Rating Methodology

Structured Finance

Global Credit-Linked Note and Repackaging Vehicle Rating Criteria

Updated November 2018

Related Research

Each transaction will be accompanied with a transaction specific report that will disclose any additional observations or modifications to the Criteria. This Criteria should be read in conjunction with GCR's published 'Global Structured Finance Rating Criteria', updated September 2018.

Introduction

Global Credit Rating Co.'s ("GCR") Global Summary Credit-Linked Note ("CLN") and Repackaging Vehicle ("Repack") Rating Criteria (the "Criteria") apply to notes issued, mainly by corporates or financial institutions, that rely upon the performance of one or more underlying counterparties (the "Reference Entity or Reference Entities"). The main feature of these notes is the absence of credit enhancement, where a failure by any of the Reference Entities to perform its obligations under a transaction can result in a default of the notes. This Criteria should be read in conjunction with GCR's published 'Global Master Structured Finance Rating Criteria, updated September 2018. The Criteria does not apply to senior secured securities issued by corporates that benefit from certain structural enhancements i.e. Structured Bonds, where GCR's 'Global Structurally Enhanced Corporate Bonds Ratings Criteria, updated November 2018, applies.

CLNs are typically transactions where an investor purchases a note issued by a bankruptcy remote SPV (the "Issuer"), although the Issuer can also be an operating entity (such as a bank). The note is synthetically credit linked to a Reference Entity or Reference Entities, which may be achieved by a credit default swap ("CDS") or other means. Proceeds from the issuance of the note are used to purchase a qualified investment or underlying securities issued by the Reference Entities (this may also include loans advanced to Reference Entities where the SPV acquires the loan and loan agreement which may have been advanced by a separate entity). The qualified investment or underlying security acquired by the SPV thus collateralises the note or CDS. Single-name CLNs reference one Reference Entity, whereas multi name CLNs can reference multiple Reference Entities and often form repackaging programmes. CLNs are thus dependent upon the performance of each Reference Entity under its obligations on the qualified investment or underlying security. A default of any Reference Entity or its failure to perform its obligations on the qualified investments or underlying security can lead to a default on the CLN. If no such credit event occurs it is expected that a CLN will be redeemed in full upon its maturity date. Typically CLNs and Repacks *de facto* include several risk presenting entities/counterparties that perform supportive functions to the transaction such as the account bank or swap counterparties.

This Criteria is an update to the version published in May 2017. The update of this Criteria will not have an impact on any existing transactions that have been rated under it. Going forward, all new transactions will be rated using this Criteria.

Credit Quality of Reference Entities

The credit quality of the Reference Entities is critical within the analysis of CLNs or Repacks. Reliance is placed upon the credit rating or credit assessment of the Reference Entity as the CLNs do not benefit from credit enhancement or other structural enhancements. For Repack programmes or multi name CLNs, the lowest rated Reference Entity will drive the rating analysis, as it is considered to contribute the most risk to the structure (‘*weak link approach*’). GCR expects all Reference Entities to have a long-term and short-term credit rating accorded. Whilst ideally these entities should be rated by GCR, GCR does accept ratings from other licensed Credit Rating Agencies; however, in some instances notching may apply (up or down) where GCR may have a different view on a certain entity. GCR also expects that any entity that performs any supportive role within the transaction, such as account bank or swap counterparty amongst others, has an adequate rating so as not to constrain the rating of the notes issued by the Issuer. GCR expects the transaction to incorporate downgrade language in respect of the supporting counterparties, such that counterparties whose credit ratings are downgraded to below the required ratings are replaced.

For single name CLNs, the rating is accorded by a straight look-through to the underlying Reference Entity’s credit rating or credit assessment. A default of the underlying Reference Entity is likely to lead to a termination of the transaction and default of the issued notes. For Repacks which are not series segregated, or CLNs that rely upon multi-name Reference Entities, GCR will use a weakest link approach. Where there is more than one Reference Entity, GCR will use the rating of the lowest rated entity as its base for the analysis. Where an underlying security issued by the Reference Entity is fully guaranteed by a more highly rated entity or if the underlying security has the benefit of a put option, GCR will use the rating of the guarantor or the put provider in place of the rating of the Reference Entity in its analysis.

Counterparties that belong to the same corporate group will be regarded as one Reference Entity.

Where the rating of the lowest rated Reference Entity (or the weakest link counterparty) is on Rating Watch or has a Rating Outlook, the rating of the note will also reflect such Rating Watch or Outlook.

Credit Quality of Issuing Entity

In the event the issuing entity of the CLN is considered to be an operating entity (i.e. an entity not regarded as bankruptcy remote), such as a bank, GCR will apply a similar analysis in that a weakest link approach will be applied. In this regard, the lower rating of the bank or the Reference Entity will form the base of the analysis for the rating of the CLN.

Early Termination

CLN/Repack transactions include early termination events, which in turn lead to an automatic unwinding of the transaction and may result in a potential loss to the note investor. ‘Standard’ early termination events are accounted for in the rating accorded to the notes.
For example, ‘standard’ termination events are considered to be termination upon default of an underlying Reference Entity, if a transaction becomes subject to tax or if it becomes illegal to maintain a transaction. If other termination events exist, GCR will also consider these in its analysis. Such events will be detailed in the individual rating reports. Where early termination risks are not sufficiently mitigated, GCR may decline to rate a transaction. In the event of a default, claims against the Issuer are typically limited to the proceeds from the underlying security and GCR expects that this default will not affect any other notes that may have been issued by the Issuer that are credit linked to different underlying securities.

