

RFC Process Summary:

RFC Process Summary: Counterparty Risk Framework: Methodology And Assumptions

March 8, 2019

On Oct. 9, 2018, S&P Global Ratings published a request for comment (RFC) on proposed revisions to its criteria for assessing counterparty risk in structured finance (see "Request For Comment: Counterparty Risk Framework: Methodology And Assumptions," published Oct. 9, 2018). Following feedback from the market, we finalized and published our criteria, titled "Counterparty Risk Framework: Methodology And Assumptions," on March 8, 2019.

We'd like to thank the market participants who provided feedback. We made some changes and clarifications based on this feedback. However, we did not make all the changes suggested. This article provides an overview of the changes between the RFC and the final criteria, and the rationale behind those changes. We made other changes that are purely stylistic and intended to clarify our methodology; we include the most significant of these changes in this article.

The comments we received mostly focused on our proposed analysis of derivative counterparty risk.

Summary Of Changes Resulting From Market Feedback

Maximum supported rating for derivative counterparties – additional rating floor

Change. We have included in the final criteria an additional floor to the maximum supported rating for derivative counterparties, based on our collateral framework assessment for the derivative exposure and our analysis of the rating outcome if the transaction were to become unhedged. This additional consideration can lead to a maximum supported rating of up to three notches above the rating that would be supported if the transaction were unhedged. The uplift is a function of the collateral framework assessment. We would generally apply this approach only in cases where termination payments would be subordinated to payments on the rated notes following a default of the counterparty.

Rationale. This change is in response to market feedback regarding situations where the available combination of downgrade remedies would include some weakness, resulting in a constraint to the maximum supported rating under our criteria. Specifically, market participants felt that the framework proposed in the RFC did not sufficiently differentiate our assessment of derivative

ANALYTICAL CONTACT

Matthew S Mitchell, CFA
London
(44) 20-7176-8581
matthew.mitchell@spglobal.com

CRITERIA CONTACTS

Andrew O'Neill, CFA
London
(44) 20-7176-3578
andrew.oneill@spglobal.com

Claire K Robert
Paris
(33) 1-4420-6681
claire.robert@spglobal.com

counterparty risk based on the materiality of the risk if the transaction became unhedged following a default of the counterparty. In the RFC, we proposed to differentiate on this basis only in applying a floor to the maximum supported rating, set at the rating level that available credit enhancement would support, if a transaction became unhedged. We considered that, in such cases, the RFC did not allow us to differentiate sufficiently between hedged transactions with some weakness in downgrade remedies and truly unhedged transactions. This additional consideration allows better differentiation between hedged and unhedged transactions by capturing the strength of the collateral framework. Collateral reduces the risk of a transaction becoming unhedged by providing the resources to replace a defaulted counterparty.

Calibration of volatility buffers for derivative counterparties

Additional granularity by remaining weighted average life of the derivative contract

Change. In the final criteria, we have added additional granularity to the volatility buffer assumptions, based on the remaining weighted average life of a derivative. Specifically, we have added two new buckets, to include volatility buffer assumptions for derivatives with a remaining weighted average life in the 1-2 year and 5-7 year. The RFC applied the same volatility buffers for all derivatives within the 1-3 year bucket, and within the 5-10 year bucket.

Rationale. We agree with the market feedback that the remaining weighted average life of a derivative has a significant impact on that derivative's price volatility. We agree therefore that the 1-3 year and 5-10 year buckets proposed in the RFC were too broad, due to a large difference in the volatility risk between the shortest and longest maturities in each bucket.

Alternative calculation of volatility buffers for interest rate derivatives based on a multiple of DV01

Change. We have included in the final criteria the consideration of volatility buffers calculated as a multiple of DV01 (dollar-value of a basis point) for interest rate swaps, as an alternative to a fixed percentage of the derivative notional amount.

Rationale. This change reflects that DV01 is a market standard measure of the volatility of the mark-to-market value of a derivative. By calculating volatility buffers based on DV01, counterparties may better adapt the amount of collateral posted to the volatility of a specific derivative at any point in time. This is consistent with the intent of the criteria, that volatility buffers should protect the issuer from the risk of volatility in the value of a derivative between the default of the initial counterparty and the entry into a new derivative with a replacement counterparty. We have sized the DV01 multiples to capture assumed interest rate shifts that are consistent with the calibration of our volatility buffer assumptions expressed as a fixed percentage of the notional amount. We have also considered convexity risk in the calibration of the DV01 multiples.

