this applies to the SPV, the following adjustments are generally necessary:
  - (2): Disapply;
  - (3): Exclude the granting of security under transaction documents;
  - (4): Exclude actions taken by Counterparty or affiliates;
  - (6): Delete "seeks or" and expressly exclude the transaction's Trustee, Custodian and other analogous parties; and
  - (7): Disapply. See "Additional Termination Events" in *Table 3B*, following page.
  - (8): Apply, to the extent (1) - (7) apply; disapply otherwise.
  - (9): Disapply.

Table 3B  
**Termination Events - Applicability to Counterparty & SPV<sup>1</sup>**

TERMINATION EVENT	COUNTERPARTY AS AFFECTED PARTY	SPV AS AFFECTED PARTY
Illegality (s. 5(b)(i))	Optional	Optional
Tax Event (s. 5(b)(ii))	Optional <sup>2</sup>	Optional
Tax Event Upon Merger (s. 5(b)(iii))	Optional	Optional
Credit Event Upon Merger (s. 5(b)(iv))	Optional	Optional
Additional Termination Events	<ul style="list-style-type: none"> <li>• Failure to replace self or procure guarantor over own hedge obligations within 30 days after Second Trigger, BUT ONLY WHERE at least one eligible party has submitted a "live bid".</li> <li>• Failure to post First Trigger Collateral Amount</li> </ul>	<ul style="list-style-type: none"> <li>• Acceleration of rated debt.<sup>3</sup></li> <li>• Rated debt redeemed in whole.<sup>3</sup></li> <li>• Rated debt redeemed in part.<sup>3,4,5</sup></li> <li>• Indenture Event of Default, followed by irrevocable vote by noteholders to accelerate or redeem rated notes.<sup>3</sup></li> <li>• Materially adverse change to transaction documents w/o Counterparty consent.<sup>6</sup></li> <li>• New hedge executed by SPV without existing Counterparty consent.<sup>7</sup></li> </ul>

1. Section references are to the 1992 ISDA Master Agreement.

2. If this applies, either (i) delete sub-paragraph (x) of Tax Event or (ii) the SPV and the Trustee should receive satisfactory legal opinions at closing that, under current law, none of the Counterparty's or the SPV's payments are subject to withholding tax.

3. In certain cashflow transactions, non-rescindable liquidation of the collateral should be included as a condition precedent to this ATE. Hedge counterparty does not participate in vote deciding to accelerate.

4. Partial termination of the hedge (with the SPV as the sole Affected Party) may apply, provided that either: (a) both redeemed and remaining rated debtholders are kept whole after termination payment made; or (b) the risk associated with such a partial termination is considered in the rating.

5. Disapply to redemption of notes to cure coverage failures in CDOs, unless both hedge reductions and termination payments explicitly modeled at close and considered in the rating.

7. To be considered on a case-by-case basis.

Table 4A-1  
**First Trigger Collateral Amount**

### Applicability

If the Counterparty has Moody's rating(s) which are at the following levels and does not have a sufficiently rated guarantor, the First Trigger Collateral Amount must be posted on at least weekly basis (unless and until the Counterparty replaces itself with an eligible institution or procures a sufficiently rated guarantor for its obligations under the hedge):

**A3** or **A2**, if Counterparty has only a long-term rating<sup>1</sup>;

OR

**A3** or **P-2**, if Counterparty has both long and short-term ratings;

If the Counterparty's Moody's rating(s) are downgraded to the "Second Trigger" level, the actions corresponding to the Second Trigger should be instead taken. If a Counterparty's rating(s) are subsequently upgraded above the First Trigger level, it is no longer required to post any collateral at all, replace itself or procure a sufficiently rated guarantor for its obligations.

### First Trigger Collateral Amounts

The collateral to be posted by the Counterparty at the First Trigger depends upon the type of hedge, as set out in the table below. Where a Counterparty provides more than one hedge to a cashflow transaction under a single Master Agreement, it may net the First Trigger Collateral Amount for each hedge and post on an aggregate basis. At any Calculation Date where the sum of the mid-market value of the hedge and the estimate of its potential increase is negative or zero, no collateral is owed to the cashflow transaction.

The First Trigger Collateral Amounts assume risk periods equal to the interval between posting dates<sup>20</sup> plus the number of days allowed for a cure period, generally a total of five business days for daily posting and nine business days for weekly posting.

<b>First Trigger Collateral Amounts<sup>2</sup></b>	
<b>Single currency swaps, transaction-specific hedges, caps, floors &amp; swaptions</b>	
Daily Posting:	$\text{Max}[0, \text{MtM}^3 + \text{Min}[15 * \text{DV01}, 2\% * \text{hedge notional}]]$
Weekly Posting:	$\text{Max}[0, \text{MtM}^3 + \text{Min}[25 * \text{DV01}, 4\% * \text{hedge notional}]]$
<b>Cross-currency swaps, transaction-specific hedges, caps, floors &amp; swaptions</b>	
Daily Posting:	$\text{Max}[0, \text{MtM}^3 + \text{Min}[1.00\% * \text{hedge notional}^4 + 10 * \text{DV01}^5, 2.5\% * \text{hedge notional}^4]]$
Weekly Posting:	$\text{Max}[0, \text{MtM}^3 + \text{Min}[2.00\% * \text{hedge notional}^4 + 20 * \text{DV01}^5, 5\% * \text{hedge notional}^4]]$

1. Long-term rating = senior unsecured rating.
2. Calculation should be in same currency as that of rated liabilities. However, for certain single-currency hedges addressing asset mismatches only, calculation may be made in the currency of the hedge itself, even where different from that of the rated liabilities.
3. MtM = Mid-market value.
4. "Hedge Notional" for cross-currency hedge = notional of that leg denominated in same currency as rated liabilities of cashflow transaction.
5. Larger of two DV01's corresponding to each leg of a cross-currency hedge.

<sup>20</sup> Taking account of the difference between the valuation time and the time of transfer.

Table 4A-2

**Potential Increase of Mid-market Value of Hedges<sup>1</sup> at First Trigger**

The following estimates of the potential increase in the mid-market valuation of a hedge may be used without reference to DV01. In this case, the First Trigger Collateral Amount =  $\text{Max}(0, \text{Mark-to-market value} + \text{hedge notional}^2 * \text{the respective potential increase below})$ .

Weighted Average Life of Hedge in Years	Single Currency Hedges		Currency Hedges <sup>2</sup>	
	Posting Frequency		Daily	Weekly
	Daily	Weekly	Daily	Weekly
1 or less	0.15%	0.25%	1.10%	2.20%
2 or less but more than 1	0.30%	0.50%	1.20%	2.40%
3 or less but more than 2	0.40%	0.70%	1.30%	2.60%
4 or less but more than 3	0.60%	1.00%	1.40%	2.80%
5 or less but more than 4	0.70%	1.20%	1.50%	2.90%
6 or less but more than 5	0.80%	1.40%	1.60%	3.10%
7 or less but more than 6	1.00%	1.60%	1.60%	3.30%
8 or less but more than 7	1.10%	1.80%	1.70%	3.40%
9 or less but more than 8	1.20%	2.00%	1.80%	3.60%
10 or less but more than 9	1.30%	2.20%	1.90%	3.80%
11 or less but more than 10	1.40%	2.30%	1.90%	3.90%
12 or less but more than 11	1.50%	2.50%	2.00%	4.00%
13 or less but more than 12	1.60%	2.70%	2.10%	4.10%
14 or less but more than 13	1.70%	2.80%	2.10%	4.30%
15 or less but more than 14	1.80%	3.00%	2.20%	4.40%
16 or less but more than 15	1.90%	3.20%	2.30%	4.50%
17 or less but more than 16	2.00%	3.30%	2.30%	4.60%
18 or less but more than 17	2.00%	3.50%	2.40%	4.80%
19 or less but more than 18	2.00%	3.60%	2.40%	4.90%
20 or less but more than 19	2.00%	3.70%	2.50%	5.00%
21 or less but more than 20	2.00%	3.90%	2.50%	5.00%
22 or less but more than 21	2.00%	4.00%	2.50%	5.00%
23 or less but more than 22	2.00%	4.00%	2.50%	5.00%
24 or less but more than 23	2.00%	4.00%	2.50%	5.00%
25 or less but more than 24	2.00%	4.00%	2.50%	5.00%
26 or less but more than 25	2.00%	4.00%	2.50%	5.00%
27 or less but more than 26	2.00%	4.00%	2.50%	5.00%
28 or less but more than 27	2.00%	4.00%	2.50%	5.00%
29 or less but more than 28	2.00%	4.00%	2.50%	5.00%
more than 29	2.00%	4.00%	2.50%	5.00%

1. Table 4A-2 addresses potential increase of all interest-rate and currency hedges, including swaps, caps, floors, swap-tions and transaction-specific hedges.
2. "Hedge Notional" for cross-currency hedge = notional of that leg denominated in same currency as rated liabilities of cashflow transaction.

Table 4B-1  
**Second Trigger Collateral Amount**

### APPLICABILITY

If the Counterparty has Moody's rating(s) at or below the following levels, or withdrawn, and does not have a sufficiently rated guarantor, it posts the Second Trigger Collateral Amount until replacing itself with an eligible institution or procuring a sufficiently rated guarantor for its obligations under the hedge:

**Baa1**, if Counterparty has only a long-term rating<sup>1</sup>:

OR

**Baa1** or **P-3**, if Counterparty has both long and short-term ratings.

If the Counterparty's Moody's ratings are upgraded to the "First Trigger" level, the actions corresponding to the First Trigger should be instead taken. If a Counterparty's ratings are further upgraded to above the First Trigger level, it is no longer required to post any collateral at all, replace itself or procure a sufficiently rated guarantor for its obligations.

### Second Trigger Collateral Amounts

The collateral to be posted by the Counterparty at the Second Trigger depends upon the type of hedge, as set out in the table below. Note: This collateral must be posted pending replacement/procuring guarantor; it is not a substitute for either. Where a Counterparty provides multiple hedges to a cashflow transaction under a single Master Agreement, it may net the Second Trigger Collateral Amount for each hedge and post on an aggregate basis. At any Calculation Date where the sum of the mid-market value of the hedge and the estimate of its potential increase is negative or zero, no collateral is owed to the cashflow transaction.

The Second Trigger Collateral Amounts assume risk periods equal to the interval between posting dates<sup>21</sup> plus the number of days allowed for a cure period plus an additional 30 business days to arrange replacement, if needed. As a result, the risk period equals a total of 35 business days for daily posting and 39 business days for weekly posting.

<b>Second Trigger Collateral Amounts<sup>2</sup></b>	
<b>Single currency swap, no optionality (excludes transaction-specific hedges, caps, floors &amp; swaptions)</b>	
Daily Posting:	Max[0, next payment, MtM <sup>3</sup> + Min[ 50 * DV01, 8% * hedge notional]]
Weekly Posting:	Max[0, next payment, MtM <sup>3</sup> + Min[ 60 * DV01, 9% * hedge notional]]
<b>Single currency transaction-specific hedges, caps, floors &amp; swaptions</b>	
Daily Posting:	Max[0, next payment, MtM <sup>3</sup> + Min[ 65 * DV01 <sup>4</sup> , 10% * hedge notional]]
Weekly Posting:	Max[0, next payment, MtM <sup>3</sup> + Min[ 75 * DV01 <sup>4</sup> , 11% * hedge notional]]
<b>Cross-currency swap, no optionality (excludes transaction-specific hedges, caps, floors &amp; swaptions)</b>	
Daily Posting:	Max[0, next payment <sup>5</sup> , MtM <sup>3</sup> + Min[ 6.00% of hedge notional <sup>7</sup> + 15 * DV016, 9% * hedge notional <sup>6</sup> ]]
Weekly Posting:	Max[0, next payment <sup>5</sup> , MtM <sup>3</sup> + Min[ 7.00% of hedge notional <sup>7</sup> + 25 * DV016, 10% * hedge notional <sup>6</sup> ]]
<b>Cross-currency transaction-specific hedges, caps, floors &amp; swaptions</b>	
Daily Posting:	Max[0, next payment <sup>5</sup> , MtM <sup>3</sup> + Min[ 6.00% of hedge notional <sup>6</sup> + 30 * DV01 <sup>4,7</sup> , 11% hedge notional <sup>6</sup> ]]
Weekly Posting:	Max[0, next payment <sup>5</sup> , MtM <sup>3</sup> + Min[ 7.00% of hedge notional <sup>6</sup> + 40 * DV01 <sup>4,7</sup> , 12% * hedge notional <sup>6</sup> ]]

1 Long-term rating = senior unsecured rating.

2 Calculation should be in same currency as that of rated liabilities. However, for certain single-currency hedges addressing asset mismatches only, calculation may be made in the currency of the hedge itself, even where different from that of the rated liabilities.

3 MtM = Mid-market value.

4 "DV01" for transaction-specific hedge uses same assumptions as mid-market value.

5 Excludes exchange of notional.

6 "Hedge Notional" for cross-currency hedge = notional of that leg denominated in same currency as rated liabilities of cashflow transaction.

7 Larger of two DV01's corresponding to each leg of a cross-currency hedge.

<sup>21</sup> Taking account of the difference between the valuation time and the time of transfer.



Table 4B-2  
**Potential Increase of Mid-market Value of Swaps<sup>1</sup> at Second Trigger**

The following estimates of the potential increase in the mid-market valuation of a swap without optionality may be used without reference to DV01. In this case, the Second Trigger Collateral Amount = Max(0, Next payment<sup>2</sup>, Mark-to-market value + hedge notional<sup>3</sup> \* the respective potential increase listed below).

<b>Swaps Only (Excludes Caps, Floors &amp; Transaction-Specific Hedges)</b>				
Weighted Average Life of Hedge in Years	Single Currency Swap		Currency Swaps <sup>3</sup>	
	Posting Frequency		Daily	Weekly
	Daily	Weekly		
1 or less	0.50%	0.60%	6.10%	7.25%
2 or less but more than 1	1.00%	1.20%	6.30%	7.50%
3 or less but more than 2	1.50%	1.70%	6.40%	7.70%
4 or less but more than 3	1.90%	2.30%	6.60%	8.00%
5 or less but more than 4	2.40%	2.80%	6.70%	8.20%
6 or less but more than 5	2.80%	3.30%	6.80%	8.40%
7 or less but more than 6	3.20%	3.80%	7.00%	8.60%
8 or less but more than 7	3.60%	4.30%	7.10%	8.80%
9 or less but more than 8	4.00%	4.80%	7.20%	9.00%
10 or less but more than 9	4.40%	5.30%	7.30%	9.20%
11 or less but more than 10	4.70%	5.60%	7.40%	9.30%
12 or less but more than 11	5.00%	6.00%	7.50%	9.50%
13 or less but more than 12	5.40%	6.40%	7.60%	9.70%
14 or less but more than 13	5.70%	6.80%	7.70%	9.80%
15 or less but more than 14	6.00%	7.20%	7.80%	10.00%
16 or less but more than 15	6.30%	7.60%	7.90%	10.00%
17 or less but more than 16	6.60%	7.90%	8.00%	10.00%
18 or less but more than 17	6.90%	8.30%	8.10%	10.00%
19 or less but more than 18	7.20%	8.60%	8.20%	10.00%
20 or less but more than 19	7.50%	9.00%	8.20%	10.00%
21 or less but more than 20	7.80%	9.00%	8.30%	10.00%
22 or less but more than 21	8.00%	9.00%	8.40%	10.00%
23 or less but more than 22	8.00%	9.00%	8.50%	10.00%
24 or less but more than 23	8.00%	9.00%	8.60%	10.00%
25 or less but more than 24	8.00%	9.00%	8.60%	10.00%
26 or less but more than 25	8.00%	9.00%	8.70%	10.00%
27 or less but more than 26	8.00%	9.00%	8.80%	10.00%
28 or less but more than 27	8.00%	9.00%	8.80%	10.00%
29 or less but more than 28	8.00%	9.00%	8.90%	10.00%
more than 29	8.00%	9.00%	9.00%	10.00%

1. Table 4B-2 addresses potential increase of interest-rate and currency swaps only. The potential increase in mid-market valuation of interest-rate and currency hedges with options, including caps, floors, swaptions and transaction-specific hedges, is addressed in Table 4B-3.
2. Excludes exchange of notional.
3. "Hedge Notional" for cross-currency hedge = notional of that leg denominated in same currency as rated liabilities of cashflow transaction.

Table 4B-3

**Potential Increase of Mid-Market Value of Options & Transaction-Specific Hedges<sup>1</sup> at Second Trigger**

The following estimates of the potential increase in the mid-market valuation of a hedge with optionality may be used without reference to DV01. In this case, the Second Trigger Collateral Amount will =  $\text{Max}(0, \text{Next payment}^2, \text{Mark-to-market value} + \text{hedge notional}^3 * \text{the respective potential increase listed below})$ .

<b>Caps, Floors, Swaptions &amp; Transaction Specific Hedges</b>				
<b>Weighted Average Life of Hedge in Years</b>	<b>Single Currency Hedges</b>		<b>Currency Hedges<sup>2</sup></b>	
	<b>Posting Frequency</b>		<b>Daily</b>	<b>Weekly</b>
	<b>Daily</b>	<b>Weekly</b>		
1 or less	0.65%	0.75%	6.30%	7.40%
2 or less but more than 1	1.30%	1.50%	6.60%	7.80%
3 or less but more than 2	1.90%	2.20%	6.90%	8.20%
4 or less but more than 3	2.50%	2.90%	7.10%	8.50%
5 or less but more than 4	3.10%	3.60%	7.40%	8.90%
6 or less but more than 5	3.60%	4.20%	7.70%	9.20%
7 or less but more than 6	4.20%	4.80%	7.90%	9.60%
8 or less but more than 7	4.70%	5.40%	8.20%	9.90%
9 or less but more than 8	5.20%	6.00%	8.40%	10.20%
10 or less but more than 9	5.70%	6.60%	8.60%	10.50%
11 or less but more than 10	6.10%	7.00%	8.80%	10.70%
12 or less but more than 11	6.50%	7.50%	9.00%	11.00%
13 or less but more than 12	7.00%	8.00%	9.20%	11.30%
14 or less but more than 13	7.40%	8.50%	9.40%	11.50%
15 or less but more than 14	7.80%	9.00%	9.60%	11.80%
16 or less but more than 15	8.20%	9.50%	9.80%	12.00%
17 or less but more than 16	8.60%	9.90%	10.00%	12.00%
18 or less but more than 17	9.00%	10.40%	10.10%	12.00%
19 or less but more than 18	9.40%	10.80%	10.30%	12.00%
20 or less but more than 19	9.70%	11.00%	10.50%	12.00%
21 or less but more than 20	10.00%	11.00%	10.70%	12.00%
22 or less but more than 21	10.00%	11.00%	10.80%	12.00%
23 or less but more than 22	10.00%	11.00%	11.00%	12.00%
24 or less but more than 23	10.00%	11.00%	11.00%	12.00%
25 or less but more than 24	10.00%	11.00%	11.00%	12.00%
26 or less but more than 25	10.00%	11.00%	11.00%	12.00%
27 or less but more than 26	10.00%	11.00%	11.00%	12.00%
28 or less but more than 27	10.00%	11.00%	11.00%	12.00%
29 or less but more than 28	10.00%	11.00%	11.00%	12.00%
more than 29	10.00%	11.00%	11.00%	12.00%

1. Table 4B-3 addresses potential increase of interest-rate and currency options and transaction-specific hedges only. The potential increase in mid-market valuation of interest-rate and currency swaps with no optionality are addressed in Table 4B-2.
2. Excludes exchange of notional.
3. "Hedge Notional" for cross-currency hedge = notional of that leg denominated in same currency as rated liabilities of cashflow transaction.