Legal Opinion

GCR expects to receive a legal opinion to include capacity language in respect of transaction parties; as well as that transaction documentation is legal, valid, binding and enforceable against the relevant transaction parties and underlying reference counterparties.

Performance Monitoring

On-going monitoring of the performance of transactions as well as the underlying Reference Entities or other counterparties are key to the rating process and maintaining current ratings.

Surveillance panels are held at a minimum annually or as events warrant. Upward or downward rating action on a Reference Entity will trigger a surveillance panel and potential rating action. For public transactions, GCR will publish a performance report at a minimum on an annual basis or as events warrant.

Qualification

Note that GCR is not a legal, tax or financial adviser and will only provide a credit opinion of the rated securities. For example, a rating does not cover a potential change in the applicable laws nor can it be regarded as an audit. Moreover, GCR is not a party to the transaction documents nor does it provide legal, tax or structuring advice.

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GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S STRUCTURED FINANCE GLOSSARY

Account Bank	A bank where the transaction account is held.
Advance	A lending term, to transfer funds from the creditor to the debtor.
Agreement	A negotiated and usually legally enforceable understanding between two or more legally competent parties.
Bankruptcy	Court proceedings at which an individual or a company is declared unable to pay its creditors. The liability of a bankrupt company typically exceeds its assets.
Bankruptcy Remote	A feature, through real security and guarantees that reduces the enforceability of a creditor against a Special Purpose Vehicle. Typically a Security Special Purpose Vehicle should be bankruptcy remote.
Bond	A long term debt instrument issued by either: a company, institution or the government to raise funds.
Claim	A formal request or demand.
Collateral	An asset pledged as security in event of default.
Credit	A contractual agreement in which a borrower receives something of value now, and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company
Credit Default Swap	A form of insurance against non-performance of a third party's obligations.
Credit Enhancement	Limited protection to a transaction against losses arising from the assets. The credit enhancement can be either internal or external. Internal credit enhancement may include: Subordination; over-collateralisation; excess spread; security package; arrears reserve; reserve fund and hedging. External credit enhancement may include: Guarantees; Letters of Credit and hedging.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Default	A default occurs when: 1.) The Borrower is unable to repay its debt obligations in full; 2.) A credit-loss event such as charge-off, specific provision or distressed restructuring involving the forgiveness or postponement of obligations; 3.) The borrower is past due more than X days on any debt obligations as defined in the transaction documents; 4.) The obligor has filed for bankruptcy or similar protection from creditors.
Downgrade	The assignment of a lower credit rating to a corporate, sovereign of debt instrument by a credit rating agency. Opposite of upgrade.
Enforceable	To make sure people do what is required by a law or rule et cetera.
Guarantee	An undertaking for performance of another's obligations in event of default.
Guarantor	A party that gives the guarantee.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Issuer	The party indebted or the person making repayments for its borrowings.
Legal Opinion	An opinion regarding the validity and enforceable of a transaction's legal documents.
Loan	A sum of money borrowed by a debtor that is expected to be paid back with interest to the creditor. A debt instrument where immovable property is the collateral for the loan. A mortgage gives the lender a right to take possession of the property if the borrower fails to repay the loan. Registration is a prerequisite for the existence of any mortgage loan. A mortgage can be registered over either a corporeal or incorporeal property, even if it does not belong to the mortgagee. Also called a Mortgage bond.
Long-Term Rating	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Loss	A tangible or intangible, financial or non-financial loss of economic value.
Notching	A movement in ratings.
Obligation	The title given to the legal relationship that exists between parties to an agreement when they acquire personal rights against each other for entitlement to perform.
Option	Either a call or a put option. A call option gives the holder the right to buy assets at an agreed price on or before a particular date. A put option gives the holder the right to sell assets at an agreed price on or before a particular date.
Proceeds	Funds from issuance of debt securities or sale of assets.
Rated Securities	Debt securities that have been accorded a credit rating.
Rating Outlook	A Rating outlook indicates the potential direction of a rated entity's rating over the medium term, typically one to two years. An outlook may be defined as: 'Stable' (nothing to suggest that the rating will change), 'Positive' (the rating symbol may be raised), 'Negative' (the rating symbol may be lowered) or 'Evolving' (the rating symbol may be raised or lowered).
Rating Watch	Indicates that a rating is under review for possible change in the short term and the movement may be either positive or negative.
Repack	Rearrangement of securities with the intent to be more attractive for investment. Junior tranches (that have a higher degree of default risk) of a securitisation transactions that have been repackaged into separate debt securities (according to their degree of risk) that utilise credit-enhancement techniques to mitigate the risk. A CDO is created to distribute the

	prepayment risk amongst different classes of Notes.
Securities	Various instruments used in the capital market to raise funds.
Security	An asset deposited or pledged as a guarantee of the fulfilment of an undertaking or the repayment of a loan, to be forfeited in case of default.
Senior	A security that has a higher repayment priority than junior securities.
Short-Term Rating	A short term rating is an opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Structural Enhancement	This may be provided as credit enhancement or as various other methods to enhance the security of a transaction such as performance triggers, short revolving periods et cetera.
Structured Finance	A method of raising funds in the capital markets. A Structured Finance transaction is established to accomplish certain funding objectives whist reducing risk.
Surveillance	Process of monitoring a transaction according to triggers, covenants and key performance indicators.
Swap	An agreement between two parties for the exchange of a series of future cash flows. The exchange of one security for another. Normally an investment bank, which provides a swap.
Transaction	A transaction that enables an Issuer to issue debt securities in the capital markets. A debt issuance programme that allows an Issuer the continued and flexible issuance of several types of securities in accordance with the programme terms and conditions.