This change applies only to interest rate derivatives (which were the main focus of market feedback received); for foreign exchange derivatives, the final criteria consider only volatility buffers as a fixed percentage of notional. This is because we consider that the key volatility risk in a foreign exchange derivative is a sudden significant change in the spot exchange rate, meaning that the additional nuance provided by a DV01-based approach is less relevant.

Summary Of Changes Resulting From Internal Comments

Collateral framework assessment – collateral posting trigger

Change. In the RFC, we proposed to assess the collateral framework as "weak," if the collateral posting trigger were below the replacement trigger. In the final criteria, we allow for an adjustment to the maximum supported rating in this circumstance, but do not provide a prescriptive adjustment.

Rationale. The purpose of this provision in the RFC was to reduce the cumulative benefit of replacement and collateral in the maximum supported rating, in this highly unusual circumstance. Due to the atypical nature of this situation, we consider that a less prescriptive approach is appropriate, to allow the capture of all relevant facts.

Summary Of Key Market Feedback Resulting In No Amendments

We received the following comments during the RFC process, which did not lead to any amendments in our final criteria.

Calibration of quantitative assumptions in our collateral framework assessment

Feedback. Respondents requested further detail on how S&P Global Ratings calibrated the volatility buffer, market value haircut, and currency haircut assumptions included in the RFC.

Response. All of the quantitative assumptions included in our collateral framework assessment aim to mitigate volatility risks that may render the amount of available collateral insufficient to replace a defaulted counterparty. We differentiate the collateral framework assessment on the basis of the period of time over which we believe that volatility risks are covered: The longer the coverage period, the likelier the issuer will have sufficient collateral to replace a defaulted counterparty and, therefore, the stronger the collateral framework assessment.

Specifically, the criteria assess the collateral framework as "strong" if we consider that volatility risks are covered over a period of 90 calendar days following the default of the counterparty, and "adequate" if the coverage period is between two weeks and 90 calendar days. If we assess that collateral covers the exposure to the counterparty, but the period of volatility coverage would be less than two weeks, we would assess the framework as "moderate." If we assess that collateral would not cover the exposure to the counterparty (or indeed if no collateral is posted), we would assess the framework as "weak." These considerations inform the calibration of the quantitative assumptions commensurate with each assessment level.

Based on the above descriptions of the assessment levels, volatility buffer assumptions are relevant for "strong" and "adequate." Our criteria include volatility buffer assumptions set as a fixed percentage of the derivative notional amount. These numbers were calibrated by assessing the volatility of each swap type over the relevant time period (90 calendar days for "strong," two weeks for "adequate"). Our analysis was informed, in particular, by historical data on swap price movements during periods of stress. We note that the main time windows driving our assumptions are the mid-1980s in the U.S. and the early 1990s in the U.K. We also simulated stressed

mark-to-market (MTM) volatility on idealized swaps in hypothetical rate volatility scenarios over the same relevant time periods.

We note that the aforementioned change in the final criteria for interest rate derivatives, to consider volatility buffers calculated as a multiple of DV01 as an alternative to a fixed percentage of the notional amount, provides additional nuance to the coverage of volatility risk. The assumed multiples included in the final criteria (220 basis points for "strong," 100 basis points for "adequate") also provide transparency on the rate shift that we assume should be covered to reach each assessment level.

Our criteria explain that we calibrate market value haircut assumptions based on historical data. In our published guidance article, "Guidance: Counterparty Risk Framework: Methodology And Assumptions," March 8, 2019, we have included our assumptions for certain eligible sovereigns and covered bonds. For "strong" and "adequate" assessments, the sovereign assumptions are based on observed historical price moves over the relevant time period (90 calendar days for "strong," two weeks for "adequate"). Our dataset focused in particular on available price data for individual U.S. Treasury securities, and comparisons in long-term sovereign yield data across eligible sovereigns.