Table 5A  
**Valuation Percentages**  
 Where Credit Support Amount is EURO Denominated

INSTRUMENT	FIRST TRIGGER Business Days Risk: = 4 BDs + Posting Frequency;		SECOND TRIGGER = 34 BDs + Posting Frequency	
	Daily	Weekly	Daily	Weekly
EURO Cash	100%	100%	100%	100%
Sterling Cash	99%	98%	97%	96%
U.S. Dollar Cash	98%	97%	94%	93%
Yen Cash	98%	97%	93%	92%
U.S. Dollar Denominated Fixed-Rate Negotiable Treasury Debt issued by the U.S. Treasury Department with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	93%	92%
2 to 3 years	98%	97%	92%	91%
3 to 5 years	98%	97%	91%	90%
5 to 7 years	98%	97%	90%	88%
7 to 10 years	98%	97%	88%	87%
10 to 20 years	98%	97%	85%	83%
> 20 years	98%	97%	83%	81%
U.S. Dollar Denominated Floating-Rate Negotiable Treasury Debt Issued by The U.S. Treasury Department				
All Maturities	98%	97%	93%	92%
U.S. Dollar Denominated Fixed-Rate U.S. Agency Debentures with Remaining Maturity				
< 1 Year	98%	97%	93%	92%
1 to 2 years	98%	97%	93%	91%
2 to 3 years	98%	97%	92%	90%
3 to 5 years	98%	97%	90%	89%
5 to 7 years	98%	97%	89%	87%
7 to 10 years	98%	97%	87%	86%
10 to 20 years	98%	97%	84%	82%
> 20 years	98%	97%	82%	80%
U.S. Dollar Denominated Floating-Rate U.S. Agency Debentures				
All Maturities	98%	97%	92%	91%
EURO Denominated Fixed-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's with Remaining Maturity				
< 1 Year	100%	100%	100%	100%
1 to 2 years	100%	100%	99%	99%
2 to 3 years	100%	100%	98%	98%
3 to 5 years	100%	100%	96%	96%
5 to 7 years	100%	100%	95%	94%
7 to 10 years	100%	100%	94%	93%
10 to 20 years	100%	100%	89%	88%
> 20 years	100%	100%	87%	86%
EURO Denominated Floating-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's				
All Maturities	100%	100%	99%	99%
Sterling Denominated Fixed-Rate United Kingdom Gilts with Remaining Maturity				
< 1 Year	99%	98%	96%	95%
1 to 2 years	99%	98%	95%	94%
2 to 3 years	99%	98%	94%	93%
3 to 5 years	99%	98%	93%	92%
5 to 7 years	99%	98%	92%	91%
7 to 10 years	99%	98%	91%	90%
10 to 20 years	99%	98%	87%	85%
> 20 years	99%	98%	85%	84%
Sterling Denominated Floating-Rate United Kingdom Gilts				
All Maturities	99%	98%	96%	95%
Yen Denominated Fixed-Rate Japanese Government Bonds with Remaining Maturity				
< 1 Year	99%	98%	95%	94%
1 to 2 years	99%	98%	94%	93%
2 to 3 years	99%	98%	93%	92%
3 to 5 years	99%	98%	92%	91%
5 to 7 years	99%	98%	91%	90%
7 to 10 years	99%	98%	90%	89%
10 to 20 years	99%	98%	86%	84%
> 20 years	99%	98%	84%	83%
Yen Denominated Floating-Rate Japanese Government Bonds				
All Maturities	99%	98%	95%	94%



Table 5B  
Valuation Percentages

Where Credit Support Amount is STERLING Denominated

INSTRUMENT	FIRST TRIGGER Business Days Risk: =4 BDs + Posting Frequency;		SECOND TRIGGER = 34 BDs + Posting Frequency	
	Daily	Weekly	Daily	Weekly
Sterling Cash	100%	100%	100%	100%
EURO Cash	99%	98%	97%	96%
U.S. Dollar Cash	98%	97%	95%	94%
U.S. Dollar Denominated Fixed-Rate Negotiable Treasury Debt issued by the U.S. Treasury Department with Remaining Maturity				
< 1 Year	98%	97%	95%	94%
1 to 2 years	98%	97%	94%	93%
2 to 3 years	98%	97%	93%	92%
3 to 5 years	98%	97%	92%	91%
5 to 7 years	98%	97%	91%	89%
7 to 10 years	98%	97%	89%	88%
10 to 20 years	98%	97%	86%	84%
> 20 years	98%	97%	84%	82%
U.S. Dollar Denominated Floating-Rate Negotiable Treasury Debt Issued by The U.S. Treasury Department				
All Maturities	98%	97%	94%	93%
U.S. Dollar Denominated Fixed-Rate U.S. Agency Debentures with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	94%	92%
2 to 3 years	98%	97%	93%	91%
3 to 5 years	98%	97%	91%	90%
5 to 7 years	98%	97%	90%	88%
7 to 10 years	98%	97%	88%	87%
10 to 20 years	98%	97%	85%	83%
> 20 years	98%	97%	83%	81%
U.S. Dollar Denominated Floating-Rate U.S. Agency Debentures				
All Maturities	98%	97%	93%	92%
EURO Denominated Fixed-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's with Remaining Maturity				
< 1 Year	99%	98%	97%	96%
1 to 2 years	99%	98%	96%	95%
2 to 3 years	99%	98%	95%	94%
3 to 5 years	99%	98%	93%	92%
5 to 7 years	99%	98%	92%	90%
7 to 10 years	99%	98%	91%	89%
10 to 20 years	99%	98%	86%	84%
> 20 years	99%	98%	84%	83%
EURO Denominated Floating-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's				
All Maturities	99%	98%	96%	95%
Sterling Denominated Fixed-Rate United Kingdom Gilts with Remaining Maturity				
< 1 Year	100%	100%	99%	99%
1 to 2 years	100%	100%	98%	98%
2 to 3 years	100%	100%	97%	97%
3 to 5 years	100%	100%	96%	96%
5 to 7 years	100%	100%	95%	95%
7 to 10 years	100%	100%	94%	94%
10 to 20 years	100%	100%	90%	89%
> 20 years	100%	100%	88%	87%
Sterling Denominated Floating-Rate United Kingdom Gilts				
All Maturities	100%	100%	99%	99%

Table 5C

**Valuation Percentages**

Where Credit Support Amount is U.S. DOLLAR Denominated

INSTRUMENT	FIRST TRIGGER Business Days Risk: = 4 BDs + Posting Frequency;		SECOND TRIGGER = 34 BDs + Posting Frequency	
	Daily	Weekly	Daily	Weekly
U.S. Dollar Cash	100%	100%	100%	100%
EURO Cash	98%	97%	94%	93%
Sterling Cash	98%	97%	95%	94%
Yen Cash	98%	97%	94%	93%
U.S. Dollar Denominated Fixed-Rate Negotiable Treasury Debt issued by the U.S. Treasury Department with Remaining Maturity				
< 1 Year	100%	100%	100%	100%
1 to 2 years	100%	100%	99%	99%
2 to 3 years	100%	100%	98%	98%
3 to 5 years	100%	100%	97%	97%
5 to 7 years	100%	100%	96%	95%
7 to 10 years	100%	100%	94%	94%
10 to 20 years	100%	100%	90%	89%
> 20 years	100%	100%	88%	87%
U.S. Dollar Denominated Floating-Rate Negotiable Treasury Debt Issued by The U.S. Treasury Department				
All Maturities	100%	100%	99%	99%
U.S. Dollar Denominated Fixed-Rate U.S. Agency Debentures with Remaining Maturity				
< 1 Year	100%	100%	99%	99%
1 to 2 years	100%	100%	99%	98%
2 to 3 years	100%	100%	98%	97%
3 to 5 years	100%	100%	96%	96%
5 to 7 years	100%	100%	93%	94%
7 to 10 years	100%	100%	93%	93%
10 to 20 years	100%	100%	89%	88%
> 20 years	100%	100%	87%	86%
U.S. Dollar Denominated Floating-Rate U.S. Agency Debentures				
All Maturities	100%	100%	98%	98%
EURO Denominated Fixed-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	93%	92%
2 to 3 years	98%	97%	92%	91%
3 to 5 years	98%	97%	90%	89%
5 to 7 years	98%	97%	89%	87%
7 to 10 years	98%	97%	88%	86%
10 to 20 years	98%	97%	84%	82%
> 20 years	98%	97%	82%	80%
EURO Denominated Floating-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's				
All Maturities	98%	97%	93%	92%
Sterling Denominated Fixed-Rate United Kingdom Gilts with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	93%	92%
2 to 3 years	98%	97%	92%	91%
3 to 5 years	98%	97%	91%	90%
5 to 7 years	98%	97%	90%	89%
7 to 10 years	98%	97%	89%	88%
10 to 20 years	98%	97%	86%	84%
> 20 years	98%	97%	84%	82%
Sterling Denominated Floating-Rate United Kingdom Gilts				
All Maturities	98%	97%	94%	93%
Yen Denominated Fixed-Rate Japanese Government Bonds with Remaining Maturity				
< 1 Year	99%	98%	96%	95%
1 to 2 years	99%	98%	95%	94%
2 to 3 years	99%	98%	94%	93%
3 to 5 years	99%	98%	93%	92%
5 to 7 years	99%	98%	92%	91%
7 to 10 years	99%	98%	91%	90%
10 to 20 years	99%	98%	87%	86%
> 20 years	99%	98%	86%	84%
Yen Denominated Floating-Rate Japanese Government Bonds				
All Maturities	99%	98%	95%	94%

Table 5D

**Valuation Percentages**

Where Credit Support Amount is AUSTRALIAN DOLLAR Denominated

INSTRUMENT	FIRST TRIGGER Business Days Risk: = 4 BDs + Posting Frequency;		SECOND TRIGGER = 34 BDs + Posting Frequency	
	Daily	Weekly	Daily	Weekly
Australian Dollar Cash	100%	100%	100%	100%
U.S. Dollar Cash	98%	97%	94%	93%
Yen Cash	98%	97%	94%	93%
Australian Dollar Denominated Fixed-Rate Australian Government Bonds with Remaining Maturity				
< 1 Year	100%	100%	98%	98%
1 to 2 years	100%	100%	98%	97%
2 to 3 years	100%	100%	97%	96%
3 to 5 years	100%	100%	96%	95%
5 to 7 years	100%	100%	94%	94%
7 to 10 years	100%	100%	93%	93%
10 to 20 years	100%	100%	89%	88%
> 20 years	100%	100%	87%	86%
Australian Dollar Denominated Fixed-Rate Australian Government Bonds				
All Maturities	100%	100%	98%	98%
Yen Denominated Fixed-Rate Japanese Government Bonds with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	94%	93%
2 to 3 years	98%	97%	93%	92%
3 to 5 years	98%	97%	92%	90%
5 to 7 years	98%	97%	91%	89%
7 to 10 years	98%	97%	90%	88%
10 to 20 years	98%	97%	86%	85%
> 20 years	98%	97%	85%	83%
Yen Denominated Floating-Rate Japanese Government Bonds				
All Maturities	98%	97%	92%	91%
U.S. Dollar Denominated Fixed-Rate Negotiable Treasury Debt issued by the U.S. Treasury Department with Remaining Maturity				
< 1 Year	98%	97%	95%	94%
1 to 2 years	98%	97%	94%	93%
2 to 3 years	98%	97%	93%	92%
3 to 5 years	98%	97%	92%	91%
5 to 7 years	98%	97%	91%	89%
7 to 10 years	98%	97%	89%	88%
10 to 20 years	98%	97%	86%	84%
> 20 years	98%	97%	84%	82%
U.S. Dollar Denominated Floating-Rate Negotiable Treasury Debt Issued by The U.S. Treasury Department				
all Maturities	98%	97%	94%	93%

Table 5E  
Valuation Percentages

Where Credit Support Amount is JAPANESE YEN Denominated

INSTRUMENT	FIRST TRIGGER Business Days Risk: = 4 BDs + Posting Frequency;		SECOND TRIGGER = 34 BDs + Posting Frequency	
	Daily	Weekly	Daily	Weekly
U.S. Dollar Cash	98%	97%	94%	93%
EURO Cash	98%	97%	94%	92%
Sterling Cash	98%	97%	95%	92%
Yen Cash	100%	100%	100%	100%
U.S. Dollar Denominated Fixed-Rate Negotiable Treasury Debt issued by the U.S. Treasury Department with Remaining Maturity				
< 1 Year	98%	97%	94%	93%
1 to 2 years	98%	97%	93%	92%
2 to 3 years	98%	97%	92%	91%
3 to 5 years	98%	97%	91%	90%
5 to 7 years	98%	97%	90%	88%
7 to 10 years	98%	97%	88%	87%
10 to 20 years	98%	97%	85%	83%
> 20 years	98%	97%	83%	81%
U.S. Dollar Denominated Floating-Rate Negotiable Treasury Debt Issued by The U.S. Treasury Department				
All Maturities	98%	97%	93%	92%
U.S. Dollar Denominated Fixed-Rate U.S. Agency Debentures with Remaining Maturity				
< 1 Year	98%	97%	93%	92%
1 to 2 years	98%	97%	93%	91%
2 to 3 years	98%	97%	92%	90%
3 to 5 years	98%	97%	90%	89%
5 to 7 years	98%	97%	89%	87%
7 to 10 years	98%	97%	87%	86%
10 to 20 years	98%	97%	84%	82%
> 20 years	98%	97%	82%	80%
U.S. Dollar Denominated Floating-Rate U.S. Agency Debentures				
All Maturities	98%	97%	92%	91%
EURO Denominated Fixed-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's with Remaining Maturity				
< 1 Year	98%	97%	93%	92%
1 to 2 years	98%	97%	92%	91%
2 to 3 years	98%	97%	91%	90%
3 to 5 years	98%	97%	89%	88%
5 to 7 years	98%	97%	88%	86%
7 to 10 years	98%	97%	87%	85%
10 to 20 years	98%	97%	82%	80%
> 20 years	98%	97%	80%	78%
EURO Denominated Floating-Rate Euro-Zone Government Bonds Rated Aa3 or Above by Moody's				
All Maturities	98%	97%	92%	91%
Sterling Denominated Fixed-Rate United Kingdom Gilts with Remaining Maturity				
< 1 Year	96%	95%	92%	91%
1 to 2 years	96%	95%	91%	90%
2 to 3 years	96%	95%	90%	91%
3 to 5 years	96%	95%	89%	88%
5 to 7 years	96%	95%	88%	87%
7 to 10 years	96%	95%	87%	86%
10 to 20 years	96%	95%	84%	82%
> 20 years	96%	95%	82%	80%
Sterling Denominated Floating-Rate United Kingdom Gilts				
All Maturities	98%	95%	94%	93%
Yen Denominated Fixed-Rate Japanese Government Bonds with Remaining Maturity				
< 1 Year	100%	100%	100%	100%
1 to 2 years	100%	100%	99%	99%
2 to 3 years	100%	100%	98%	98%
3 to 5 years	100%	100%	98%	98%
5 to 7 years	100%	100%	97%	96%
7 to 10 years	100%	100%	95%	95%
10 to 20 years	100%	100%	92%	91%
> 20 years	100%	100%	90%	90%
Yen Denominated Floating-Rate Japanese Government Bonds				
All Maturities	100%	100%	99%	99%

## XI WITHHOLDING TAX

### General

Generally speaking, withholding tax is a tax that is charged to someone (the "payer") who must make a payment to another person (the "payee"). It most frequently applies when the respective offices through which the payer and payee act under the hedge are in different jurisdictions.<sup>22</sup> Many jurisdictions have signed bi-lateral agreements with others so that payers in those jurisdictions are not charged withholding tax or are charged withholding tax at a reduced rate.

A party to an agreement may therefore agree that, if withholding tax applies to payments that it is required to make under that agreement, the party will "gross up" the payments. If a payer agrees to gross up and if withholding tax applies to the payer's payments, the payer has the obligation to pay such additional amount to the payee that, when considering the amount of withholding tax payable by the payer, would result in the payee receiving the amount that it would have received but for the withholding tax.

Gross up provisions may be unqualified, or may be qualified in that they do not require the payer to gross up in certain circumstances. The ISDA Master contains a gross-up provision, but it is qualified, so that the payer is not required to gross up in any of the following circumstances:

- (a) if withholding tax applies due to a connection of the payee to the jurisdiction of the payer;
- (b) if the withholding tax applies due to the payee representation (see below) being incorrect as of the date that it is given;
- (c) if the withholding tax applies due to the payee failing to notify the payer that its payee tax representation (see below) has become incorrect; or
- (d) if the payee does not provide all tax forms and other documents reasonably requested by the payer.

### Withholding in Hedges for Cashflow Transactions

If withholding tax applies to payments made by the Counterparty to the SPV under a hedge, and if the Counterparty is not required to gross up, the SPV will obviously receive less than the full amount owing to it. Also, if the SPV were required to gross up, and withholding tax applied to its payments under the hedge, the SPV would likely be required to divert funds otherwise destined for rated debt and pay it to the Counterparty. Any of these scenarios could involve substantial amounts of money, and will usually be material to a cashflow transaction involving a hedge.

Therefore, in order to address the risks described above, the following principles should generally be incorporated into every hedge in a cashflow transaction: or

- (1) Either:
  - (i) The SPV should not gross up (i.e., disapply the standard gross up provisions from s. 2(d)(i)(4) of the Master Agreement); or
  - (ii) The SPV and the Trustee should receive a satisfactory legal opinion at closing confirming that, under current law, no withholding applies to payments (including termination payments) that the SPV makes under the hedge<sup>23</sup>.
- (2) Either:
  - (i) The Counterparty should be required to agree to an unqualified gross-up requirement<sup>24</sup>; or
  - (ii) The SPV and the Trustee should receive a satisfactory legal opinion at closing confirming that, under current law, no withholding applies to payments (including termination payments) that the Counterparty makes under the hedge<sup>23</sup>.

<sup>22</sup> Specifically, one must consider the laws of (a) the jurisdiction of incorporation of both parties, (b) the jurisdiction of the governing law of the hedge and (c) jurisdiction(s) containing the office(s) through which each party to the hedge acts.

<sup>23</sup> The opinion should be provided by a law firm and Moody's should receive a copy of it.

<sup>24</sup> For this purpose, "unqualified gross-up" means that the qualification in (a) above does not apply (qualifications (b), (c) and (d) above may apply). Technically, this need only be an unqualified gross up for all withholdings or deductions in respect of payments that it makes under the hedge other than those which arise due to a Change in Tax Law.

- (3) Any tax representations of a legal nature given by the SPV should be supported by a satisfactory legal opinion<sup>25</sup>.
- (4) As a condition to any transfer or replacement of the hedge, any tax opinion that was necessary at closing under 1-3 above should be provided in relation to the new hedge, unless the relevant terms of the hedge are amended to avoid the need for such opinion.
- (5) If the Counterparty's obligations are guaranteed:
  - (i) The guarantor should be required to gross-up for withholding tax in relation to guarantee payments;
  - (ii) The SPV and the Trustee should receive a satisfactory legal opinion that, under current law, no withholding applies to payments under the guarantee<sup>25</sup>; or
  - (iii) The hedge should provide that, if withholding tax is deducted from any payment under a guarantee, the amount owing by the Counterparty under the hedge shall be increased to ensure that the net amount actually received by the SPV from the guarantor (after deduction for tax) is the same as it would have been had no withholding been required.
- (6) Some transaction party (other than the Counterparty) should be required to assist the SPV in preparing tax forms (and determining whether they are "reasonably requested").
- (7) The Tax Event Termination Event should be addressed as discussed above in *Table 3B*.

<sup>25</sup> The opinion should be provided by a law firm and Moody's should receive a copy of it.



## APPENDIX

### Pro Forma ISDA Schedule and CSA Provisions

THE PRO FORMA ISDA SCHEDULE AND CSA PROVISIONS IN THIS APPENDIX ARE AN EXAMPLE OF HOW THE FRAMEWORK MAY BE INCORPORATED IN HEDGE AGREEMENTS EXECUTED UNDER THE 1992 ISDA MASTER AGREEMENT. IN CERTAIN RESPECTS, THE PRO FORMAS ARE MORE DETAILED THAN THE FRAMEWORK AND SHOULD BE REGARDED AS A MORE COMPLETE EXPRESSION OF MOODY'S CRITERIA. FOR THE PURPOSE OF THE PRO FORMAS, PARTY A IS THE COUNTERPARTY AND PARTY B IS THE SPV.

THE PRO FORMAS ARE MERELY INTENDED TO SET OUT PROVISIONS WHICH, IF INCORPORATED INTO HEDGE AGREEMENTS EXECUTED UNDER THE 1992 ISDA MASTER AGREEMENT, ARE LIKELY TO ALLOW MOODY'S TO DE-LINK THE CREDIT RISK OF A COUNTERPARTY FROM THE CREDIT RISK ASSOCIATED WITH A CASHFLOW TRANSACTION WHEN ASSESSING SUCH A CASHFLOW TRANSACTION, AND ARE NOT INTENDED FOR ANY OTHER PURPOSE. IN PARTICULAR, THE PRO FORMAS ARE NOT INTENDED TO BE LEGAL OR TAX ADVICE OR ADVICE ON HOW TO DRAFT TRANSACTION DOCUMENTATION TO ANY PERSON (INCLUDING ANY COUNTERPARTY OR SPV) AND THEY DO NOT TAKE INTO ACCOUNT THE SPECIFIC REQUIREMENTS OF ANY PERSON. SUCH PERSONS SHOULD TAKE THEIR OWN LEGAL AND TAX ADVICE WHEN STRUCTURING, NEGOTIATING AND DOCUMENTING SUCH TRANSACTIONS.

## SCHEDULE

### Part 1. Termination Provisions

- (a) **Payments on Early Termination.** For the purposes of Section 6(e) of this Agreement, Market Quotation and The Second Method will apply.
- (b) **"Termination Currency"** means [For currency swap or combined interest rate/currency swap, insert the currency of the Notes. For single-currency swap, insert the currency of the swap.]

### Part 2. Tax Representations<sup>1</sup>

### Part 3. Agreement to Deliver Documents<sup>2</sup>

### Part 4. Miscellaneous

- (a) **Calculation Agent.** The Calculation Agent is Party A.
- (b) **"Credit Support Provider"** means in relation to Party A, the guarantor under any Eligible Guarantee, and in relation to Party B, none.
- (c) **"Credit Support Document"** means the Credit Support Annex<sup>3</sup> and any Eligible Guarantee.
- (d) **Single Agreement.** Section 1(c) shall be amended by the addition of the words ", the Credit Support Annex after the words "Master Agreement"<sup>4</sup>.
- (e) **Local Business Day.** The definition of Local Business Day in Section 14 of this Agreement shall be amended by the addition of the words "or any Credit Support Document" after "Section 2(a)(i)" and the addition of the words "or Credit Support Document" after "Confirmation"<sup>4</sup>.

<sup>1</sup> Any Tax Representations given by Party B that are of a legal nature should be supported by a satisfactory legal opinion

<sup>2</sup> To be completed as appropriate.

<sup>3</sup> It is not necessary to specify an English law Credit Support Annex as a Credit Support Document.

<sup>4</sup> Not required for English law Credit Support Annex

**Part 5. Other Provisions**(a) **No Set-Off.**

- (i) All payments under this Agreement shall be made without set-off or counterclaim, except as expressly provided for in Section 2(c) or Section 6.
- (ii) Section 6(e) shall be amended by the deletion of the following sentence; "The amount, if any, payable in respect of an Early Termination Date and determined pursuant to this Section will be subject to any Set-off."

(b) **Security Interest.**<sup>5</sup>(c) **Events of Default.**

Section 5 shall be amended as follows:

- (i) Section 5(a)(ii) will not apply in respect of Party B.
- (ii) Section 5(a)(iii) will not apply in respect of Party B [except that Section 5(a)(iii)(1) will apply in respect of Party B's obligations under Paragraph [2(b)/3(b)] of the Credit Support Annex<sup>6</sup>].
- (iii) Section 5(a)(iv) will not apply in respect of Party B<sup>7</sup>.
- (iv) Section 5(a)(v) will not apply in respect of Party B.
- (v) Section 5(a)(vii)(2), (7) and (9) will not apply in respect of Party B.
- (vi) Section 5(a)(vii)(3) will not apply in respect of Party B to the extent it refers to any assignment, arrangement or composition that is effected by or pursuant to the [Transaction Documents].
- (vii) Section 5(a)(vii)(4) will not apply in respect of Party B to the extent that it refers to proceedings or petitions instituted or presented by Party A or any of its Affiliates.
- (viii) Section 5(a)(vii)(6) will not apply in respect of Party B to the extent that it refers to (i) any appointment that is effected by or pursuant to the [Transaction Documents] or (ii) any appointment that Party B has not become subject to.
- (ix) Section 5(a)(vii)(8) will apply to Party B only to the extent that it applies to Section 5(a)(vii)(1), (3), (4), (5) and (6), as amended above.
- (x) Without prejudice to any Event of Default resulting from Party A's failure to post collateral in accordance with the criteria of [*reference other rating agencies*], any failure by Party A to comply with or perform any obligation to be complied with or performed by Party A under the Credit Support Annex shall not be an Event of Default unless (A) the Second Rating Trigger Requirements apply and at least 30 Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply and (B) such failure is not remedied on or before the third Local Business Day after notice of such failure is given to Party A.

<sup>5</sup> Party A to acknowledge that Party B has created a security interest in respect of its rights under this Agreement (if applicable).

<sup>6</sup> May insert wording in square brackets if the Credit Support Annex is specified as a Credit Support Document.

<sup>7</sup> Permitted application of Section 5(a)(iv) is described in *Table 3A* of the Framework.



(d) **Tax Event.**

Section 5(b)(ii) will apply, provided that the words "(x) any action taken by a taxing authority, or brought in a court of competent jurisdiction, on or after the date on which a Transaction is entered into (regardless of whether such action is taken or brought with respect to a party to this Agreement) or (y)" shall be deleted<sup>8</sup>.

(e) **Additional Termination Events.**<sup>9</sup>

Each of the following shall constitute an Additional Termination Event with Party A as Affected Party:

- (i) **First Rating Trigger Collateral.** Party A has failed to comply with or perform any obligation to be complied with or performed by Party A in accordance with the Credit Support Annex and either (A) the Second Rating Trigger Requirements do not apply or (B) less than 30 Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply; and
- (ii) **Second Rating Trigger Replacement.** (A) The Second Rating Trigger Requirements apply and 30 or more Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply and (B) at least one Eligible Replacement has made a Firm Offer that would, upon the occurrence of this Additional Termination Event, qualify as a Market Quotation (as defined in Part 5(i) below (Close-Out Calculations)) and which remains capable of becoming legally binding upon acceptance.

(f) **Ratings Downgrade.**

So long as the Second Rating Trigger Requirements apply, Party A will, at its own cost, use commercially reasonable efforts to, as soon as reasonably practicable, procure either (A) an Eligible Guarantee in respect of all of Party A's present and future obligations under this Agreement by a guarantor with the Second Trigger Required Ratings or (B) a transfer in accordance with Part 5(j)(ii) below.

(g) **Tax.**

Notwithstanding the definition of "Indemnifiable Tax" in Section 14 of this Agreement, in relation to payments by Party A, any Tax shall be an Indemnifiable Tax and in relation to payments by Party B, no Tax shall be an Indemnifiable Tax<sup>10</sup>.

(h) **Non-Petition and Limited Recourse**<sup>11</sup>.(i) **Close-Out Calculations.**

So long as Party A is (A) the Affected Party in respect of an Additional Termination Event or a Tax Event Upon Merger or (B) the Defaulting Party in respect of any Event of Default, paragraphs (i) to (vi) below shall apply:

- (i) The definition of "**Market Quotation**" shall be deleted in its entirety and replaced with the following:

<sup>8</sup> This deletion is only required in the absence of a legal opinion given by a law firm at closing confirming that none of Party A or Party B's payments under this Agreement are subject to deduction or withholding for Tax. Whether or not an opinion is given, paragraph (x) of Tax Event may (but need not) apply where Party B is the Affected Party.

<sup>9</sup> Additional Termination Events with Party B as Affected Party may be inserted in accordance with *Table 3B* of Moody's Hedge Framework.

<sup>10</sup> This provision may be modified, subject to delivery of the necessary tax opinions (see Section XI above).

<sup>11</sup> This provision should include non-petition and limited recourse language in favour of Party B.

**"Market Quotation"** means, with respect to one or more Terminated Transactions, a Firm Offer which is:

- (1) made by a Reference Market-maker that is an Eligible Replacement;
  - (2) for an amount that would be paid to Party B (expressed as a negative number) or by Party B (expressed as a positive number) in consideration of an agreement between Party B and such Reference Market-maker to enter into a transaction (the **"Replacement Transaction"**) that would have the effect of preserving for Party B the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under this Agreement in respect of such Terminated Transactions or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that Date;
  - (3) made on the basis that Unpaid Amounts in respect of the Terminated Transaction or group of Transactions are to be excluded but, without limitation, any payment or delivery that would, but for the relevant Early Termination Date, have been required (assuming satisfaction of each applicable condition precedent) after that Early Termination Date is to be included; and
  - (4) made in respect of a Replacement Transaction with terms that are, in all material respects, no less beneficial for Party B than those of this Agreement (save for the exclusion of provisions relating to Transactions that are not Terminated Transactions), as determined by Party B."
- (ii) In determining whether or not a Firm Offer satisfies the condition in sub-paragraph (4) of Market Quotation, Party B shall act in a commercially reasonable manner<sup>12</sup>.
- (iii) The definition of **"Settlement Amount"** shall be deleted in its entirety and replaced with the following:

**"Settlement Amount"** means, with respect to any Early Termination Date:

- (1) if, on or prior to such Early Termination Date, a Market Quotation for the relevant Terminated Transaction or group of Terminated Transactions is accepted by Party B so as to become legally binding, the Termination Currency Equivalent of the amount (whether positive or negative) of such Market Quotation;
- (2) if, on such Early Termination Date, no Market Quotation for the relevant Terminated Transaction or group of Terminated Transactions has been accepted by Party B so as to become legally binding and one or more Market Quotations have been communicated to Party B and remain capable of becoming legally binding upon acceptance by Party B, the Termination Currency Equivalent of the amount (whether positive or negative) of the lowest of such Market Quotations (for the avoidance of doubt, (i) a Market Quotation expressed as a negative number is lower than a Market Quotation expressed as a positive number and (ii) the lower of two Market Quotations expressed as negative numbers is the one with the largest absolute value); or
- (3) if, on such Early Termination Date, no Market Quotation for the relevant Terminated Transaction or group of Terminated Transactions is accepted by Party B so as to become legally binding and no Market Quotations have been communicated to Party B and remain capable of becoming legally binding upon acceptance by Party B, Party B's Loss (whether positive or negative and without reference to any Unpaid amounts) for the relevant Terminated Transaction or group of Terminated Transactions."

<sup>12</sup> Some transaction party (other than Party A) should be required to assist Party B in making this determination.

- (iv) At any time on or before the Early Termination Date at which two or more Market Quotations have been communicated to Party B and remain capable of becoming legally binding upon acceptance by Party B, Party B shall be entitled to accept only the lowest of such Market Quotations (for the avoidance of doubt, (i) a Market Quotation expressed as a negative number is lower than a Market Quotation expressed as a positive number and (ii) the lower of two Market Quotations expressed as negative numbers is the one with the largest absolute value).
- (v) If Party B requests Party A in writing to obtain Market Quotations, Party A shall use reasonable efforts to do so before the Early Termination Date.
- (vi) If the Settlement Amount is a negative number, Section 6(e)(i)(3) of this Agreement shall be deleted in its entirety and replaced with the following:

**“Second Method and Market Quotation.”** If Second Method and Market Quotation apply, (1) Party B shall pay to Party A an amount equal to the absolute value of the Settlement Amount in respect of the Terminated Transactions, (2) Party B shall pay to Party A the Termination Currency Equivalent of the Unpaid Amounts owing to Party A and (3) Party A shall pay to Party B the Termination Currency Equivalent of the Unpaid Amounts owing to Party B, Provided that, (i) the amounts payable under (2) and (3) shall be subject to netting in accordance with Section 2(c) of this Agreement and (ii) notwithstanding any other provision of this Agreement, any amount payable by Party A under (3) shall not be netted against any amount payable by Party B under (1).”<sup>13</sup>

(j) **Transfers.**

- (i) Subject to Section 6(b)(ii) and Part 5(j)(ii) below, Party A may not transfer (whether by way of security or otherwise) any interest or obligation in or under this Agreement without the prior written consent of Party B.
- (ii) Subject to giving prior written notification to Party B, if the First Rating Trigger Requirements apply, Party A may (at its own cost) transfer all or substantially all its rights and obligations with respect to this Agreement to any other entity (a **“Transferee”**) that is an Eligible Replacement such that the Transferee contracts with Party B on terms that:
  - (x) have the effect of preserving for Party B the economic equivalent of all payment and delivery obligations (whether absolute or contingent and assuming the satisfaction of each applicable condition precedent) under this Agreement immediately before such transfer; and
  - (y) are, in all material respects, no less beneficial for Party B than the terms of this Agreement immediately before such transfer, as determined by Party B.
- (iii) In determining whether or not a transfer satisfies the condition in sub-paragraph (y) of Part 5(j)(ii) above, Party B shall act in a commercially reasonable manner<sup>14</sup>.
- (iv) If an entity has made a Firm Offer (which remains capable of becoming legally binding upon acceptance) to be the transferee of a transfer to be made in accordance with Part 5(j)(ii) above, Party B shall, at Party A's written request and cost, take any reasonable steps required to be taken by it to effect such transfer.

<sup>13</sup> This sub-paragraph (vi) is not required if the ISDA Credit Support Annex (English law) is used.

<sup>14</sup> Some transaction party (other than Party A) should be required to assist Party B in making this determination.

(k) *Moody's Notifications.*

Notwithstanding any other provision of this agreement, this Agreement shall not be amended, no Early Termination Date shall be effectively designated by Party B, and no transfer of any rights or obligations under this agreement shall be made unless Moody's has been given prior written notice of such amendment, designation or transfer.

(l) *Definitions.*

For the purpose of this Agreement:

**"Eligible Guarantee"** means an unconditional and irrevocable guarantee that is provided by a guarantor as principal debtor rather than surety and is directly enforceable by Party B, where (A) a law firm has given a legal opinion confirming that none of the guarantor's payments to Party B under such guarantee will be subject to deduction or withholding for Tax and such opinion has been delivered to Moody's, (B) such guarantee provides that, in the event that any of such guarantor's payments to Party B are subject to deduction or withholding for Tax, such guarantor is required to pay such additional amount as is necessary to ensure that the net amount actually received by Party B (free and clear of any tax) will equal the full amount Party B would have received had no such deduction or withholding been required or (C) in the event that any payment under such guarantee is made net of deduction or withholding for Tax, Party A is required, under Section 2(a)(i), to make such additional payment as is necessary to ensure that the net amount actually received by Party B from the guarantor will equal the full amount Party B would have received had no such deduction or withholding been required.

**"Eligible Replacement"** means an entity (A) with the Second Trigger Required Ratings or (B) whose present and future obligations owing to Party B under this Agreement (or its replacement, as applicable) are guaranteed pursuant to an Eligible Guarantee provided by a guarantor with the Second Trigger Required Ratings<sup>15</sup>.

**"Firm Offer"** means an offer which, when made, was capable of becoming legally binding upon acceptance.

**"Moody's Short-term Rating"** means a rating assigned by Moody's under its short-term rating scale in respect of an entity's short-term, unsecured and unsubordinated debt obligations.

**"Relevant Entities"** means Party A and any guarantor under an Eligible Guarantee in respect of all of Party A's present and future obligations under this Agreement<sup>16</sup>.

The **"First Rating Trigger Requirements"** shall apply so long as no Relevant Entity has the First Trigger Required Ratings.

An entity shall have the **"First Trigger Required Ratings"** (A) where such entity is the subject of a Moody's Short-term Rating, if such rating is **"Prime-1"** and its long-term, unsecured and unsubordinated debt or counterparty obligations are rated **"A2"** or above by Moody's and (B) where such entity is not the subject of a Moody's Short-term Rating, if its long-term, unsecured and unsubordinated debt or counterparty obligations are rated **"A1"** or above by Moody's.

<sup>15</sup> If any tax opinions are required in relation to the original hedge (see Section XI above), there should be an additional requirement incorporated in the definition of "Eligible Replacement" to the effect that either (i) the relevant opinions are delivered to Moody's in relation to the hedge provided by the Eligible Replacement or (ii) the terms of the new hedge are amended so as to avoid the need for opinions.

<sup>16</sup> In order for a guarantor to be a Relevant Entity, the guarantee should cover both payment and delivery obligations of Party A.

The "**Second Rating Trigger Requirements**" shall apply so long as no Relevant Entity has the Second Trigger Required Ratings.

An entity shall have the "**Second Trigger Required Ratings**" (A) where such entity is the subject of a Moody's Short-term Rating, if such rating is "**Prime-2**" or above and its long-term, unsecured and unsubordinated debt or counterparty obligations are rated "**A3**" or above by Moody's and (B) where such entity is not the subject of a Moody's Short-term Rating, if its long-term, unsecured and unsubordinated debt or counterparty obligations are rated "**A3**" or above by Moody's.



**PARAGRAPH 11 OF THE ISDA CREDIT SUPPORT ANNEX (ENGLISH LAW)<sup>1</sup>**

(a) *Base Currency and Eligible Currency.*

- (i) **"Base Currency"** means [For currency swap or combined interest rate/currency swap, insert the currency of the Notes. For single-currency swap, insert the currency of the swap.]
- (ii) **"Eligible Currency"** means the Base Currency<sup>2</sup>.

(b) *Credit Support Obligations.*

(i) *Delivery Amount and Return Amount.*

(A) Paragraph 2(a) (Delivery Amount) shall apply, except that:

- (i) the words "upon a demand made by the Transferee on or promptly following a Valuation Date" shall be deleted and replaced by the words "not later than the close of business on each Valuation Date";
- (ii) the sentence beginning "Unless otherwise specified in Paragraph 11(b)" shall be deleted in its entirety and replaced with the following:

"The **"Delivery Amount"** applicable to the Transferor for any Valuation Date will equal the greatest of:

- (1) the amount by which the Moody's Credit Support Amount exceeds the Value (determined using the Moody's Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date);
  - (2) the amount by which the [ABC Rating Agency] Credit Support Amount exceeds the Value (determined using the [ABC Rating Agency] Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date); and
  - (3) the amount by which the [XYZ Rating Agency] Credit Support Amount exceeds the Value (determined using the [XYZ Rating Agency] Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date)]."; and
- (iii) if, on any Valuation Date, the Delivery Amount equals or exceeds the Transferor's Minimum Transfer Amount, the Transferor will transfer to the Transferee sufficient Eligible Credit Support to ensure that, immediately following such transfer, the Delivery Amount shall be zero.

<sup>1</sup> The pro forma provisions also apply to the ISDA Credit Support Annex (New York law), subject to making the necessary modifications.  
<sup>2</sup> Also specify any other currencies in which cash may be posted.



(B) Paragraph 2(b) (Return Amount) shall apply, except that:

- (i) the sentence beginning "Unless otherwise specified in Paragraph 11(b)" shall be deleted in its entirety and replaced by the following:

"The **"Return Amount"** applicable to the Transferee for any Valuation Date will equal the least of:

- (1) the amount by which the Value (determined using the Moody's Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date) exceeds the Moody's Credit Support Amount [;
  - (2) the amount by which (a) the Value (determined using the [ABC Rating Agency] Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date) exceeds (b) the [ABC Rating Agency] Credit Support Amount; and
  - (3) the amount by which (a) the Value (determined using the [XYZ Rating Agency] Valuation Percentages) of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in each case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date) exceeds (b) the [XYZ Rating Agency] Credit Support Amount]."; and
- (ii) in no event shall the Transferee be required to transfer any Equivalent Credit Support under Paragraph 2(b) if, immediately following such transfer, the Delivery Amount would be greater than zero.

(ii) **Eligible Credit Support.**

[Insert Table 5A, 5B, 5C, 5D or 5E (as applicable) from the Framework, and delete the "Daily" or "Weekly" column, as appropriate. Insert the following wording after the table: **"Moody's Valuation Percentages"** means, in respect of each instrument in the above table, (i) so long as the Moody's Threshold for Party A is zero and either (A) the Second Rating Trigger Requirements do not apply or (B) less than 30 Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply, the corresponding percentage in the column headed "First Trigger" and (ii) so long as (A) the Second Rating Trigger Requirements apply and (B) at least 30 Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply, the corresponding percentage in the column headed "Second Trigger".]

(iii) **Thresholds.**

(A) **"Independent Amount"** means with respect to Party A and Party B: zero

(B) **"Moody's Threshold"** means, (A) so long as the First Rating Trigger Requirements apply and either (i) the First Rating Trigger Requirements have applied since this Annex was executed or (ii) at least 30 Local Business days have elapsed since the last time the First Rating Trigger Requirements did not apply, zero and (B) at any other time, infinity.

**"[ABC Rating Agency] Threshold"** means [to be inserted].

"[XYZ Rating Agency] Threshold" means [to be inserted].

(C) "**Minimum Transfer Amount**" means with respect to Party A and Party B: [Base Currency] 100,000.

(D) **Rounding.** The Delivery Amount will be rounded up to the nearest integral multiple of [Base Currency] 10,000 and the Return Amount will be rounded down to the nearest integral multiple of [Base Currency] 10,000.

(iv) "**Exposure**" has the meaning specified in Paragraph 10, except that (1) after the word "Agreement" the words "(assuming, for this purpose only, that Part 5(i) (Close-Out Calculations) of the Schedule is deleted)" shall be inserted and (2) at the end of the definition of Exposure, the words "with terms that are, in all material respects, no less beneficial for Party B than those of this Agreement" shall be added.

(c) **Valuation and Timing.**

(i) "**Valuation Agent**" means Party A in all circumstances.

(ii) "**Valuation Date**" means [the first Local Business Day in each week / each Local Business Day<sup>3</sup>].

(iii) "**Valuation Time**" means the close of business in the city of the Valuation Agent on the Local Business Day immediately preceding the Valuation Date or date of calculation, as applicable, Provided that the calculations of Value and Credit Support Amount will, as far as practicable, be made as of approximately the same time on the same date.

(iv) "**Notification Time**" means 11:00 a.m., [London / New York<sup>3</sup>] time, on a Local Business Day.

(d) **Exchange Date.**

"**Exchange Date**" has the meaning specified in Paragraph 3(c)(ii).

(e) **Dispute Resolution.**

(i) "**Resolution Time**" means 1:00 p.m., [London / New York<sup>3</sup>] time on the Local Business Day following the date on which the notice is given that gives rise to a dispute under Paragraph 4.