The covered bond market value haircut assumptions for "strong" and "adequate" assessment levels are calibrated as 1.5x the sovereign haircuts. This multiple reflects our view that a specific covered bond security may see more price volatility than a highly rated sovereign in a period of stress, in particular due to any issuer-specific concerns. The 1.5x multiple also reflects the lower data availability for price movements in specific covered bond securities through periods of significant rate volatility. For a "moderate" assessment, the market value haircuts are aligned with those set out in the Basel regulatory framework for margin requirements on over-the-counter derivatives (with extrapolation for longer-maturity assets).

Our currency haircut assumptions, included in our published guidance article for eligible currencies, are similarly based on historical observations, and specifically on observed exchange rate changes between currency pairs among the eligible currencies, over the relevant time period for each assessment (90 calendar days after a counterparty default for "strong," two weeks for "moderate"). Currency haircut assumptions for both the "adequate" and "moderate" assessments are aligned with the 8% haircut set out in the Basel regulatory framework for margin requirements on over-the-counter derivatives.

Remedy period for collateral posting

Feedback. The remedy period for collateral posting on derivatives should be extended to 30 business days from 10 business days, following the downgrade of the counterparty below the applicable rating trigger, to allow for the administrative demands of the initiation of collateral posting.

Response. Our criteria establish a remedy period of 10 business days for a counterparty to post collateral, in situations where collateral is only posted following a downgrade of the rating on the counterparty. It also sets the minimum rating below which posting should begin for each collateral framework assessment. A longer remedy period increases the risk that a counterparty may default before it has started to post collateral, leaving the issuer without collateral to re hedge its exposure. We note that if collateral is posted from the initiation of the derivative, the concept of a remedy period is not applicable.

Adjusting remedy periods to reflect regulatory counterparty rating requirements for covered bonds

Feedback. Certain regulatory frameworks for covered bonds included minimum rating requirements for counterparties that may result in the replacement of a counterparty before it breaches the minimum eligible counterparty ratings set out in S&P Global Ratings' criteria. The counterparty's contractual requirements to post and revalue collateral support these frameworks. The remedy periods in the criteria should be adjusted to capture this.

Response. The remedy periods set out in our criteria are associated with the counterparty's contractual commitment to replace itself if its rating is lowered below the minimum eligible counterparty rating. To the extent that regulatory requirements result in the replacement of the counterparty before its rating is lowered below the minimum eligible counterparty rating under our criteria, our analysis would consider the rating of the new counterparty. We note that, where regulatory frameworks specify minimum counterparty ratings, these may not be equivalent to a replacement framework as contemplated under our criteria. This is because the rating requirement may not relate specifically to a rating provided by S&P Global Ratings, and may not be time-bound to a similar remedy period.

Prepayment rate assumptions for derivative collateral volatility buffers

Feedback. The RFC included a consideration of the prepayment rate assumed by a counterparty in determining the remaining weighted-average life (WAL) of a derivative for the purpose of computing volatility buffers. While a low prepayment speed assumption is conservative for computing the volatility of a derivative's MTM value, this is not the case for determining the actual MTM of a balance-guaranteed swap, due to negative convexity associated with prepayment risk. The criteria should aim to dissipate this confusion.

Response. We have not amended the final criteria in response to this feedback. We agree that the assumed prepayment speed will have a different impact on the calculation of MTM volatility than on the calculation of MTM itself. However, the prepayment rate considerations included in the criteria are indeed only relevant to the determination of volatility buffers. The provision is included in our criteria to mitigate the risk that the posted volatility buffer amount may be insufficient due to a high prepayment rate assumption. The criteria do not include any consideration of the prepayment rate assumed in the determination of the MTM itself.

Volatility buffers for cross-currency derivatives

Feedback. The RFC proposed to simplify the approach to volatility buffers for cross-currency derivatives by using a single category rather than the three categories included in our previous criteria for different types of cross-currency swap (fixed-floating, floating-floating, and fixed-fixed). The change generally results in an increase to the applicable volatility buffers for floating-floating cross-currency derivatives to support a given rating, all else equal. The respondent argued that this impact was not appropriate for the sake of simplification.