(ii) **Value.** For the purpose of Paragraphs 4(a)(4)(i)(C) and 4(a)(4)(ii), on any date the Value of the outstanding Credit Support Balance or of any transfer of Eligible Credit Support or Equivalent Credit Support, as the case may be, will be calculated as follows:

(A) with respect to any Eligible Credit Support or Equivalent Credit Support comprising securities ("**Securities**") the Base Currency Equivalent of the sum of (a)(x) the last bid price on such date for such Securities on the principal national securities exchange on which such Securities are listed, multiplied by the applicable Valuation Percentage; or (y) where any Securities are not listed on a national securities exchange, the bid price for such Securities quoted as at the close of business on such date by any principal market maker (which shall not be and shall be independent from the Valuation Agent) for such Securities chosen by the Valuation Agent, multiplied by the applicable Valuation Percentage; or (z) if no such bid price is listed or quoted for such date, the last bid price listed or quoted (as the case may be), as of the day next preceding such date on which such prices were

<sup>3</sup> Delete as appropriate.

available, multiplied by the applicable Valuation Percentage; plus (b) the accrued interest where applicable on such Securities (except to the extent that such interest shall have been paid to the Transferor pursuant to Paragraph 5(c)(ii) or included in the applicable price referred to in subparagraph (a) above) as of such date; and

(B) with respect to any Cash, the Base Currency Equivalent of the amount thereof.

(iii) **Alternative.** The provisions of Paragraph 4 will apply.

(f) **Distributions and Interest Amount.**

(i) **"Interest Rate"** means [to be inserted].

(ii) **Transfer of Interest Amount.** The transfer of the Interest Amount will be made on [to be inserted] or, if that date is not a Valuation Date, the next following Valuation Date.

(iii) **Alternative to Interest Amount.** Paragraph 5(c)(ii) will apply. Provided that Party B shall not be obliged to transfer any Interest Amount unless and until it has earned and received such Interest Amount.

(iv) **"Distributions"** means, with respect to any Eligible Credit Support comprised in the Credit Support Balance consisting of securities, all principal, interest and other payments and distributions of cash or other property to which a holder of securities of the same type, nominal value, description and amount as such Eligible Credit Support would have received from time to time.

(v) **"Distribution Date"** means, with respect to any Eligible Credit Support comprised in the Credit Support Balance other than cash, each date on which a holder of such Eligible Credit Support would have received Distributions or, if that date is not a Valuation Date, the next following Valuation Date.

(g) **Other Provisions.**

(i) **Transfer Timing.** The following words shall be inserted at the end of the final paragraph of Paragraph 3(a): "Provided that any transfer of Eligible Credit Support by the Transferor pursuant to Paragraph 2(a) shall be made not later than the close of business on the relevant Valuation Date, regardless of whether any demand for transfer is received."

(ii) **Early Termination.** The heading for Paragraph 6 shall be deleted and replaced with "Early Termination" and the following shall be added after the word "Default" in the first line of Paragraph 6, "in relation to all Transactions or a Termination Event in relation to all Transactions".

(iii) **Expenses.** Notwithstanding Paragraph 8, the Transferor will be responsible for, and will reimburse the Transferee for, all transfer and other taxes and other costs involved in the transfer of Eligible Credit Support either from the Transferor to the Transferee or from the Transferee to the Transferor pursuant to this Annex.

(iv) **Single Transferor and Single Transferee.** Party A shall always be the Transferor and Party B shall always be the Transferee.

(v) *Moody's Criteria*<sup>4</sup>.

**"Moody's Credit Support Amount"** means, for any Valuation Date:

- (A) if the Moody's Threshold is infinity, zero;
- (B) if the Moody's Threshold is zero and (1) the Second Rating Trigger Requirements do not apply or (2) less than 30 Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply, the greater of:
  - (i) zero; and
  - (ii) the sum of (x) the Transferee's Exposure and (y) the aggregate of the Moody's First Trigger Additional Amounts in respect of such Valuation Date for all Transactions (other than the Transaction constituted by this Annex); and
- (C) if the Second Rating Trigger Requirements apply and 30 or more Local Business Days have elapsed since the last time the Second Rating Trigger Requirements did not apply, the greater of:
  - (i) zero;
  - (ii) the aggregate amount of the Next Payments (each determined based on the rates prevailing on such Valuation Date) for all Next Payment Dates; and
  - (iii) the sum of (x) the Transferee's Exposure and (y) the aggregate of the Additional Second Trigger Collateral Amounts in respect of such Valuation Date for all Transactions (other than the Transaction constituted by this Annex).

**"Moody's First Trigger Additional Amount"**<sup>5</sup> means, for any Valuation Date:

- (A) in respect of any Transaction that is a cross-currency hedge, the lesser of (x) the sum of (1) the product of the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date and the Moody's First Trigger Cross Currency Notional Amount Lower Multiplier and (2) the product of the Moody's First Trigger Cross Currency DV01 Multiplier and the Transaction Cross Currency DV01 for such Transaction and (y) the product of the Moody's First Trigger Cross Currency Notional Amount Higher Multiplier and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date; and
- (B) in respect of any Transaction that is not a cross-currency hedge, the lesser of (x) the product of the Moody's First Trigger Single Currency DV01 Multiplier and the Transaction Single Currency DV01 for such Transaction and (y) the product of the Moody's First Trigger Single Currency Notional Amount Multiplier and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date.

**"Moody's First Trigger Cross Currency DV01 Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 10 and (B) otherwise, 20.

**"Moody's First Trigger Cross Currency Notional Amount Higher Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.025 and (B) otherwise, 0.05.

<sup>4</sup> The provisions in this sub-paragraph (v) cater for all types of swaps covered by the Framework.

<sup>5</sup> This definition assumes DV01 is to be used. It may be replaced with alternative language based on *Table 4A-2* of the Framework.



**"Moody's First Trigger Cross Currency Notional Amount Lower Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.01 and (B) otherwise, 0.02.

**"Moody's First Trigger Single Currency DV01 Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 15 and (B) otherwise, 25.

**"Moody's First Trigger Single Currency Notional Amount Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.02 and (B) otherwise, 0.04.

**"Moody's Second Trigger Additional Amount"**<sup>6</sup> means, for any Valuation Date:

(A) in respect of any Transaction that is both a cross-currency hedge and an Optionality Hedge, the lesser of (x) the sum of (1) the product of Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date and the Moody's Second Trigger Cross Currency Notional Amount Lower Multiplier and (2) the product of the Moody's Second Trigger Cross Currency DV01 Multiplier (Optionality) and the Transaction Cross Currency DV01 for such Transaction and (y) the product of the Moody's Second Trigger Cross Currency Notional Amount Higher Multiplier (Optionality) and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date;

(B) in respect of any Transaction that is a cross-currency hedge and is not an Optionality Hedge, the lesser of (x) the sum of (1) the product of Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date and the Moody's Second Trigger Cross Currency Notional Amount Lower Multiplier and (2) the Moody's Second Trigger Cross Currency DV01 Multiplier and the Transaction Cross Currency DV01 for such Transaction and (y) the product of the Moody's Second Trigger Cross Currency Notional Amount Higher Multiplier and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date;

(C) in respect of any Transaction that is not a cross-currency hedge and is an Optionality Hedge, the lesser of (x) the product of the Moody's Second Trigger Single Currency DV01 Multiplier (Optionality) and the Transaction Single Currency DV01 for such Transaction and (y) the product of the Moody's Second Trigger Single Currency Notional Amount Multiplier (Optionality) and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date; and

(D) in respect of any Transaction that is neither a cross-currency hedge nor an Optionality Hedge, the lesser of (x) the product of the Moody's Second Trigger Single Currency DV01 Multiplier and the Transaction Single Currency DV01 for such Transaction and (y) the product of the Moody's Second Trigger Single Currency Notional Amount Multiplier and the Transaction Notional Amount for such Transaction for the Calculation Period which includes such Valuation Date.

**"Moody's Second Trigger Cross Currency DV01 Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 15 and (B) otherwise, 25.

**"Moody's Second Trigger Cross Currency DV01 Multiplier (Optionality)"** means, (A) if each Local Business Day is a Valuation Date, 30 and (B) otherwise, 40.

**"Moody's Second Trigger Cross Currency Notional Amount Higher Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.09 and (B) otherwise, 0.1.

<sup>6</sup> This definition assumes DV01 is to be used. It may be replaced with alternative language based on *Tables 4B-2 and 4B-3* of the Framework.

**"Moody's Second Trigger Cross Currency Notional Amount Higher Multiplier (Optionality)"** means, (A) if each Local Business Day is a Valuation Date, 0.11 and (B) otherwise, 0.12.

**"Moody's Second Trigger Cross Currency Notional Amount Lower Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.06 and (B) otherwise, 0.07.

**"Moody's Second Trigger Single Currency DV01 Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 50 and (B) otherwise, 60.

**"Moody's Second Trigger Single Currency DV01 Multiplier (Optionality)"** means, (A) if each Local Business Day is a Valuation Date, 65 and (B) otherwise, 75.

**"Moody's Second Trigger Single Currency Notional Amount Multiplier"** means, (A) if each Local Business Day is a Valuation Date, 0.08 and (B) otherwise, 0.09.

**"Moody's Second Trigger Single Currency Notional Amount Multiplier (Optionality)"** means, (A) if each Local Business Day is a Valuation Date, 0.10 and (B) otherwise, 0.11.

**"Next Payment"** means, in respect of each Next Payment Date, the greater of (i) the Base Currency Equivalent of any payments<sup>7</sup> due to be made by Party A under Section 2(a) on such Next Payment Date less the Base Currency Equivalent of any payments<sup>4</sup> due to be made by Party B under Section 2(a) on such Next Payment Date and (ii) zero.

**"Next Payment Date"** means each date on which the next scheduled payment under any Transaction (other than the Transaction constituted by this Annex) is due to be paid.

**"Optionality Hedge"** means any Transaction that is a cap, floor, swaption, or a Transaction-Specific Hedge.

**"Transaction Cross Currency DV01"** means, with respect to a Transaction and any date of determination, the greater of (i) the estimated change in the mid-market value with respect to such Transaction that would result from a one basis point change in the relevant swap curve (denominated in the currency of Party A's payment obligations under such Transaction) on such date and (ii) the estimated change in the mid-market value with respect to such Transaction that would result from a one basis point change in the relevant swap curve (denominated in the currency of Party B's payment obligations under such Transaction) on such date, in each case as determined by the Valuation Agent in good faith and in a commercially reasonable manner in accordance with the relevant methodology customarily used by the Valuation Agent.

**"Transaction Notional Amount"** means (A) in respect of any Transaction that is a cross currency hedge, the Base Currency Equivalent of the Currency Amount applicable to Party A's payment obligations and (B) in respect of any other Transaction, the Base Currency Equivalent of the Notional Amount.

**"Transaction Single Currency DV01"** means, with respect to a Transaction and any date of determination, the estimated change in the mid-market value with respect to such Transaction that would result from a one basis point change in the relevant swap curve on such date, as determined by the Valuation Agent in good faith and in a commercially reasonable manner in accordance with the relevant methodology customarily used by the Valuation Agent.

<sup>7</sup> May exclude exchanges of notional under cross-currency Transactions.



**"Transaction-Specific Hedge"** means any Transaction in respect of which the Transaction Notional Amount for each Calculation Period is "balance guaranteed" or otherwise not an amount that is fixed at the inception of the Transaction.

(vi) **[ABC Rating Agency] Criteria.**

**"[ABC Rating Agency] Credit Support Amount"** means:

(A) if the [ABC Rating Agency] Threshold is infinity, zero; and

(B) if the [ABC Rating Agency] Threshold is zero, [to be inserted].

(vii) **[XYZ Rating Agency] Criteria.**

**"[XYZ Rating Agency] Credit Support Amount"** means:

(A) if the [XYZ Rating Agency] Threshold is infinity, zero; and

(B) if the [XYZ Rating Agency] Threshold is zero, [to be inserted].

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# **EXHIBIT B**

Structured Finance  
Criteria Report

**Counterparty Risk in Structured  
Finance Transactions: Hedge  
Criteria**

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**Related Research**

- "Commingle Risk in Structured Finance Transactions (Servicer and Account Bank Criteria)," dated June 9, 2004
- "Counterparty Risk in Structured Finance: Qualified Investments Criteria," dated June 30, 2004
- "Liquidity Support in Structured Finance Transactions (Liquidity Provider Rating Criteria)," dated July 13, 2004
- "Special-Purpose Vehicles in Structured Finance Transactions," dated June 13, 2006

**■ Summary**

In structured finance (SF) transactions, the ratings assigned are very closely linked to the performance of the hedge counterparty (the counterparty), and any nonperformance may cause either a downgrade or a default of the relevant rated class of notes. Hence, it is of the highest importance to analyze all the risks related to a hedge agreement when rating an SF transaction. Fitch Ratings has updated its rating criteria for hedge counterparties and has summarized its conclusions in this report. Updates include:

- Formalization of the criteria application to other hedge instruments.
- Simplification of the minimum rating approach.
- Revised volatility cushions (VCs) and advance rates (ARs).

Fitch's criteria expects hedge counterparties to be highly rated entities and rating triggers to be set to mitigate the counterparty's credit risk should its rating fall below certain levels. Fitch expects a rated transaction to be remote from any loss arising as a consequence of counterparty risk.

Fitch expects counterparties to have a Fitch short-term rating of 'F1' or better and a Fitch long-term rating of 'A' or better for SF transactions with a notes rating of 'AA-' or higher. Defined minimum counterparty rating criteria for SF transactions with notes rated below 'AA-' are shown in Appendix 1 (*see page 14*). The distinction between minimum counterparty ratings for swaps with or without the exchange of notional has been eliminated.

Upon the downgrade of the counterparty to a rating below the rating threshold but still at an investment-grade rating level, Fitch views negatively transactions where the structural protection is not secured by implementing one of the following within 30 calendar days of the downgrade:

- Seek a suitably rated replacement.
- Arrange for a guarantor that meets the threshold criteria.
- Post collateral to cover the potential loss upon its default.

**Key Criteria Components**

- Eligible hedge counterparties in SF transactions (*see page 10*).
- Structural protections upon downgrade (*see page 10*).
- Collateral types and ARs (*see page 14*).
- VCs: methodology and amounts (*see page 15*).
- ARs: methodology and amounts (*see page 18*).

August 1, 2007

## ■ Types of Swaps

A swap is an exchange of defined obligations, usually payments, between two parties over time and according to a precise schedule. A key characteristic of a swap is that the participants have differing cost structures in specific areas, the benefits of which are made accessible to the counterparty via the swap. This could relate to their asset and liability profiles, access to markets, opinions about the future, or appetite for a particular risk. This difference is ultimately expressed via the terms of the swap, which articulate the comparative advantages of the parties to the exchange.

A wide variety of obligations are swapped under swap contracts in today's markets. Those typical in finance (and hence applicable to SF transactions) are interest rate swaps, currency swaps, credit default swaps (CDS), and total return swaps (TRS). Depending on an entity's motives, such instruments can be used either to gain exposure to risk in a speculative sense or, conversely, to hedge an existing position related to another obligation.

### Interest Rate, Basis, and Forward Swaps

Under an interest rate swap agreement, counterparties exchange interest payments based on different references. For instance, interest payments calculated on a London Interbank Offered Rate (LIBOR) can be exchanged against interest calculated on a fixed rate. By replacing an interest rate reference on one side of the balance sheet with another via the interest rate swap, an entity is able to match the interest references of its debt with those of its assets. This eliminates the counterparty's exposure to fluctuations of one reference factor. If the legs of the swap refer to a fixed-rate reference on the one side and a floating-rate reference on the other, the swap is described as a fixed-floating (or interest rate) swap. If both legs of the swaps refer to a floating-rate reference, the instrument is called a basis swap. Aside from the references themselves, the impact of different determination dates on a single reference can also be swapped under a basis swap. Examples of basis swaps are an exchange of interest referenced to the 91-day Treasury bill against interest indexed to three-month LIBOR, or the exchange of interest referenced to six-month Euro Interbank Offered Rate (EURIBOR) determined on March 10 and Sept. 10 against interest referenced to the same index but determined on June 20 and Dec. 20.

Forward swaps are agreements to enter into a swap on a pre-agreed future date. While the terms of the swap (such as maturity and interest rate references) are set at

the execution of the forward agreement, the swap does not take effect until the future date. Forward swaps are useful instruments for locking in market conditions at a certain point for transactions occurring in the future. For instance, to hedge a debt refinancing or anticipated debt issuances against assets held today, a counterparty can lock in the forward rate based on market expectations of future interest rates.

### Currency Swaps

Under a currency swap, counterparties exchange payments in different currencies, enabling them to match the currencies of their assets and liabilities. For an SF transaction, this may apply when the issuer's assets are not in the same currency as its liabilities, exposing noteholders to an adverse movement in the relevant exchange rate between the levels at closing and on every subsequent payment date.

While only the interest based on a notional is exchanged for interest rate swaps, under a currency swap, both the interest and the notional are exchanged into the particular currency, substantially increasing the volume of the payment streams. In SF transactions, a swap is typically entered into at closing. The issuer pays the counterparty the notional in the currency of the issuance and receives in exchange a payment in the assets' currency, equal to the notional of the swap, converted at the swap exchange rate — typically the spot rate at closing. On every payment date, the interest paid in the assets' currency will be exchanged for payments in the liabilities' currency and passed on to investors. Principal payments received are either exchanged on their payment date or when they are required to be paid to the noteholders but, in any case, according to the exchange rate set at inception. This will often depend on whether the assets' redemption profiles are amortizing or bullet.

Cross-currency swaps may not only exchange the currencies of principal and interest payments but also transform the interest rate references of the underlying instruments. For example, a swap may well exchange principal and interest in U.S. dollars (USD) for Euros (EUR), but may also exchange interest calculated on three-month USD LIBOR for a payment calculated on six-month EURIBOR under the same instrument.

### Total Return Swaps

TRS are designed to replace potentially unstable returns on a portfolio with payments whose definition

is designed to eliminate certain payment mismatches between the assets and liabilities. TRS are used, inter alia, in instances where the composition of the portfolio is liable to change due to different rates of amortization (or nonperformance) across the various assets. They may also be used in preference to a series of separate swaps that would be required for a portfolio with highly heterogeneous returns (for example, if the assets in the portfolio refer to a number of different interest references).

TRS have become common in certain jurisdictions and asset classes (e.g. Spanish residential mortgage-backed securities [RMBS]) and vary substantially from one to the other. For example, certain TRS may not only exchange the asset portfolio return for a specified spread, but also provide the issuer with protection against a rapid increase in the weighted average margin on the notes in a sequential transaction, thereby guaranteeing a certain level of excess spread on a given portfolio. This is exemplified where the counterparty owes amounts referenced to what is due under the issued SF notes.

Often seen in synthetic transactions where the returns on the collateral are swapped against payments due on the issued SF securities, the TRS swaps not only the interest payments but also the principal payments, regardless of the performance of the underlying collateral. In this case, the TRS counterparty effectively provides a wrap, covering the default risk on the underlying collateral.

### Contingency Swaps

Contingency swaps, which are not uncommon in highly complex collateralized debt obligation (CDO) transactions, are structured to meet the particular preferences of two counterparties. In SF transactions, such a swap might consist of an exchange of interest payments referring to a fixed or floating rate for a fixed payment plus a spread that depends on the development of an equity index (for example, the FTSE 100 Index).

### Credit Default Swaps

CDS are different from the above-mentioned instruments in two ways: a) their purpose is usually not to hedge the issuer of SF notes against payment mismatches, but rather to expose it to the credit risk of obligors referenced under the swap; and b) payments are not exchanged in both directions on a regular basis, but are only due regularly from the protection buyer to the protection seller (the issuer), while the protection seller

(the counterparty) will need to make a loss payment if predefined credit events occur. While the first leg of the swap involves the protection buyer making regular premium payments to the protection seller, the seller would pay the protection buyer an amount determined according to the terms of the CDS following the occurrence of a credit event.

Synthetic transactions use CDS to transfer risk to the issuer, although in both true sale and synthetic transactions, the issuer may additionally buy protection on assets to which it is exposed using a CDS. Protection may be sought against specific credit events affecting a reference entity or may follow standard market conventions. In CDO transactions, for example, standard credit events affecting the referenced obligor are bankruptcy, failure to pay, and restructuring. *(For further explanations on the mechanics of synthetic CDOs, see Fitch Research on "Global Rating Criteria for Collateralised Debt Obligations," dated Oct. 18, 2006, available on Fitch's web site at [www.fitchratings.com](http://www.fitchratings.com).)*

The presence of counterparty risk depends on the issuer's role under a CDS. In selling protection, its exposure to counterparty risk extends only to the premium payments; if protection is being bought, however, the issuer is exposed to the seller's creditworthiness in an amount equivalent to the loss upon default of a referenced obligation — i.e. the entire notional less any recovery amount.

### Interest Rate Caps

A cap is an exchange of obligations, where one party pays a single or periodic fixed amount and the other party pays periodic amounts based on the excess over a specified floating interest rate, which will be reset periodically, over a specified fixed per annum rate. Interest rate caps can be useful to an issuer of floating-rate debt that wishes to establish a ceiling on future interest rates.

### Interest Rate Collars

A collar is the combination of an interest rate cap and an interest rate floor. A floor is an exchange of obligations, where one party pays a single or periodic fixed amount and the other pays periodic amounts based on the excess of a specified per annum fixed interest rate over a specified floating rate that will be periodically reset. In an interest rate collar transaction, one party is the floating-rate payer on the cap and the other party is the floating-rate payer on the floor. To create the collar, the issuer generally



purchases a cap to establish a ceiling on future rates and sells a floor. The sale proceeds of the floor offset the price of the cap, decreasing execution costs but imposing a floor that limits the possible benefit of interest rates that decline through the floor.

## ■ Notional Amount

The notional is the amount upon which the hedge payments are calculated. The notional may be a fixed amount for a certain term after which it falls to zero (bullet), may amortize or accrete according to a predefined schedule (amortizing or accreting), or may track the outstanding amount of assets or liabilities of the issuer (balance guaranteed).

In contrast with a bullet hedge, the notional of amortizing or accreting hedges is designed to change in accordance with the expected amortization or accretion rate of the issuer's assets. Both types of structures are intended to enable a close match between the asset and liability amounts hedged. Unless a hedge amortizes, the notional may soon exceed the principal amount of the related debt as it is redeemed. The notional amount of accreting hedges increases to mirror the increase in asset principal — for example, as a construction loan in a commercial mortgage-backed securities transaction is drawn down.

Notwithstanding this, the risk of over- or under-hedging is not completely eliminated by such an amortizing or accreting structure. If, for instance, the asset amortizes at a higher rate than is forecast in the swap agreement (due, for example, to faster prepayments on the underlying assets), the notional of the swap may still exceed the principal of the asset. Similarly, if a loan is drawn down more quickly or slowly than is envisaged in the related swap agreement, an accreting swap could cause the notes to be under- or over-hedged, respectively.

This can be mitigated by the use of so-called flexi-swaps, where amortization or accretion can vary within a predefined band. In this way, the risk of uncertain prepayments or drawdowns is shared between the counterparty and the issuer, and the additional risk is priced into the hedge.

A complete hedge against volatile asset amounts can be achieved only via a balance-guaranteed hedge, which transfers all risk related to prepayment and accretion to the counterparty. The notional of such hedges exactly tracks the asset balance; however,

since the counterparty's view on the amortization or accretion path is essential for the pricing of the hedge, it becomes clear that such instruments are more difficult to price and replace.

## ■ Hedge Documentation

### Master Agreement, Confirmation, and Schedule

Hedges in international SF transactions are almost exclusively governed by the master agreement established by the International Swaps and Derivatives Association, Inc. (ISDA), a generic document that governs the basic terms of the hedge. It sets out the broad parameters of the transaction, including a set of definitions, general payment provisions, netting arrangements, events of default, and events of early termination.

Nearly all securitizations using swaps, caps, and floors adopt the Multicurrency-Cross Border version of the ISDA master agreement rather than the Local Currency-Single Jurisdiction version, regardless of the number of currencies or jurisdictions contemplated. Currently, most securitization transactions are expected to use either the 1992 or the 2002 version of the ISDA master agreement. Fitch recognizes that securitizations may operate under the 1992 ISDA master agreement, notwithstanding the 2002 version. Both the 1992 and 2002 master agreements can be governed by either New York or English law. In some instances, however, Fitch has seen master agreements drafted in local language and governed under local law. While such local master agreements may just be a translation of the ISDA master agreement, Fitch will nevertheless review such master agreement and any information or local law legal opinions, if provided, to identify any risks in relation to the application of local law.

The master agreement is accompanied by and subject to a confirmation and a schedule, which supplement and override, to the extent of any inconsistency, the master agreement. The confirmation details the actual rates and indexes governing the hedge, the dates when payments are due, and the notional amount for calculating the payments. The schedule will supplement or amend certain provisions related to the master agreement and will often introduce additional termination events. If the creditworthiness of the counterparty is not of sufficient quality, its credit risk may be mitigated through collateralization of its exposure, the terms of which are typically set out in an annex to the schedule called the credit support

annex (CSA). Typically in SF transactions, each hedge agreement consists of one ISDA master agreement, one schedule, one CSA (if applicable), and one confirmation. If an issuer enters into more than one hedge, even if with the same counterparty (for example, one hedge for senior notes and one for junior notes), each hedge typically has its own schedule, CSA (if applicable), and confirmation, while one ISDA master agreement covers all hedges between the same two parties. The terms of the CSA are discussed in Documentation and Administration of Credit Support on page 12.

The 2002 ISDA master agreement is similar in form and substance to the 1992 version. Interestingly, of the substantive differences between the agreements, many relate to termination. While the events that can bring about termination have not changed materially, the time in which termination can be effected subsequent to certain events occurring has been decreased, and the method for calculating termination payment amounts due has changed. While Fitch finds the 1992 ISDA master agreement adequate for its credit analysis in securitizations, it views the ability to terminate earlier under certain circumstances set out in the 2002 ISDA master agreement as a positive development, since this allows the issuer to replace a stressed counterparty earlier in the process.

### Events of Default and Termination Events

The ISDA master agreements define events of default and termination events that can bring about the termination of a hedge. An event of default gives the nondefaulting party the right to terminate the hedge agreement. Alternatively, the schedule may provide for automatic termination following specified events of default. A termination event gives either one or both parties the right to terminate one or more, but not necessarily all, hedge transactions between them. Since most SF transactions have only one hedge with the counterparty, or a series of hedges supplementing each other for the benefit of the issuer, Fitch views events of default and termination events in the same manner, as each can bring about a termination of the hedges.

The events of default set out in the ISDA master agreement are summarized as follows:

- Failure to pay or deliver. A party fails to make any payment or delivery due, with a grace period of three business days after notification (ISDA 1992) or one business day (ISDA 2002).
- Breach of agreement. A party fails to comply with an obligation in accordance with the agreement,

and this is not remedied within 30 days after notification of such failure.

- Credit support default. The party relies on a credit support provider, and that support goes away, is disavowed, or otherwise comes into serious question.
- Misrepresentation with material consequences.
- Default under a specified transaction.
- Cross-default, which is default on debt over an agreed threshold.
- Bankruptcy or similar insolvency events.
- Merger without assumption. One party merges, and the merged entity does not assume the obligations under the hedge agreement.

The termination events set out in the ISDA master agreements are as follows:

- Illegality. A change in the law makes it illegal for a counterparty to abide by the terms of the hedge agreement.
- Force majeure event (ISDA 2002 only). A party cannot comply due to some extreme external event, such as a natural disaster, an act of terrorism, or an act of war, and cannot cure such noncompliance within eight local business days. While ISDA 1992 does not specify force majeure, such an event would probably cause one of the events of default previously specified.
- Tax event. A change in tax law makes a party withhold or deduct tax.
- Tax event upon merger. A party must withhold or deduct tax due to the merger of a party.
- A credit event upon merger. A party merges, and the merged entity is substantially weaker than the party prior to the merger.

The party directly affected by or having caused the termination event is termed the affected party. It is possible that both parties could be affected by the same event. A tax event upon merger adds the concept of a burdened party, as described below. Depending on the type of termination event, the affected party, the burdened party, the party that is not the affected party, or either party will have the right to terminate the hedge agreement.

The affected party in the case of the termination events previously described, and additionally the burdened party in the case of tax event upon merger, are described as follows:

- Illegality. The affected party is impaired from making or receiving its payment under the hedge because it is illegal.

- Force majeure event. The affected party is impaired from making or receiving its payment under the hedge due to the force majeure event.
- Tax event. The affected party is either the party that must make a higher payment on its leg because its tax authority has levied a tax on the payment or the party that receives a lower payment on its leg because the tax authority has levied a tax on the receipt of payment.
- Tax event upon merger. The burdened party is either the party that must make a higher payment on its leg due to a tax levied by the tax authority as the result of a merger or the party that receives a lower payment on its leg because the tax authority has levied a tax on the receipt of payment as the result of a merger. The affected party is the entity that has merged.
- Credit event upon merger. The affected party is the party that is left substantially weaker after the merger.

The party allowed to terminate the hedge upon the occurrence of each of the termination events is described as follows:

- Illegality — either party.
- Force majeure event — either party.
- Tax event — the affected party.
- Tax event upon merger — the burdened party, if the burdened party is different from the affected party.
- Credit event upon merger — the party that is not the affected party.

The terms of the master agreement are often amended by the schedule, which may introduce or remove certain events of default or termination events relevant to the transaction in question. Examples of additional events include the following:

- Acceleration/enforcement notice. This can occur if, upon default, the trustee serves a notice upon the issuer, accelerating payment so that the notes become immediately due and payable. Fitch views positively transactions that allow the issuer to terminate the hedge if acceleration occurs. This mitigates the risk, if the counterparty is the only party able to terminate, that it may not choose to do so or may be unable to do so.
- Redemption of notes by the issuer. For the same reason as set out above in “Acceleration/enforcement notice,” Fitch views positively transactions that provide that both parties have the right to terminate the hedge upon redemption of the notes.

- Credit downgrade. This can occur if the counterparty, as opposed to the issuer, is downgraded below the rating trigger and does not take the action specified to be taken upon downgrade. The counterparty would be the affected party, with the right to terminate being at the option of the issuer as the non-affected party.

Examples of events of default that are expected to be modified in the schedule follow.

### **Breach of Agreement**

Bankruptcy-remote, special purpose vehicles (SPVs) can perform various roles in SF transactions, from being issuers of the notes to intermediate roles such as borrowers from the issuer. The SPV will be bound by covenants in the SF transaction documents. In SF transactions, the rights of the counterparty to take action following a breach by the SPV are limited by the SF transaction documents. All the SF secured creditors (including the counterparty) agree only to take collective action to terminate agreements, accelerate the SPV’s obligations in a default, and enforce secured rights through the trustee or other appointed representative. Typically, therefore, this event of default is not applied to the SPV. A breach of the hedge agreement by the SPV can, however, still lead to a termination if the parties have provided for the breach to be a default under the notes and acceleration or enforcement of the notes is included as an additional termination event.

For the counterparty, it would be usual for this event of default to apply to derivatives executed in its ordinary course of business. For this reason, Fitch prefers this event of default to apply to the counterparty in an SF transaction, as it would in its ordinary derivative transactions.

### **Credit Support Default**

Typically, this event of default does not apply to the SPV, as it should have no credit support documents or credit support providers. For the counterparty, this event of default may apply, depending on the SF transaction. Where the counterparty’s obligations are guaranteed, the guarantee should be a credit support document of the counterparty and the guarantor a credit support provider of the counterparty. In this way, a default under the guarantee will be an event of default under the hedge, and certain other events of default (such as bankruptcy) will apply to the guarantor.

### **Misrepresentation**

For the reason outlined previously in Breach of Agreement, the rights of the counterparty under



the hedge to action a misrepresentation by the SPV should be no greater than the rights of the other SF transaction-secured creditors. Typically, therefore, this event of default is disappplied in respect of the SPV, based on the covenants in the SF transaction documents. In relation to this event of default, the counterparty usually also has the benefit of securitization legal opinions supporting the representations of the SPV. If the parties have provided for it, any misrepresentation by the SPV may trigger a default under the notes leading to acceleration or enforcement, which can be included as an additional termination event.

Also for the reasons outlined previously in Breach of Agreement, the counterparty, it would be usual for this event of default to apply to the counterparty in derivatives executed in its ordinary course of business. For this reason, Fitch prefers this event of default to apply to the counterparty in an SF transaction, as it would in its ordinary derivative transactions.

### **Bankruptcy**

Again, for the reasons outlined in Breach of Agreement, this event of default typically should not apply to the SPV. The counterparty's rights to take action to terminate the hedge upon the SPV's bankruptcy being subject to the SF transaction documents. If this event of default is applied to the SPV, Fitch would expect the definition in the hedge to be modified so as to conform with the equivalent definition in the SF transaction documents.

This event of default is expected to apply to the counterparty, as not only will bankruptcy indicate that the counterparty may not have the financial means to meet its payment obligations under the hedge, but the SF transaction creditors (including the SPV and, in turn, the noteholders) should be able, in the event of the counterparty's bankruptcy, to instruct the trustee to terminate the hedge and replace the counterparty.

### **Default Under Specified Transactions**

This event of default typically does not apply to either the SPV or the counterparty. One reason for disapplying this event with respect to both parties is that, typically, an SF transaction will not have any link to other transactions. For example, in instances where there is a multi-issuance SPV but issuances that are intended to be segregated and stand-alone, the SPV's hedges with a counterparty (which would have been named specified transactions) would be terminated due to a default under one hedge if this event is not disappplied. However, where there is more than one

hedge with the same counterparty hedging different classes of rated notes within the same SF transaction, then Fitch would expect this event to be applied to the counterparty so that the SPV would be in a position to terminate the hedges at the same time.

### **Cross-Default**

This event of default typically should not apply to the SPV where it is established as a bankruptcy-remote entity solely for the purpose of executing the SF transaction(s). This is because the transaction parties would typically wish to avoid any link between the hedged SF transaction and other unrelated transactions with the same counterparty.

Fitch views positively circumstances where this event of default applies to the counterparty, as it provides a separate and additional credit trigger that may occur prior to the occurrence of other credit-linked events (such as bankruptcy or rating downgrade triggers). Fitch will, on a case-by-case basis, review the appropriateness of the trigger amount for the cross-default (the threshold amount) and the scope of the transactions included within the range of cross-default (the specified indebtedness).

Examples of termination events expected to be modified in the schedule are outlined in the following sections.

### **Tax Event**

This termination event typically applies to the SPV, as affected party, allowing the SPV to terminate the hedge if payments made by the counterparty become subject to a withholding tax following a change of law and the counterparty is not obliged to gross up those payments.

This termination event is disappplied to the counterparty as affected party (so that the counterparty cannot terminate the hedge), where the counterparty has agreed to accept the risk of the change in tax during the term of the SF transaction. This occurs where the counterparty has agreed to gross up its payments to the SPV (if a withholding tax is imposed on the counterparty) or the counterparty has agreed to accept the risk of a withholding tax being imposed on the SPV (and the SPV has not agreed to gross up, which would be usual).

### **Tax Event Upon Merger**

This termination event typically applies to the SPV as the burdened party because payments made by the counterparty (or a successor entity) could be subject to withholding as a result of a merger involving the

counterparty, and the counterparty (or a successor entity) may not be obliged to gross up those payments.

However, the counterparty has more control over and may be able to foresee whether, as a result of its merger, payments made by it or to it (or a successor entity) may be subject to withholding tax. In addition, the SPV's ability to merge with another entity will be restricted in the SF transaction documents, making receipt of lower payments due to withholding tax levied on the SPV improbable. For these reasons, this termination event is usually disappplied to the counterparty.

### **Credit Event Upon Merger**

The risk of an SPV triggering a credit event by merging with another entity is mitigated in SF transactions, as the SPV is typically an independent, bankruptcy-remote entity established solely for its role in the SF transaction and, typically, is limited in the SF transaction documents from doing other business or merging with another entity. For these reasons, this termination event is typically disappplied to the SPV.

This termination event may or may not apply to the counterparty. However, if it is applied to the counterparty, this will be viewed positively by Fitch as it provides the SPV with an additional credit-linked termination event to the extent that the counterparty is materially weaker after the merger.

### **Early Termination Payments Due**

Payments under early termination are handled differently by the 1992 and 2002 master agreements and also receive different treatment if events of default and termination events occur.

The 1992 master agreement provides for two payment methods (the first method and the second method) and two payment measures (market quotation and loss). The payment methods and payment measures are elected in the schedule.

If early termination results from an event of default, the first payment method provides that payments upon termination will be due only to the nondefaulting party (i.e. the defaulting party is not due any payment even if its leg was in the money at the termination date). The second method provides that payments upon termination are due to the counterparty in favor of which the hedge was in the money at termination, regardless of which was responsible for the termination. Hence, under the

second method, the party causing the termination may be due a termination payment from the nondefaulting party.

The market quotation payment measure is defined as an amount determined by reference to market for an instrument similar to the terminated hedge. The loss payment measure is defined as the sum of total losses and costs suffered by the nondefaulting party upon termination of the hedge, determined reasonably and in good faith by the nondefaulting party.

Hedges in securitizations using the 1992 master agreement typically use the second method and market quotation. Under this arrangement, the nondefaulting party presents the hedge terms to a number of dealers that will be asked to quote a price to take over the hedge from the defaulting counterparty. If three or more quotations can be obtained, the arithmetical mean of the three quotations will be taken, and the party that is out of the money will have to pay that amount to the party that is in the money.

If early termination results from a termination event, the course of action depends on whether one or both parties have been affected. If there is one affected party, the payment calculation is identical to the second method, regardless of whether the schedule calls for the first or second method. The payment measure applied will be market quotation or loss, as set out in the schedule. For both payment method and payment measure, the affected party is treated as the defaulting party and the party that is not affected as the nondefaulting party.

If both parties are affected and market quotation applies, each party obtains a settlement amount through the market quotation method previously described, and the payment amount is equal to half the difference of the two results. If both parties are affected and loss applies, each party calculates its loss as a result of the hedge's termination, and the payment amount is equal to half the difference between the two results.

The 2002 ISDA master agreement handles early termination payments in a slightly different manner. Payment methods and payment measures do not have to be set out in the schedule, as the agreement calls for the same general procedure for all hedges.

If early termination results from an event of default, the nondefaulting party will determine the losses or

costs incurred by replacing the defaulting counterparty or providing the nondefaulting party with the economic equivalent of the hedge. To calculate this, the nondefaulting party can use information such as third-party quotations and relevant market data. Where market quotations are obtained, the 2002 master agreement does not define how these should be used to determine the payment amount. As with the second method calculation previously described, payment could be due to either the defaulting or the nondefaulting party as a result of this calculation.

If early termination results from a termination event, and if there is one affected party, the payment calculation would be handled as with an event of default under the 2002 master agreement, whereby the affected party is treated as the defaulting party and the unaffected party as the nondefaulting party. If both are affected, each party calculates an amount in accordance with the paragraph above, and the payment amount is equal to half the difference of the two results.

## ■ Counterparty Risk In Hedge Agreements

### Risk of an Event of Default

In an SF transaction, one party to the hedge will be the SPV and the other the counterparty, typically a financial institution. As described previously, if one party to the hedge agreement defaults, the other party can call for the agreement to terminate early.

Under a hedge agreement, both counterparties face the risk that the other party may default. However, SF transactions are typically structured in such a way that the SPV would be highly unlikely to be the cause of a hedge event of default. Events such as breach of agreement or misrepresentation tend to be disappplied with respect to the SPV. Alternatively, where they are not disappplied, Fitch reviews the representations and warranties and covenants given by the SPV and considers any credit implications such inclusion may have.

Payments from the SPV issuer to the counterparty usually rank senior in the cash flow waterfall to the notes, meaning the SPV issuer would fail to make a hedge payment at a critical stage of the transaction, when the highest rated notes would already be in default. Moreover, the SPV issuer should, typically, be structured as bankruptcy remote. This is achieved by, inter alia: there typically being

few and known creditors at the inception of the SF transaction and structural mitigants and protections in place during the life of the transaction as to who the SPV issuer's creditors should be; SF transactions typically include a covenant given by all the transaction-secured creditors of the SPV issuer not to apply to wind up, liquidate, or take similar action against the SPV (the nonpetition language) until after the redemption of the notes. The SPV issuer is created typically as an orphan vehicle delinked from the originator and is subject to restrictions on its business objectives, purposes, and ability to raise indebtedness; and restrictions on its ability to merge with other companies. Hence, the possibility of the SPV issuer becoming insolvent for any reason other than nonperformance under the most senior rated notes is remote.

On the other hand, the SPV issuer itself is exposed to the counterparty in that the counterparty or its credit support provider may become insolvent, for example, or the counterparty may breach an agreement under the hedge. This is why Fitch publishes rating criteria for hedge counterparties in SF transactions. The criteria expect counterparties to be highly rated entities with a view to neutralizing the hedge counterparty credit risk.

### Risk of a Termination Event

Termination events can be caused by credit-related and non-credit-related events. If a non-credit-related termination event, such as illegality, or a tax event occurs, the counterparty's ability to pay any termination costs should not be affected, and the payment calculation methods and measures are designed to provide the SPV with enough funds to pay for a replacement hedge provider. Termination events caused by a credit-related event, such as a credit event upon merger, introduce counterparty credit risk in the same way as described in Risk of an Event of Default and will consequently be covered by the counterparty rating criteria.

Certain termination events, such as force majeure, illegality, or a tax event, may be unavoidable. These events are beyond the scope of a Fitch credit rating, and investors should be aware that any resultant risks are not expressed in the rating.