Response. We have maintained the volatility buffer assumptions proposed in the RFC. The change proposed in the RFC was not simplification for its own sake. In the RFC, we proposed to recalibrate our volatility buffer assumptions, relative to previous criteria, to better reflect the actual risk of volatility in swap values after a counterparty default. Based on market feedback on our previous criteria and our own research, we concluded that the difference in volatility risk between the three different categories in our previous criteria was much lower than implied in the volatility buffers in our previous criteria. This is because the main driver of volatility in cross-currency derivatives is the spot exchange rate. As a result of this, we also concluded that the volatility buffers in our previous criteria were generally too low for floating-floating cross-currency swaps, and too high for fixed-fixed cross-currency swaps, relative to the calibration of our other volatility buffer assumptions.

Market value haircuts for 'AAA' sovereigns

Feedback. One respondent questioned why market value haircuts should apply to 'AAA' sovereigns.

Response. The purpose of market value haircuts is to mitigate the risk that the market value of an asset posted as collateral by a derivative counterparty may decline between the time of the counterparty's default and the time that the issuer has entered into a replacement hedge. These haircuts are not related to the credit risk of the asset. We consider that market value risk is relevant even for 'AAA' assets posted as collateral.

Market value haircuts for Danish matched-funding covered bonds

Feedback. Danish covered bonds with a matched-funding structure have lower market value risk than other covered bonds, because a decline in bond prices would lead to borrowers repurchasing the bond linked to their mortgage, supporting bond prices.

Response. In the absence of substantial supporting data demonstrating the above hypothesis through a period of market value declines in covered bonds, we do not consider that this argument is sufficient to support a separate category of market value haircuts for Danish matched-funded covered bonds. Our market value haircut assumptions are intended to address the risk of sharp price declines in the collateral assets in the short-term aftermath of a counterparty default (up to 90 days, depending on the collateral framework considered). We consider that it is unlikely that the effect described would be this immediate. Significant bond price declines are also likely to reflect an increasing interest rate environment, in which borrowers are less likely to refinance opportunistically, such that the effect may be limited to borrowers with the available cash to repurchase the bond.

Replacement obligation for bank accounts

Feedback. For bank accounts, the replacement obligation should rest with the issuer/trustee and the counterparty should not need to cover replacement costs.

Response. Our RFC already stated that the replacement obligation for a bank account may rest with the issuer or its trustee. In existing transactions, the counterparty typically covers the replacement cost. If the cost rests with the issuer, our RFC simply explained that we would assess the impact of the cost on the transaction cash flows. We have therefore not made any amendment in our final criteria in response to this comment.

Key Clarifications In Response To Questions Received During The Comment Period

Applicable counterparty rating

We have included in our published guidance document additional clarity regarding the types of obligations for which the issuer credit rating (ICR) or resolution counterparty rating (RCR) on a counterparty would be the applicable counterparty rating. We have also clarified the applicable counterparty rating in the tables in the covered bond section of the final criteria.

Rating supported by the combination of collateral and the issuer's termination rights

We have added a clarification that the uplift described does not lead to further uplift above the rating supported by the combination of replacement, collateral, and the issuer's termination rights.

Collateral framework assessment for derivative counterparties

We have added a summary table showing the factors that we analyze as part of our collateral framework assessment.

Derivative termination payments

The final criteria maintain the approach proposed in the RFC, to reduce the maximum supported rating for a derivative counterparty to reflect liquidity risk, if termination payments would not be subordinated to payments on the rated notes upon the counterparty's default. The RFC contemplated that we would not reduce the maximum supported rating if the liquidity risk were mitigated by the issuer's available liquidity sources intended to support its ability to post margin to the counterparty, where applicable. In the final criteria, we have broadened the language to clarify that we would not reduce the maximum supported rating if we have assessed that the liquidity risk has been mitigated, and that an issuer that has available liquidity to support margin posting is an example of a situation where we may reach this conclusion.

Eligible assets for collateral posting

For the avoidance of doubt, we have added cash as an eligible asset in the published guidance to the final criteria.

Description of counterparties related/unrelated to a covered bond issuer

We have clarified the description in the final criteria to better capture situations where the counterparty is not a subsidiary of the covered bond issuer, but both entities are subsidiaries of the same parent.

Application of the materiality threshold to derivative counterparties in covered bond transactions

In our published guidance, we have clarified the specific application of this threshold to situations where there are multiple derivatives on the same assets within a cover pool with the same counterparty.

Related Criteria And Research

- Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Guidance: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019

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