## ■ Coverage of Counterparty Risk in Hedge Agreements

As described previously, default and termination events caused by the counterparty can result in a loss



for the SPV issuer if either the counterparty does not pay termination amounts due to the SPV (for example, when the swap was in the money for the SPV issuer) or the SPV has to pay termination amounts to the defaulted counterparty (for example, when the swap was in the money for the counterparty and it does not receive an equal payment from a replacement counterparty). To reduce this counterparty-related credit risk, Fitch expects the structure to mitigate the risk of a counterparty causing a default or termination event.

Structures should aim to achieve this by reducing the counterparty risk to a degree where the likelihood of the counterparty going into default is close to zero, or the default would cause zero losses to the transaction. Hence, any structural protection mechanisms should address the counterparty's default probability, expressed in its rating, and the magnitude of any potential loss in the event the counterparty goes into default.

This is summarized as:

$$EL_{\text{hedge}} = DP_{\text{CP}} \times RC \approx 0$$

where:  $EL_{\text{hedge}}$  = expected loss under the hedge;  
 $DP_{\text{CP}}$  = default probability of the CP;  
 $RC$  = costs of a replacement of the defaulted CP;  
 and  
 $CP$  = the counterparty.

### Eligible Hedge Counterparties in Structured Finance Transactions

Fitch believes the likelihood of an 'A' rated counterparty migrating into default over a very short time is so remote that it is consistent with the long-term risk of 'AAA'. Hence, where structural protections ensure that the default risk of a counterparty whose rating falls below 'A' is covered immediately by appropriate measures, the agency may accept counterparties with a long-term rating of 'A' or better to support better rated transactions.

Based on this position, Fitch expects counterparties to have a Fitch short-term rating of 'F1' or better and a Fitch long-term rating of 'A' or better for SF transactions with a notes rating of 'AA-' or higher.

The distinction between minimum counterparty ratings for hedges with or without the exchange of notional has been eliminated. This simplification was introduced based on the incorporation of hedge payment risk into the counterparty's corporate rating.

In the rare cases where the proposed counterparty has a Fitch long-term rating but not a Fitch short-term rating, the agency may rely on its assessment of the long-term rating only. In the cases where the proposed counterparty does not carry a Fitch rating, the agency may rely on its internal view of the creditworthiness of the counterparty. For other derivative instruments not listed here, the previously mentioned rules will be applied accordingly.

Fitch has also defined counterparty criteria for SF transactions with notes rated below 'AA-'. The respective minimum counterparty ratings for various transaction ratings are shown in Appendix I on page 14.

### Structural Protections Upon Downgrade

Upon the counterparty's downgrade below the rating threshold (or trigger) of 'A/F1', Fitch expects credit mitigants and protections to be included in the structure. Fitch views positively SF transaction structures that provide for the counterparty to take one of the following actions within 30 calendar days of the downgrade (the cure period):

- **Replacement:** Replace itself with a rated entity consistent with the criteria described herein and transfer its rights and obligations to such replacement, with any replacement costs being paid by the outgoing counterparty.
- **Guarantor (Co-Obligor):** Arrange for a rated entity consistent with the criteria described herein to provide an unconditional guarantee for its hedge obligations, with any fee due being paid directly by the guaranteed counterparty.
- **Collateral:** Post collateral to cover the potential replacement costs of the hedge at a minimum amount (not applicable for contingency swaps), as defined below.

Additionally, for CDS where the counterparty in question is buying protection, it may be acceptable to post the premium for one payment period, since the premium is a set amount that can be determined in advance, and the termination of such a swap would coincide with the termination of the SPV issuer's exposure to the credit risk of the reference portfolio. The cure period previously referred to applies to all types of hedges.

Where, upon a downgrade, the parties' action of choice is collateral and the counterparty consequently suffers a further downgrade below a short-term rating of 'F2' or a long-term rating of 'BBB+', or where the initial downgrade already took the rating below 'F2' or 'BBB+', replacement or guarantor are Fitch's preferred

actions of choice. If the counterparty elects collateral, Fitch expects the mark-to-market calculations and the correct and timely posting of collateral to be verified by an independent third party. Upon a further downgrade below investment grade, Fitch expects replacement or guarantor to apply. During the time in which a replacement or guarantor is being sought following an initial or further downgrade below investment grade, Fitch also expects collateral to be posted as a measure of protection for the SPV. In the case of guarantor, both the guarantee and the legal opinion attached to it will be reviewed by Fitch or its legal counsel to assess the enforceability of the guarantee.

While both replacement and guarantor return the counterparty's creditworthiness at least to the same level as before the downgrade, collateral relates to the potential loss upon default of the counterparty. When posting of collateral is the parties' chosen action, the collateral to be posted should be sufficient to ensure that the potential loss upon default of the counterparty is virtually zero.

The collateral amount (CA) will be determined as follows:

- For hedges with a notional that follows a schedule, and where referenced rates (e.g. premia or interest rate bases) are set in advance and not subject to change, Fitch expects the CA posted to be:

$$CA_{\text{hedge}} = \max[MV_{\text{hedge}} + VC_{\text{hedge}} \times N_{\text{hedge}}; 0]$$

max = maximum  
 MV = market value  
 VC = volatility cushion  
 N = notional amount

The hedges to which this collateralization method applies include all interest rate hedges or currency swaps with fixed amortization schedules, an amortization band, or bullet profiles.

- For hedges whose referenced rates are set in advance, but whose notional amount is not predetermined according to a fixed schedule or within a fixed boundary, Fitch expects the CA posted to be:

$$CA_{\text{hedge}} = \max[MV_{\text{hedge}} + VC_{\text{hedge}} \times 105\% \times N_{\text{hedge}}; 0]$$

max = maximum  
 MV = market value  
 VC = volatility cushion  
 N = notional amount

The hedges to which this collateralization method applies include all balance-guaranteed interest rate hedges or currency swaps.

- For swaps where a potential payment obligation may fall due at an unspecified time upon occurrence of a given event, and where the maximum amount of this payment can be specified, Fitch expects the CA posted to be equal to this maximum potential payment amount.

The hedges to which this collateralization method applies include CDS, under which the issuer buys protection, TRS, which cover the default risk of the reference collateral, or contingency swaps, whereby a set payment falls due on the breach of a certain benchmark. (An example of this is a swap where the counterparty's obligation will increase by a specified amount when an equity index exceeds a certain benchmark.)

- For contingency swaps where a potential payment obligation may fall due at an unspecified time upon occurrence of a given event, and where this payment cannot be quantified, collateral is not a preferred option, since the amount to be posted cannot be determined. Therefore, Fitch expects the counterparty to find a replacement or guarantor meeting the criteria described herein.

Hedge market values in favor of the counterparty are defined as negative market values. The previous formulas reflect that collateral will also be provided, even if the hedge is only at the market rate. Only where the hedge's market value is significantly in favor of the counterparty will it be unnecessary to post collateral.

The adjustment of the VC for balance-guaranteed hedges by a factor of 105% is justified by the disparities in market values determined by different market participants. For balance-guaranteed hedges, where market participants may have different views on the hedge's amortization profile, the likelihood of valuation differences exists. In discussions with Fitch, market participants confirmed that the future market value changes of balanced-guaranteed hedges are subject to higher calculation differences than those of derivatives with set amortization profiles because the counterparty also takes on the prepayment risk attached to the notional amount.

The VCs are dependent on the type of hedge and its weighted average life (WAL), assuming zero prepayment rate and zero default in the portfolio. For products with typically high prepayment rates, Fitch

may be comfortable with WAL calculations in line with their base case assumptions. The VCs for the most common hedge types are presented in Appendix 2 with a description of the method used to calculate them (*see page 15*).

### Collateral Types and Advance Rates

Collateral can be posted in any currency referenced in the hedge, and the collateral of choice should be of such credit quality that it would introduce only negligible additional credit risk. Depending on the term of the posted collateral, the following minimum Fitch ratings apply:

- Maximum term of 30 days — 'F1'.
- Maximum term of 360 days — 'F1+'.
- Maximum term of greater than 360 days — 'AAA'.

ARs cover the market value risk of any collateral not due daily. Dependent on the AR, the actual CA to be posted can be higher than the CA, leading to overcollateralization. The actual CA posted should always be:

$$\frac{CA_{\text{hedge}}}{AR_{\text{collateral}}}$$

The AR addresses the risk of a change in market value of a collateral security over the period of time it takes to find a substitute counterparty upon default of the counterparty posting the collateral. Fitch's ARs have been calculated to cover a four-week period. With weekly posting of collateral, this implies a three-week replacement period.

Fitch expects the collateral to be held in an account either in the name of or pledged to the SPV. Fitch will also review the relevant legal opinion(s) regarding the enforceability, ranking, and perfection of the security interests created when a counterparty collateralizes its position.

Appendix 3 shows the respective ARs for commonly used collateral types and explains the calculation methodology (*see page 18*).

### ■ Waterfall Applications for Hedge Termination Payments

As mentioned in a previous section, rating downgrade triggers are designed to reduce the exposure of the SF notes to a default of the counterparty. Failure to execute any of the mitigants previously referred to (or any other appropriate mitigants) could leave noteholders at risk of a shortfall in interest and/or principal payments upon the early termination of the hedge, since the second method favored under hedge

documents could lead to termination payments being owed by the SPV issuer.

One way to provide additional protection to the noteholders in the event of a default by the counterparty is to make any termination payments owed by the SPV to the counterparty subordinate to any payments of interest and/or principal and the topping up of any reserve fund in the SF transaction's priority of payments.

If a hedge terminates due to an event beyond the control of either party (such as a tax or regulatory event or an illegality), Fitch would expect any termination payments owed by the SPV to the counterparty to be either payable prior to or ranked pari passu with the most senior securities in the priority of payments.

### ■ Documentation and Administration of Credit Support

Credit support in the form of collateral provided to the hedge agreement is set out in the CSA. Experience with recent downgrades of market participants suggests that drafting a CSA is a time-consuming and negotiation-intensive exercise and may be a major burden for entities involved in several hedges affected by a counterparty's downgrade. Although the 30-calendar-day cure period may be sufficient for one CSA, it might prove too short for the simultaneous drafting of numerous CSAs. To avoid the possibility that a credit risk could remain uncovered due to an operational failure to execute the CSA in time, Fitch expects CSAs to be drafted and approved by the initial SF transaction counterparties before it assigns final ratings to the transaction. Fitch will review CSA templates to assess whether they conform to Fitch's criteria from time to time for rated SF transactions.

Aside from the collateral and OC requirements, the CSA also addresses the duties of the various counterparties to the CSA, the frequency of mark-to-market collateral and hedge valuation, as well as the posting of collateral, the types of eligible collateral, the payment threshold, and the minimum transfer amount.

For Fitch-rated transactions, Fitch expects the market value of the hedge and any collateral to be determined at least weekly. Likewise, any additional collateral required should be posted on a weekly basis. Fitch expects required collateral to be posted on the valuation day or, at the latest, the day after the valuation day.

Once collateral has been posted, the payment threshold addresses the difference between the collateral's market value and the CA to be posted. For Fitch-rated transactions, Fitch expects a payment threshold of zero to apply. The minimum transfer amount is the minimum amount the payment threshold must be exceeded before any additional collateral, once it has been posted, must be provided. Fitch is comfortable with the setting of the minimum transfer amount at USD25,000 or its equivalent as, in its view, this will still provide for any material shortfall of the collateral's market value over the CA to be delivered under the hedge. Where minimum transfer amounts above this limit are proposed, this risk may have to be taken into account in the rating analysis, depending upon its materiality to the transaction.

### ■ **Fitch's Approach When No Action is Taken**

If none of the actions described above are taken within 30 calendar days of the downgrade of the counterparty below the respective rating threshold, the SPV may or may not terminate the hedge agreement.

Irrespective of what the SPV (or the trustee for the noteholders) actions are, Fitch will put the affected tranches of the SF transaction on Rating Watch Negative (RWN) after the expiry of the cure period. In the past, Fitch has seen downgrade language where action is not taken upon downgrade of the counterparty, but only upon Fitch's negative rating action. Fitch is not comfortable with such language because it introduces uncertainty as to whether the obligation (to take one of the mitigating actions) will be triggered and, at best, extends the length of the cure period.

After the expiry of the cure period, a period of 10 business days (typically two calendar weeks) may be granted to take outstanding action. Fitch will use this period to analyze the transaction as if it were unhedged — i.e. apply interest rate or foreign currency risk stress scenarios to cash flows and test the tranches' ability to withstand the respective stresses.

If Fitch's analysis shows that the credit enhancement available to the rated notes is sufficient to cover the expected loss for the respective tranche, the ratings may be taken off RWN and affirmed. However, this is only likely to apply to transactions where either the available credit enhancement has significantly increased — e.g. through the deleveraging of the transaction — or the quality of the underlying portfolio has substantially improved without a corresponding upgrade in the ratings.

If available credit enhancement is not sufficient to support the current rating of the SF notes and no appropriate action is taken within the granted grace period, it is expected that the notes will be downgraded to the higher rating of the level commensurate with available credit enhancement and the counterparty's long-term rating. If, for instance, the shortfall in credit enhancement indicates a tranche's downgrade from 'A' to 'BBB', but the counterparty's long-term credit rating is at 'A-', the floor for the downgrade will be 'A-'. It is not appropriate to determine the required rating action according to the market value of the swap — i.e. no downgrade when the hedge is in favor of the SPV — since the market value is volatile, whereas a rating should not be.



## Credit Policy

### ■ Appendix 1

#### Overview of Minimum Hedge Counterparty Ratings

Highest Notes' Rating	Minimum Counterparty Rating	Replacement/Guarantee Recommended Upon Downgrade Below
'AA-' or Better	'F1/A'	'F2/BBB+'
'A+/A'	'F1/A'	'F2/BBB+'
'A-/BBB+'	'F2/BBB+'	'F2/BBB+'
'BBB' or Lower	Hedge Counterparty's Long-Term Rating To Be as Good as Highest Rated Notes	

The above table shows the minimum Fitch ratings to be maintained by a hedge counterparty depending on the rating of the highest-rated notes. The criteria for notes rated 'AA-' or higher are described in detail in the report. Where the highest rated notes in a transaction carry a rating of 'A+' or below, lower minimum Fitch ratings apply for the hedge counterparty. Here,

the same structural protection mechanisms (guarantor, replacement, and collateralization) will be applied within the same cure period (30 calendar days) as for notes rated 'AA-' or higher. For the hedge counterparties rated below 'BBB-', Fitch's criteria expect them to be replaced once their rating drops below the rating of the highest rated notes outstanding.



■ **Appendix 2: Volatility Cushions — Methodology and Amounts**

By incorporating VCs into the CA calculation, Fitch takes into account the fact that the market values of hedge agreements (and hence the SPV's credit exposure to hedge counterparties) are subject to volatility over time. The mark-to-market volatility for various interest rate derivatives and cross-currency swaps was analyzed for both a three-week and a four-week exposure period, reflecting the valuation and posting period of one day or one week, plus the assumed time needed to find a replacement hedge counterparty (three weeks). While the VCs included in the tables shown on the next two pages assume weekly posting of collateral, VCs corresponding to daily posting will be provided by the agency on a case-by-case basis.

The VCs have been computed as the value at risk (VAR) of the hedge instrument, assumed to be at the money on the day the collateral is posted, using confidence levels in line with market practice for short-term risk horizons and reflective of the SF notes' rating. Higher confidence intervals were applied to higher rating scenarios. These VAR estimates have been derived using both the parametric and the historical approach.

Parametric VAR estimates have been computed according to the delta-normal method, whereby a first-order approximation is used to determine the derivative's profit and loss profile as a function of the changes in the relevant interest rates (and exchange rate for cross-currency swaps), and the latter are assumed to be normally distributed. A preliminary step for this computation has been mapping the derivative's cash flows into the equivalent positions in adjacent standard-maturity zero coupon bonds.

Historical simulation has then been used to cross-check and fine tune the parametric VAR estimates. By using a bootstrap approach to simulate the market value movements based on historical data, the agency captured the correlation between risk factors as well as fat tails, jumps, or any departure from the normal distribution typically assumed under the parametric approach. Moreover, by randomly selecting data clusters instead of individual data points, the agency also addressed the issue of serial auto correlation that the data may display.

Fitch believes the same collateralization buffers are generally applicable to both interest rate swaps and collars, while a different set of VCs is needed for interest rate caps; the latter has been derived using the historical VAR approach only. Given the varying pricing assumptions for certain instruments such as balanced guaranteed swaps, Fitch elected to apply a multiplier to the VCs for these types of swaps, as described in the second formula on page 11.

VCs for hedge agreements commonly seen in SF transactions are shown in the tables on pages 16 and 17. Fitch may revise these if market volatility conditions shift substantially and/or update its criteria report to incorporate VCs for other hedge agreements.

The VCs are dependent on the type of hedge and its WAL, assuming zero prepayment rate and zero defaults in the portfolio. For products with typically high prepayment rates, Fitch may be comfortable with WAL calculations in line with their base case assumption. In cases where the WAL of the hedge includes a partial year, the applicable VC should be that corresponding to the WAL that results from rounding up to the next whole number.





## Credit Policy

### Volatility Cushions for Interest Rate Swaps and Collars

(%, Assuming Weekly Posting of Collateral)

Currency	Notes' Rating	Basis Swap	Weighted Average Life (Years)									
			1	2	3	4	5	6	7	8	9	10
AUD	'AA-' or Better	0.14	0.5	1.1	1.6	2.2	2.6	2.7	3.4	4.3	4.4	4.5
AUD	'A+/A'	0.10	0.3	0.7	1.1	1.5	1.8	1.9	2.3	2.9	3.0	3.1
AUD	'A-/BBB+'	0.07	0.2	0.5	0.8	1.1	1.3	1.4	1.7	2.1	2.2	2.3
EUR	'AA-' or Better	0.11	0.4	1.0	1.6	2.1	2.5	2.8	3.1	3.4	3.6	3.9
EUR	'A+/A'	0.07	0.2	0.6	1.0	1.3	1.5	1.7	1.9	2.1	2.2	2.4
EUR	'A-/BBB+'	0.05	0.2	0.5	0.7	1.0	1.1	1.3	1.4	1.6	1.7	1.8
GBP	'AA-' or Better	0.12	0.4	1.1	1.6	2.0	2.4	2.7	3.0	3.2	3.5	4.0
GBP	'A+/A'	0.07	0.3	0.6	0.9	1.2	1.4	1.5	1.8	1.9	2.0	2.3
GBP	'A-/BBB+'	0.05	0.2	0.5	0.7	0.9	1.1	1.2	1.4	1.5	1.6	1.8
JPY	'AA-' or Better	0.06	0.2	0.5	0.9	1.5	2.1	2.8	3.3	4.2	4.5	4.7
JPY	'A+/A'	0.03	0.1	0.3	0.5	0.8	1.1	1.5	1.8	2.2	2.4	2.5
JPY	'A-/BBB+'	0.02	0.1	0.2	0.3	0.5	0.8	1.0	1.2	1.5	1.6	1.7
USD	'AA-' or Better	0.19	0.6	1.6	2.6	3.4	4.2	4.8	5.5	5.9	6.4	7.0
USD	'A+/A'	0.10	0.3	0.8	1.3	1.7	2.1	2.4	2.8	3.0	3.3	3.6
USD	'A-/BBB+'	0.07	0.2	0.6	1.0	1.3	1.6	1.9	2.1	2.3	2.5	2.7
CHF	'AA-' or Better	0.15	0.4	1.1	1.7	2.1	2.5	2.8	3.2	3.5	3.8	4.2
CHF	'A+/A'	0.09	0.3	0.7	1.0	1.3	1.5	1.7	1.9	2.1	2.3	2.5
CHF	'A-/BBB+'	0.07	0.2	0.5	0.8	1.0	1.2	1.3	1.5	1.6	1.8	2.0
SEK	'AA-' or Better	0.11	0.4	1.0	1.5	2.0	2.5	2.8	3.2	3.4	3.7	4.1
SEK	'A+/A'	0.07	0.2	0.7	1.0	1.4	1.7	1.9	2.1	2.3	2.5	2.7
SEK	'A-/BBB+'	0.06	0.2	0.5	0.8	1.1	1.3	1.4	1.6	1.8	1.9	2.1

Note: Columns four to 10 show the volatility cushions for fixed-for-floating interest rate swaps and interest rate collars. The third column (titled Basis Swap) shows volatility cushions that apply to interest rate basis swaps; the former depend on the weighted average life, the latter do not.

### Volatility Cushions for Cross-Currency Swaps

(%, Assuming Weekly Posting of Collateral)

Currency	Notes' Rating	Basis Swap	Weighted Average Life (Years)									
			1	2	3	4	5	6	7	8	9	10
AUD/EUR	'AA-' or Better	8.4	8.4	8.6	8.8	8.9	9.1	9.2	9.4	9.5	9.6	9.8
AUD/EUR	'A+/A'	6.2	6.2	6.4	6.5	6.6	6.7	6.8	6.9	7.0	7.1	7.2
AUD/EUR	'A-/BBB+'	4.5	4.5	4.6	4.7	4.8	4.9	4.9	5.0	5.1	5.1	5.2
AUD/USD	'AA-' or Better	7.7	7.7	7.7	7.7	7.8	7.9	8.1	8.2	8.5	8.6	8.7
AUD/USD	'A+/A'	5.5	5.5	5.5	5.6	5.6	5.7	5.8	5.9	6.1	6.2	6.3
AUD/USD	'A-/BBB+'	4.6	4.6	4.6	4.7	4.7	4.8	4.9	5.0	5.1	5.2	5.3
EUR/GBP	'AA-' or Better	4.6	4.7	4.8	4.9	5.1	5.3	5.4	5.6	5.7	5.8	6.0
EUR/GBP	'A+/A'	3.7	3.8	3.8	4.0	4.1	4.2	4.4	4.5	4.6	4.7	4.9
EUR/GBP	'A-/BBB+'	3.0	3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9
EUR/USD	'AA-' or Better	8.0	8.1	8.3	8.6	8.8	9.0	9.1	9.3	9.4	9.5	9.7
EUR/USD	'A+/A'	5.1	5.2	5.3	5.5	5.6	5.8	5.9	6.0	6.0	6.1	6.2
EUR/USD	'A-/BBB+'	4.3	4.4	4.5	4.7	4.8	4.9	5.0	5.1	5.1	5.2	5.3
GBP/USD	'AA-' or Better	6.4	6.4	6.5	6.6	6.7	6.8	6.9	7.1	7.2	7.3	7.5
GBP/USD	'A+/A'	4.2	4.2	4.3	4.3	4.4	4.5	4.6	4.7	4.8	4.8	4.9
GBP/USD	'A-/BBB+'	3.4	3.4	3.5	3.5	3.6	3.6	3.7	3.8	3.8	3.9	4.0
JPY/USD	'AA-' or Better	6.5	6.5	6.5	6.5	6.5	6.6	6.7	6.8	7.0	7.1	7.4
JPY/USD	'A+/A'	4.8	4.8	4.8	4.8	4.8	4.8	4.9	5.0	5.1	5.2	5.4
JPY/USD	'A-/BBB+'	3.5	3.5	3.5	3.5	3.5	3.6	3.6	3.7	3.8	3.9	4.0
GBP/CHF	'AA-' or Better	5.2	5.2	5.3	5.5	5.6	5.8	5.9	6.1	6.2	6.3	6.5
GBP/CHF	'A+/A'	3.8	3.8	3.9	4.0	4.1	4.2	4.3	4.4	4.5	4.6	4.7
GBP/CHF	'A-/BBB+'	2.9	2.9	3.0	3.1	3.2	3.3	3.3	3.4	3.5	3.6	3.7
JPY/EUR	'AA-' or Better	8.1	8.2	8.3	8.4	8.6	8.7	8.8	8.9	9.0	9.1	9.3
JPY/EUR	'A+/A'	5.1	5.2	5.3	5.3	5.4	5.5	5.6	5.6	5.7	5.8	5.9
JPY/EUR	'A-/BBB+'	3.8	3.9	3.9	4.0	4.1	4.1	4.2	4.2	4.3	4.3	4.4

Note: Columns four to 10 show the volatility cushions for cross-currency swaps. The third column (titled Basis Swap) shows volatility cushions that apply to foreign currency basis swaps; the former depend on the weighted average life, the latter do not.



## Credit Policy

### Volatility Cushions for Interest Rate Caps

(%, Assuming Weekly Posting of Collateral)

Currency	Notes' Rating	Weighted Average Life (Years)									
		1	2	3	4	5	6	7	8	9	10
AUD	'AA-' or Better	0.4	0.9	1.3	1.7	2.0	2.3	2.4	2.7	2.8	3.2
AUD	'A+/A'	0.3	0.6	0.9	1.2	1.5	1.7	1.9	1.9	1.9	2.4
AUD	'A-/BBB+'	0.2	0.5	0.8	1.0	1.1	1.2	1.5	1.4	1.5	1.9
EUR	'AA-' or Better	0.3	0.8	1.3	1.5	1.9	1.9	2.1	2.2	2.4	2.4
EUR	A+/A	0.2	0.6	0.9	1.2	1.3	1.4	1.6	1.6	1.7	1.7
EUR	'A-/BBB+'	0.2	0.5	0.7	0.9	1.1	1.2	1.2	1.3	1.3	1.3
GBP	'AA-' or Better	0.4	1.0	1.3	1.7	1.7	1.7	2.0	2.2	2.2	2.2
GBP	'A+/A'	0.2	0.6	0.8	1.0	1.1	1.1	1.3	1.5	1.5	1.5
GBP	'A-/BBB+'	0.2	0.4	0.6	0.8	0.9	0.9	1.0	1.2	1.2	1.2
JPY	'AA-' or Better	0.1	0.4	0.8	1.4	1.8	2.6	3.2	4.0	4.5	4.5
JPY	'A+/A'	0.1	0.3	0.5	0.8	1.1	1.3	1.4	1.7	1.9	1.9
JPY	'A-/BBB+'	0.1	0.2	0.3	0.6	0.7	1.0	1.1	1.1	1.5	1.5
USD	'AA-' or Better	0.4	1.3	2.1	2.8	3.3	4.0	4.0	4.3	4.5	5.0
USD	'A+/A'	0.3	0.8	1.3	1.7	1.8	2.4	2.4	2.4	2.5	2.5
USD	'A-/BBB+'	0.2	0.6	0.9	1.2	1.2	1.6	1.6	1.8	1.8	1.9
CHF	'AA-' or Better	0.3	1.1	1.5	1.9	2.2	2.2	2.3	2.4	2.6	2.6
CHF	'A+/A'	0.3	0.6	0.8	1.0	1.3	1.4	1.6	1.7	1.9	1.9
CHF	'A-/BBB+'	0.2	0.5	0.7	0.8	1.0	1.1	1.2	1.3	1.5	1.5
SEK	'AA-' or Better	0.3	0.8	1.2	1.7	1.9	2.1	2.1	2.3	2.6	2.6
SEK	'A+/A'	0.2	0.6	0.9	1.2	1.4	1.4	1.5	1.7	1.8	1.8
SEK	'A-/BBB+'	0.2	0.4	0.7	0.9	1.1	1.2	1.2	1.3	1.4	1.4

### ■ Appendix 3: Advance Rates — Methodology and Amounts

ARs, the inverse of overcollateralization, are designed to provide coverage for movement in a collateral's market value over time, or the collateral's market value risk. For instance, for a collateral security with a 95% AR, 105.3% of securities would be posted to cover the potential exposure. ARs are a function of the exposure period, which is hereafter assumed to be four weeks, consisting of the valuation and posting period of one week plus the assumed time needed to find a replacement hedge counterparty (three weeks). ARs based on daily valuation and posting will be provided by the agency on a case-by-case basis.

In line with what was previously described for the VCs, ARs have been computed as the VAR of the collateral using confidence levels that are in line with market practice for short-term risk horizons and reflective of the SF notes' rating. Higher confidence intervals were applied to higher rating scenarios. These VAR estimates have been derived using both the parametric and the historical approach.

Parametric VAR estimates have been computed according to the delta-normal method, whereby a first-order approximation is used to determine the collateral's profit and loss profile as a function of the changes in the relevant interest rates, and the latter are assumed to be normally distributed. A preliminary step for this computation has been mapping the collateral's cash flows into the equivalent positions in adjacent standard-maturity zero coupon bonds.

Historical simulation has then been used to cross-check and fine tune the parametric VAR estimates. By using a bootstrap approach to simulate the market value movements based on historical data, the agency

captured the correlation between risk factors as well as fat tails, jumps, or any departure from the normal distribution typically assumed under the parametric approach. Moreover, by randomly selecting data clusters instead of individual data points, the agency also addressed the issue of serial auto correlation that the data may display.

Depending on the term of the posted collateral, the following minimum Fitch ratings apply to the collateral posted:

- Maximum term of 30 days — 'F1'
- Maximum term of 360 days — 'F1+'
- Maximum term of greater than 360 days — 'AAA'

The table on page 19 contains ARs for some of the collateral Fitch has more frequently seen in transactions — i.e. fixed-rate government bonds. Advance rates for U.S. agency debt (i.e. debt issued by Fannie Mae) may be calculated by applying a multiplier of 0.99 to the applicable U.S. government bond advance rate with consideration given to collateral maturity and notes rating.

This is summarized as:

$$AR (U.S. \text{ agency debt}) = 0.99 \times AR (U.S. \text{ government debt})$$

The agency may provide ARs for collateral types other than those included in this table on a case-by-case basis. If the collateral is not provided in the currency of the rated notes, the corresponding market value risk is subject to currency risk on top of interest rate risk, and a more conservative AR applies. These ARs will be provided by the agency on a case-by-case basis.



# Credit Policy

## Advance Rates for Government Bonds

(Assuming Weekly Posting of Collateral)

Region	Currency	Maturity (Years)		Notes' Rating (%)			
		>	≤	'AAA'	'AA'	'A'	'BBB'
Australia	AUD	0	1	99.5	99.7	99.7	99.8
Australia	AUD	1	3	98.5	98.9	99.2	99.3
Australia	AUD	3	5	97.6	98.1	98.7	98.9
Australia	AUD	5	7	96.5	97.4	98.2	98.6
Australia	AUD	7	10	95.4	96.8	97.6	98.1
Australia	AUD	10	15	93.6	95.9	96.8	97.4
Europe	EUR	0	1	99.6	99.7	99.8	99.8
Europe	EUR	1	3	98.7	99.1	99.3	99.4
Europe	EUR	3	5	98.0	98.6	98.9	99.1
Europe	EUR	5	7	97.5	98.2	98.6	98.9
Europe	EUR	7	10	96.8	97.7	98.2	98.6
Europe	EUR	10	15	95.9	97.1	97.7	98.2
U.K.	GBP	0	1	99.6	99.7	99.8	99.8
U.K.	GBP	1	3	98.5	99.1	99.3	99.4
U.K.	GBP	3	5	97.9	98.6	98.9	99.1
U.K.	GBP	5	7	97.2	98.2	98.6	98.9
U.K.	GBP	7	10	96.7	97.7	98.2	98.5
U.K.	GBP	10	15	95.7	97.0	97.6	98.1
Japan	JPY	0	1	99.9	99.9	99.9	100.0
Japan	JPY	1	3	99.3	99.6	99.7	99.8
Japan	JPY	3	5	98.6	99.1	99.3	99.5
Japan	JPY	5	7	97.7	98.6	99.0	99.2
Japan	JPY	7	10	96.0	98.2	98.6	98.8
Japan	JPY	10	15	94.0	97.4	98.0	98.3
U.S.	USD	0	1	99.5	99.6	99.7	99.8
U.S.	USD	1	3	98.2	98.7	99.0	99.2
U.S.	USD	3	5	96.6	97.9	98.4	98.7
U.S.	USD	5	7	95.3	97.3	97.9	98.3
U.S.	USD	7	10	93.9	96.4	97.2	97.7
U.S.	USD	10	15	92.7	95.5	96.5	97.1
Switzerland	CHF	0	1	99.5	99.7	99.8	99.8
Switzerland	CHF	1	3	98.3	99.1	99.3	99.4
Switzerland	CHF	3	5	97.6	98.7	98.9	99.2
Switzerland	CHF	5	7	97.1	98.3	98.7	99.0
Switzerland	CHF	7	10	96.7	97.8	98.3	98.7
Switzerland	CHF	10	15	95.7	97.0	97.7	98.2
Sweden	SEK	0	1	99.6	99.7	99.8	99.8
Sweden	SEK	1	3	98.6	99.0	99.2	99.4
Sweden	SEK	3	5	97.8	98.5	98.8	99.0
Sweden	SEK	5	7	97.2	98.0	98.5	98.8
Sweden	SEK	7	10	96.4	97.5	98.0	98.3
Sweden	SEK	10	15	96.0	97.0	97.8	98.2
Denmark	DKK	0	1	99.6	99.7	99.8	99.8
Denmark	DKK	1	3	98.7	99.1	99.3	99.4
Denmark	DKK	3	5	97.9	98.5	98.9	99.1
Denmark	DKK	5	7	97.4	98.1	98.5	98.8
Denmark	DKK	7	10	96.7	97.6	98.2	98.5
Canada	CAD	0	1	99.5	99.6	99.7	99.8
Canada	CAD	1	3	98.2	98.8	99.1	99.3
Canada	CAD	3	5	97.4	98.2	98.6	98.9
Canada	CAD	5	7	96.8	97.7	98.2	98.5
Canada	CAD	7	10	96.1	97.2	97.6	98.2
Canada	CAD	10	15	95.0	96.4	97.1	97.7

### ■ Appendix 4: Examples

#### 1. EUR Fixed-For-Floating Swap on a Spanish RMBS Transaction (Fixed Amortization Schedule):

Notional of swap: EUR400 million

WAL of swap: six years

Market value of swap in favor of issuer (swap counterparty out of money): EUR1.5 million

Highest note rating: 'AAA'

VC (see Appendix 2, page 16): 2.8%

CA upon downgrade below 'A/F1':

$$\begin{aligned} CA_{\text{swap}} &= \max[MV_{\text{swap}} + VC_{\text{swap}} \times N_{\text{swap}}; 0] \\ CA_{\text{swap}} &= \max[1,500,000 + 2.8\% \times 400,000,000; 0] \\ &= \max[1,500,000 + 11,200,000; 0] = \text{EUR}12,700,000 \end{aligned}$$

Collateral type: EUR-denominated government bond, six-year tenor

AR (see Appendix 3, page 19): 97.5%

Actual CA: EUR12,700,000/97.5% = EUR13,025,641

#### 2. USD Fixed-For-Floating Swap on a U.S. Credit Card Transaction (Balance Guaranteed):

Notional of swap: USD1 billion

WAL of swap: 2.8 years

Market value of swap in favor of the swap counterparty (issuer out of money): USD3 million

Highest note rating: 'AAA'

VC (see Appendix 2, page 16): 2.6% (The VC used is that corresponding to the hedge with a WAL that is rounded to the next higher whole number.)

CA upon downgrade below 'A/F1':

$$\begin{aligned} CA_{\text{swap}} &= \max[MV_{\text{swap}} + VC_{\text{swap}} \times 105\% \times N_{\text{swap}}; 0] \\ CA_{\text{swap}} &= \max[-3,000,000 + 2.6\% \times 105\% \times 1,000,000,000; 0] \\ &= \max[-3,000,000 + 27,300,000; 0] = \text{USD}24,300,000 \end{aligned}$$

Collateral type: U.S. treasuries, seven-year tenor

AR (see Appendix 3, page 19): 95.3%

Actual CA: USD24,300,000/95.3% = USD25,498,426

#### 3. JPY/USD Cross-Currency Swap on a Japanese Consumer Loan Transaction (Balance Guaranteed):

Notional of swap: JPY900 billion

WAL of swap: 3.7 years

Market value of swap in favor of the counterparty (issuer out of money): JPY7 billion

Highest note rating: 'AAA'

VC (see Appendix 2, page 16): 6.5%

CA upon downgrade below 'A/F1':

$$\begin{aligned} CA_{\text{swap}} &= \max[MV_{\text{swap}} + VC_{\text{swap}} \times 105\% \times N_{\text{swap}}; 0] \\ CA_{\text{swap}} &= \max[-7\text{bn} + 6.5\% \times 105\% \times 900\text{bn}; 0] \\ &= \max[-7\text{bn} + 61.4\text{bn}; 0] = \text{JPY}54.4 \text{ billion} \end{aligned}$$

Collateral type: Japanese government bond, nine-year tenor

AR (see Appendix 3, page 19): 96.0%

Actual CA: JPY54.4 billion/96.0% = JPY56.69 billion

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# **EXHIBIT C**





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**Criteria**

**CDO Spotlight: Counterparty Risk In Structured Finance Transactions**

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As soon as a transaction relies on a counterparty to make payments of interest and or principal, the transaction is exposed to counterparty risk, which needs to be addressed in the rating analysis.

This article clarifies our approach to considering counterparty risk when analyzing structured finance transactions. It focuses on one of two possible approaches, which is most prevalent in synthetic CDO transactions.

**Overview Of Approaches To Analyzing Counterparty Risk**

There are two general approaches that we take when considering counterparty risk: the linked approach and the delinked approach. Since the rating on the counterparty has a material affect on the risk of the notes issued, following the first approach the rating on the notes can be simply linked to the long-term rating on the counterparty.

The delinked approach structurally mitigates the credit risk of the counterparty from the notes, making them less dependent on the creditworthiness of the counterparty. This mitigated credit risk can be achieved in either of two ways: by ensuring that the counterparty would be replaced once it is no longer sufficiently rated, or by structuring the transaction in such a way that it would terminate with no loss to investors if the counterparty did not comply with certain downgrade provisions. The latter approach is mostly used in synthetic CDO transactions.

Since the linked approach needs no further explanation and the replacement provisions are described in the article *"Global Interest Rate and Currency Swaps: Calculating the Collateral Required Amount"* (see *"Related Articles"* for details), this article focuses on our requirements for mitigating counterparty risk in structures that would terminate without loss for investors.

In order to separate counterparty risk from a transaction with termination-with-no-loss characteristics, counterparties must have an initial, minimum, short-term, senior unsecured credit rating of 'A-1+' or a long-term senior unsecured credit rating of 'AA-' to support a 'AAA' rated transaction. Alternatively, they must provide additional collateral. These initial rating requirements are adjusted according to the rating on the notes issued.

If the counterparty is downgraded below 'A-1+/AA-', it either has to be replaced with a suitably rated counterparty, find a suitably rated guarantor, or post collateral in a market-standard manner.

If the counterparty is downgraded below 'A-2/BBB+', in addition it has to provide a legal opinion that provides comfort as to the ability of the SPE to terminate the swap contract and access the collateral free from interference or delay upon the bankruptcy of the counterparty. Or, if this opinion is not provided it has to pay the amount that was promised under the swap contract to the counterparty into a separate cash account of a sufficient rating.

In case the counterparty does not comply with at least one of the above provisions, the transaction should provide for termination with no loss to the noteholders. This "no loss" criterion includes losses that may arise from the payment of a termination payment under the swap or market-value loss from the collateral posted against the swap.

By adopting the above structural features, the transaction should sufficiently mitigate the credit risk of a counterparty to allow the counterparty to remain in a transaction at all rating levels without posing additional credit risk to the transaction — i.e., the ratings on the notes are not directly dependent on the counterparty's rating. The absence of at least one of these elements, however, would expose the transaction to the risk that the counterparty may fail to perform on its obligations, and thus necessitate the linking of the ratings on the issued notes to the long-term rating on the counterparty.

### **What Is Counterparty Risk?**

For most structured finance transactions, our rating addresses the creditworthiness of the obligor with respect to a specific financial obligation. It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation, and the currency in which the obligation is denominated. If the payment of interest and/or principal could be affected by the counterparty, the performance of the transaction and therefore the rating on the notes issued out of it depends on the performance of the counterparty.

While counterparty risk affects all structured finance transactions that rely on counterparties, it is especially prevalent in synthetic CDO transactions. These transactions typically include a variety of swap agreements, such as credit default swaps (CDSs), interest-rate swaps, currency swaps, total return swaps (TRSs), and asset swaps. They may also include similar agreements such as reverse repurchase (repo), exchange, and put agreements. The counterparties in these types of agreements typically contribute directly to the payment of interest and/or principal.

There are other counterparties that also provide support to synthetic CDOs and other structured finance transactions, but do not contribute directly to payments of interest and/or principal, such as account banks and custodians. The rating requirements for these entities may be found in the criteria referenced at the end of this article.

### **How Does Counterparty Risk Affect A Transaction?**

Counterparty risk has two elements that may affect a structured finance transaction. The first element is direct. As stated above, credit risk exists because of a potential default of the counterparty on which the transaction relies to contribute to the interest and/or principal payments on the notes. This default is likely to lead to a shortfall in the payment of interest and/or principal or in some cases no payment at all. As a result, the notes would most likely be considered defaulted.

The second element is less direct. While the default of the counterparty causes an immediate infringement on payments to a transaction, any termination of the swap agreement could also cause a termination payment to be paid by the noteholders. This termination risk arises when the swap at the point of termination is "out of the money" from the point of view of the noteholders. In the swaps market, the noteholders would normally be required to make a payment to the swap counterparty to be compensated for the value of the swap. This could lead to a shortfall in interest and principal payments and thus result in a default of the rated notes.

### Example Of Counterparty Risks In A Synthetic CDO Transaction

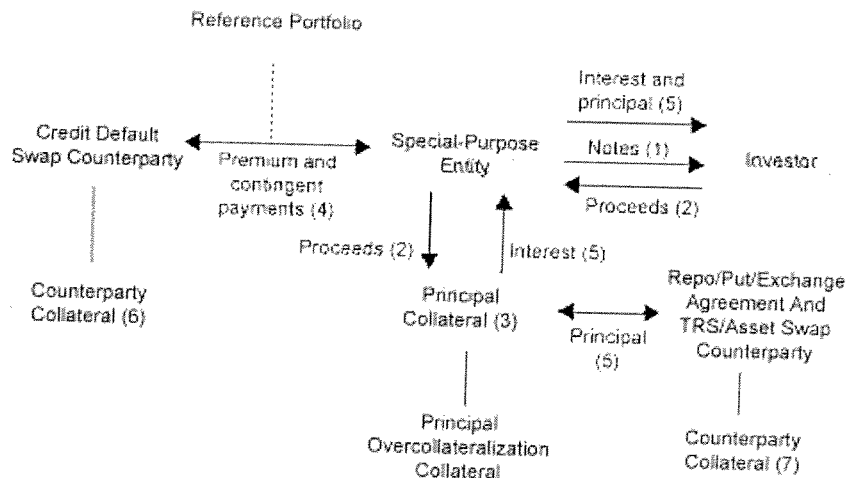
A further example of counterparty risks in synthetic CDO transactions can be found in the following sidebar.

#### Example Of Counterparty Risks In A Synthetic CDO Transaction

A bankruptcy remote vehicle (SPE) issues a note that is purchased by the investor, denoted as (1) in chart 1. With the proceeds it receives from the investor (2), the SPE purchases collateral in the same amount (3). The principal collateral is typically a highly rated, liquid security and is referred to in the chart as "principal collateral".

At the same time, the SPE enters into a CDS with the CDS counterparty referencing a portfolio of reference entities. The SPE is the protection seller and therefore has to make contingent payments once there is a credit event in the reference portfolio. The CDS counterparty is the protection buyer and therefore has to pay a premium on a periodic basis (4).

Chart 1  
Example Of Counterparty Risk In A Synthetic CDO Transaction



The noteholders receive interest on a periodic basis and principal at maturity, subject to the number of credit events in the reference pool. Interest payments come from the premium payment the SPE receives from the CDS counterparty (4) and/or the interest received from the collateral (5) to make those payments. Principal payments come from the principal collateral, often in conjunction with a repo, put, exchange, TRS, or asset swap agreement. These agreements are used to mitigate market risk when the collateral is sold. Collateral typically only needs to be sold upon early termination as the collateral matures at the same time as the notes. Alternatively, the transaction may be structured so as to physically deliver the principal collateral to noteholders, or to overcollateralize the principal collateral so as to offset market value risk. In addition the SPE also needs to ensure it has sufficient funds to pay the fees.

Other than the principal collateral, there are two other instances in the chart where obligations may be collateralized. If the CDS counterparty is rated below the levels necessary to support the interest payments on the rated notes, this risk may be offset by posting some additional collateral, indicated as "counterparty collateral" (6). Also, the repo, put, exchange, TRS, or asset swap counterparty is rated below the necessary level to support the principal payments on the rated notes. If so, the counterparty is required to post additional counterparty collateral (7).

## The Exposures To The Various Counterparties

### **Exposure To The CDS Counterparty**

The CDS counterparty makes premium payments, on which the issuer relies to pay interest on the notes.

### **Exposure To Repo, Asset Swap, TRS, Exchange Agreement Or Put Counterparty**

The issuer relies on these counterparties to make the following principal and/or interest payments:

- Asset swap/TRS/exchange agreement: all cash flows received from the collateral (typically both interest and principal) are swapped to pay all cash flows that have to be paid to the noteholders (typically both interest and principal). As a result there is exposure to the asset swap counterparty for the interest and/or principal amount.
- Put counterparty: the collateral is given to the put counterparty in return for cash. Therefore, exposure to the put counterparty for the principal amount (either the full amount or only the market risk element).
- Repo counterparty: the counterparty pays the par value of the collateral. Exposure to the repo counterparty is for the principal amount (either the full amount or only the market risk element).

In most cases there is exposure to the counterparty for only the market risk element of the collateral as the sale of the collateral would have been perfected at closing and therefore the issuer would be the owner of the collateral.

### **Exposure To Termination Payments**

On termination of the CDS, TRS, or asset swap, a termination payment could be due to the counterparty from the issuer, depending on if the swap is in or out of the money. The exact amount is difficult to size upfront.

## Different Types Of Collateral

### **Principal Collateral**

At issuance, the proceeds of the notes are invested in collateral. The rating on the collateral needs to be in accordance with the rating on the notes and any potential market risk needs to be addressed. Mitigants to the market risk are physical delivery of the collateral, overcollateralization (having more collateral than the par amount), or having a counterparty taking this risk (via repo, put, TRS, or asset swap agreement).

### **Counterparty Collateral**

If the counterparty is not or no longer adequately rated, the counterparty can remain in the transaction by collateralizing its the exposure.

### **Principal Overcollateralization Collateral**

To account for the market risk when selling the collateral, extra collateral can be provided to account for this shortfall.

## Distinguishing Between Swap Counterparty Risk In Various Structured Finance Transactions

There are two general approaches that we take when considering counterparty risk. The first is the most straightforward: since the rating on the counterparty has a material effect on the risk of the notes issued, the rating on the notes can be simply linked to that on the counterparty. Functionally, this means that the rating on the notes is linked to the long-term rating on the counterparty. Or to put it another way, the rating on the notes is "dependent" on the rating on the counterparty.

The second option is to structurally mitigate the credit risk of the counterparty from the notes, making them less dependent on the creditworthiness of the counterparty. This mitigated credit risk can be achieved in either of two ways: by ensuring that the counterparty would be replaced once it is no longer sufficiently rated; or by structuring the transaction in such a way that it would terminate with no loss to investors if the counterparty does not comply with the downgrade provisions described below.

While the former is quite commonly employed in structured finance transactions with interest-rate and foreign exchange swaps that cannot terminate early without loss, the latter is much more familiar in the context of synthetic CDOs, where transactions may be relatively easily terminated without losses incurring to investors. Indeed, this ability to terminate without unwind costs is the crucial characteristic that allows properly structured synthetic CDOs to face a diverse array of swap types and counterparties without significantly increasing noteholders' exposure to counterparty risk.

To further differentiate between these two types of structural mitigation, consider two structures: one, a typical structured finance transaction that is unable to terminate without substantial unwind costs (e.g., a cash flow CDO) and two, a structured finance transaction that can terminate early with no loss (e.g., a synthetic CDO). In both cases, we assume that an interest-rate swap is employed (slightly rare, but not unheard of in synthetic CDOs).

The function of the interest-rate swap in the cash flow CDO context is typical of most structured finance transactions: proceeds from notes issued from the SPE are used to purchase assets, the yield of which would be swapped into the rate (fixed or float) of the note coupon. In this case, the existence of the interest-rate swap is essential to the functioning of the transaction: if the interest-rate counterparty fails, the SPE is in a bind. The collateral manager would have to either sell assets in order to pay the coupon due to the transaction's sudden exposure to interest-rate risk, or would have to try to dispose the mismatched assets or liabilities, exposing the transaction to market-value risk.

In transactions that can instantly terminate with no loss to noteholders, however, there is another choice. In a synthetic CDO, notes are also issued from an SPE, the proceeds of which are reserved in cash or eligible investments. The yield on these investments might be swapped using an interest-rate swap into the appropriate note coupon. The synthetic CDO is also exposed to the risk of a portfolio of reference obligations, but never physically purchases them.

Consequently, if the interest-rate swap counterparty is unable to perform, the synthetic CDO can always terminate and simply return principal to investors, with no market-value loss. If the timing of the interest-rate swap counterparty's default is such that it falls close to a payment date, there is the risk that investors might fail to get the last coupon payment they were due. However, because the structure contains an early termination feature, the only risk that the counterparty is exposed to is this single coupon payment to the investor. Under the structural features described above, this single payment is reserved up-front (the interest-rate counterparty pays one payment in advance), so even this risk is obviated.

Thus, there are three criteria approaches that may be taken to address the risk of swap counterparties in structured finance transactions:

- Linking the rating on the structured finance notes to the long-term rating on the swap counterparty;
- Ensuring the counterparty would be replaced once it is no longer sufficiently rated to support the transaction (see further information in *"Global Interest Rate and*



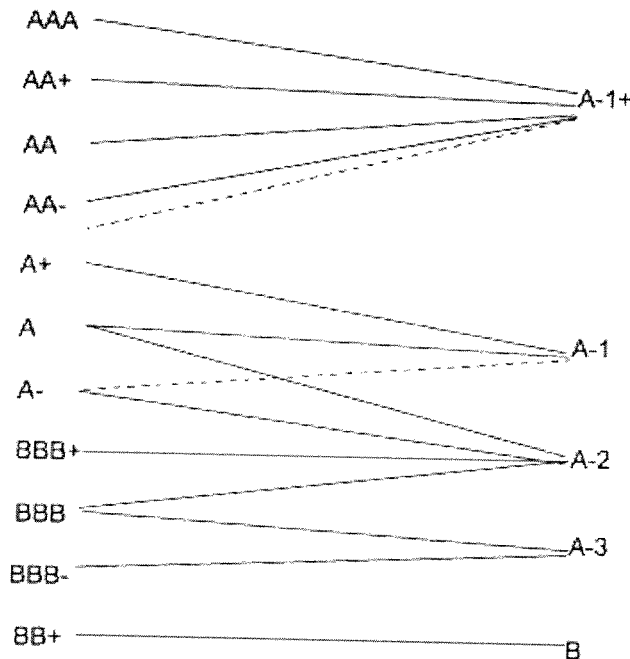
*Currency Swaps: Calculating the Collateral Required Amount*" detailed under "Related Articles" below); and

- Relying on the termination-with-no-loss characteristics of certain structured finance transactions, combined with proper structuring.

### Eligible Counterparties In Synthetic Transactions

In assessing the credit exposure to counterparties, we look to the counterparty's rating and the structural mitigants in the transaction. The initial rating requirements are adjusted according to the ratings on the notes issued. We look to either the long-term or the short-term ratings on the counterparty, as illustrated in the following chart.

**Chart 2  
Correlation of CP Ratings with  
Long-Term Corporate Credit Ratings**



*Dotted lines indicate correlations that are highly unusual.*

Initially, counterparties that do not post additional collateral must have a minimum short-term senior unsecured credit rating of 'A-1+' or a long-term senior unsecured credit rating of 'AA-' to support a 'AAA' rated transaction, in which the counterparty risk is mitigated. Again, the initial rating requirements are adjusted according to the rating on the note issued.

If the counterparty is downgraded below 'A-1+/AA-', one of the following actions needs to be taken within 30 calendar days of the date of the downgrade:

- All rights and obligations under the agreement/contract must be transferred to another entity that holds a sufficient rating or whose credit support provider holds a sufficient rating.
- A guarantee or an indemnity from a sufficiently rated entity must be provided.
- Collateral that is acceptable to us must be posted. Collateral should be delivered in a market-standard manner (e.g., under an credit support annex or CSA).

If the counterparty is downgraded below 'A-2/BBB+', one of the following actions must be taken within five calendar days of the date of the downgrade:

- All rights and obligations under the agreement/contract must be transferred to another entity that holds a sufficient rating or whose credit support provider holds a sufficient rating.
- A guarantee or an indemnity from a sufficiently rated entity must be provided.



- Collateral that is acceptable to us must be posted. In addition, a legal opinion that provides comfort as to the ability of the SPE to terminate the swap contract and access the collateral free from interference or delay upon the bankruptcy of the counterparty should be provided subject to our confirmation.
- The exact exposure amount to the counterparty must be paid into a separate cash account (not under a credit support agreement) of sufficient rating. The "exact exposure amount" in this case, is the amount that was promised under the swap contract.

If the counterparty does not comply with the downgrade provisions, the transaction must terminate with no loss to the noteholders. This "no loss" criterion includes losses that may arise from the payment of a termination payment under the swap or market value loss from the collateral posted against the swap.

By adopting the above structural features, a counterparty may remain in a transaction at all rating levels without posing significant additional credit risk to the transaction—i.e., the linkage between the note ratings and the counterparty's rating is mitigated. The absence of any one of these elements, however, will expose the transaction to the risk that the counterparty may fail to perform on its obligations, and thus necessitate the linking of the ratings on issued notes to that of the long-term rating of the counterparty.

### **Collateralization**

As described above, one of the possible remedies after the counterparty's downgrade is to provide collateral to support its obligation. In case of an early termination of the derivative contract upon the bankruptcy or insolvency of the counterparty, it is important to our analysis that the collateral is available to the SPE in a timely manner or that other factors lead to comfort on this issue. Also, the amount of collateral that needs to be provided depends on the exact exposure to the counterparty.

#### **Legal Issues**

In order for us to rely on collateral as a mitigant for counterparty risk, the collateral must be available to the SPE in a timely manner upon the bankruptcy or insolvency of the counterparty.

We consider that counterparties rated 'A-2/BBB+' or above are sufficiently rated to support the 'AAA' rated transaction so as long they can provide collateral in a market standard manner. Once the counterparty is rated below 'A-2/BBB+', there are two options, namely:

- The exposure to the counterparty must be removed by paying the exposure amount to the counterparty into a separate account (not posted under a CSA).
- Or additional legal opinions must be provided that gives comfort as to the ability of the SPE to terminate the derivative contract, net the exposures, liquidate the collateral, and apply the collateral free from interference or delay upon the bankruptcy of the counterparty subject to confirmation by us.

It is important to note that the criteria described above are applicable when collateral is supplied by insufficiently rated counterparties (i.e., "counterparty collateral" in chart 1 above) for the purposes of mitigating the credit risk posed by those counterparties. This differs from our criteria for the legal risks of the collateral in which the proceeds of the notes are invested ("principal collateral") at the close of the transaction. The SPE's timely access to this collateral must be addressed and analyzed for each transaction. In some cases legal opinions confirming this point may be required.

#### **Collateralization And Prepayment Requirements**

The amount that needs to be posted as collateral depends on the exact exposure the noteholders have to the counterparty. This can be as small as one premium payment and as large as the full principal and interest amount of the notes being supported. To illustrate this, these collateralization requirements are applied below to two of the common counterparties in synthetic single-tranche transactions: CDS counterparties and repo/put/exchange agreement and asset swap/TRS counterparties.

##### *Example 1: Credit Default Swap Counterparty*

In a CDS, the protection buyer is contractually obligated to pay regular premium payments, while the protection seller may be required to make loss payments in the case

of a credit event. Therefore, the noteholders in a synthetic single-tranche CDO are exposed to the risk that the protection buyer may fail to make its payments.

Once the protection buyer is rated below 'A-1+/AA-' but above 'A-2/BBB+', the protection buyer needs to post one premium (and also the applicable grace period and accrued interest in case of an unsettled credit event) in advance. When the counterparty's rating falls below 'A-2/BBB+', the counterparty must either be replaced or the premium needs to be prepaid in a separate 'A-1+' rated account (separate from the CSA) or legal opinions (as to timely access to counterparty collateral) need to be provided subject to our confirmation. It is important to note that if the counterparty prepays the one premium rather than posting under a CSA, generally we do not request that legal comfort be provided.

*Example 2: Repo/Put/Exchange Agreement And Asset Swap/TRS Counterparty*

In a repo or put agreement the collateral is delivered in return for the par amount of principal. In asset and TRSs the returns on the collateral are swapped into payments due on the issued notes, thereby swapping interest payments and principal payments regardless of the performance of the underlying collateral.

Once rated below 'A-1+/AA-', the counterparty must post the market risk component of the collateral. Effectively, this is the amount that is likely to be lost when selling the collateral, thereby making the collateral so-called 'AAA' good even in the event that it must be sold prior to maturity. As at closing, the sale of the principal collateral will have been perfected, leaving only the exposure to the market risk component.

If a counterparty chooses to prepay the swap, then the exact exposure amount to the counterparty must be paid into a separate cash account (not under a credit support agreement) of sufficient rating. The exact exposure amount, in this case, is the amount that was promised under the swap contract.

In many cases, this prepayment is tantamount to an early execution or termination of the swap, with no termination payments. In the case of a reverse repo, for instance, the criteria outlined above require the repo counterparty to pay the exact amount of its exposure to the SPE. This is, of course, equivalent to the principal amount that the repo counterparty exchanged in the first place. A prepayment of a repo agreement, then, means simply repurchase of the repo securities in exchange for payment of the principal amount to the SPE, effectively terminating the repo agreement.

The situation is similar in the case of a par put provider. In this case, the par put counterparty's commitment to the SPE is to provide par in exchange for collateral. Thus, the prepayment of a par put agreement is better characterized as "early execution" — upon the counterparty's decision to take this route, it must provide par to the SPE in exchange for collateral.

***The Market Risk Of Principal Overcollateralization Collateral***

In any circumstances under which collateral must be sold to make principal repayments or to mitigate the credit risk posted by a counterparty, the sale price of that collateral may be less than the initial par amount due to the market value risk of the collateral instruments. To ensure (to an appropriate rating level) that a structured finance transaction receives at least par from the sale of such collateral, an advance rate or overcollateralization amount should be calculated to offset these potential price declines.

An advance rate or overcollateralization amount is defined as the maximum borrowing amount that may be advanced against the market value of a pool of collateral. This amount is rating dependent: less needs to be advanced in support of higher ratings than lower ratings. If the advance rate is sized correctly, an investor can expect to receive par from a collateral pool with a certainty commensurate with a given rating.

There are two drivers of advance rates: the time horizon (or exposure period) and the asset-price return volatility of the collateral. The exposure period is the number of business days between the last date that the collateral was marked-to-market and the date that the collateral is ultimately sold. This period includes three time intervals: the mark-to-market period, any cure period that may exist, and an appropriate period to liquidate the collateral. The asset-price volatility is used as the market risk of the collateral as it is good proxy for risk in efficient capital markets. Thus, an asset's riskiness on a market

value basis and its advance rate are expected to be significantly and negatively correlated. Several other factors may also influence price volatility, including asset-specific factors such as the liquidity, collateral type, maturity, coupon type, and credit rating as well as factors at the portfolio level, such as the transaction's desired rating, the mark-to-market frequency, and the composition of the collateral.

In calculating advance rates for posting under a CSA, we employ a value-at-risk methodology similar to that found in many forward-looking risk measurement tools. Value-at-risk measurements are used to indicate how much value is at risk over a given exposure period with a certain confidence level. Thus, the advance-rate methodology establishes the probability that the market value of a given collateral security would not be less than the advanced amount in a given exposure period. This probability is used in turn to establish the required advance rates at a given rating level with reference to our corporate default studies. In some cases, other statistical techniques are also used to size advance rates, including approaches incorporating extreme value theorem (EVT) tools and generalized autoregressive conditional heteroskedasticity (GARCH) models.

The following table presents some of the most commonly requested advance rates in synthetic CDOs.

Advance Rates for Collateral Posted Against Counterparty Risk									
Collateral type	Asset characteristics			Fixed/Floating	Domicile	Rating on liability			
	Maturity (years)	Exposure period	Rating on collateral			AAA	AA	A	BBB
Treasury	3-5	Daily	AAA	Fixed	U.S.	97.1%	97.5%	98.1%	98.2%
Treasury	5-7	Daily	AAA	Fixed	U.S.	95.8%	96.4%	97.2%	97.4%
Treasury	7-10	Daily	AAA	Fixed	U.S.	95.2%	95.9%	96.8%	97.1%
Treasury	1-3	Weekly	AAA	Fixed	U.S.	97.6%	97.9%	98.4%	98.5%
Treasury	3-5	Weekly	AAA	Fixed	U.S.	95.3%	95.9%	96.9%	97.1%
Treasury	5-7	Weekly	AAA	Fixed	U.S.	93.2%	94.1%	95.4%	95.8%
Treasury	7-10	Weekly	AAA	Fixed	U.S.	92.2%	93.3%	94.8%	95.3%
Sovereign	1-3	Daily	AAA	Fixed	Non-U.S.	96.9%	97.3%	97.5%	97.8%
Sovereign	3-5	Daily	AAA	Fixed	Non-U.S.	94.3%	95.0%	95.9%	96.3%
Sovereign	5-7	Daily	AAA	Fixed	Non-U.S.	90.0%	91.3%	93.0%	93.6%
Sovereign	7-10	Daily	AAA	Fixed	Non-U.S.	87.7%	89.3%	91.3%	92.2%
Sovereign	1-3	Weekly	AAA	Fixed	Non-U.S.	96.9%	97.3%	97.5%	97.8%
Sovereign	3-5	Weekly	AAA	Fixed	Non-U.S.	93.3%	94.2%	95.1%	95.6%
Sovereign	5-7	Weekly	AAA	Fixed	Non-U.S.	88.7%	90.1%	91.9%	92.7%
Sovereign	7-10	Weekly	AAA	Fixed	Non-U.S.	86.1%	87.8%	89.9%	90.9%

### Related Articles

- "*Global Cash Flow and Synthetic CDO Criteria*" (published on March 21, 2002).
- "*Criteria for Rating Synthetic CDO Transactions: Credit Derivative Criteria*" (published September 2003).
- "*Global Interest Rate and Currency Swaps: Calculating the Collateral Required Amount*" (published on Feb. 26, 2004).

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