Article Title: ARCHIVE | Criteria | Structured Finance | General: RATING SWAP-INDEPENDENT SYNTHETIC SECURITIES Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Indemnification of Expenses and Liabilities by SPE Issuers," published Feb. 6, 2001, and "Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities," published Oct. 1, 2006.) Standard & Poor's follows two general approaches to rating synthetic securities: the swap-dependent approach, and the swap-independent approach. The swap-dependent approach is the more traditional. In the swap-dependent approach, the rating assigned to the synthetic security reflects the lowest rating assigned to the underlying collateral and the swap counterparty or if a guarantee that meets Standard & Poor's criteria is used, the rating of the guarantor. In a variation of this model, synthetic securities transactions have been structured to include, but not depend on, a swap agreement. For these swap-independent transactions, Standard & Poor's ratings reflect the creditworthiness of the underlying collateral and do not address the credit quality of the swap counterparty or the likelihood that the swap may terminate. The focal point of the swap-independent analysis is the collateral distribution mechanism after the swap termination, in which case the noteholders should receive the full benefit of the underlying collateral. Because the rating of the swap counterparty is not a dependent rating, Standard & Poor's assumes an early termination of the swap. Standard & Poor's is comfortable in rating a transaction using the swap-independent approach if, after the swap terminates, neither party is owed a termination payment and the transaction unwinds, in which case the holders of the synthetic securities receive their pro rata share of the underlying collateral. The credit quality of the underlying collateral thus is preserved by the distribution mechanism. Alternatively, the holders may consent to a continuation of the transaction, in which case they receive a pro rata share of the payments on the underlying collateral. The potential termination risk inherent in a swap-independent structure is highlighted by attaching an `r' symbol to the rating (see box).SideBarField001 Standard & Poor's rating on a synthetic security addresses the likelihood that investors will receive interest and principal in accordance with the terms of the synthetic issue. Transaction arrangers may request either a swap-dependent or swap-independent rating. Chart 1 illustrates a typical synthetic transaction. A fixed-interest rate bond rated `AA+' issued by company X is paired with a swap agreement in which swap counterparty Y (rated `A+') pays a LIBOR-based floating rate of interest in exchange for the bond's fixed-rate coupon. The structure results in a customized security that may not otherwise be available in the market. This security will be rated `AA+r' because the swap counterparty's rating is not a supporting rating. If the swap terminates for any reason, company X's `AA+' rated bond will be physically distributed to the investors without any swap breakage fees or termination payments (see chart 2). This distribution mechanism ensures that the `AA+' credit quality of the transaction is preserved even if the swap terminates. A swap-dependent rating approach to the synthetic described above would have resulted in a rating of `A+'. This is because the terms of a swap-dependent transaction explicitly promises to the cash flows from the swap counterparty and upon a termination of the swap agreement, the underlying `AA+' rated bond may have to be liquidated to pay a termination payment to the swap counterparty. Swap-independent transactions promise the cash flows from either the swap counterparty or the underlying security. RIGHTS TO COLLATERAL ARE KEY Issuers of swap-independent synthetic securities typically are structured as grantor trusts or partnerships in which the investors are deemed to be the owners of the underlying collateral. The investors have agreed to receive the swapped cash flows from the swap counterparty. If the swap terminates, investors will receive the unswapped cash flows from the underlying collateral or the collateral itself if they vote to terminate the trust or partnership. From a legal standpoint, Standard & Poor's seeks to ensure that there are no claims, liens, or rights of set-off against the underlying collateral before and after termination of the swap agreement. Because the rating reflects the investors' ownership interests in the underlying collateral, Standard & Poor's will apply a swap-independent rating approach only to transactions in which investors will receive the underlying collateral without having to pay any swap breakage fee or termination payments if the swap terminates. If the swap terminates, the cash flows from the issue in the above example would simply revert to those of the underlying `AA+' rated bond. SWAP TERMINATION HAS NO EFFECT Assuming no premium is paid for the swap-independent structure at closing, upon a swap termination the investor would be no worse off than if he or she had invested in the underlying collateral rather than the synthetic security. The economic impact of the termination is unknown at the time of issue and could be favorable or unfavorable depending on the market environment at the time of termination. This is because the termination of a swap agreement could have a positive or negative effect on the overall economic value of the investment. The trust can be either "in-the-money" (the marked-to-market value of the swap obligates the swap counterparty to pay a termination payment to the trust) or "out-of-the-money" (the trust owes the swap counterparty a termination payment) upon termination of the swap. If the trust is in-the-money, investors would be receiving more cash flows than if they had not entered into the swap. If the trust is out-of-the-money, investors would be receiving fewer cash flows than if they had not entered into the swap because they would have to pay a termination payment. From a credit standpoint however, swap-independent synthetic securities are not affected by the market value of the swap because investors receive the underlying collateral upon a swap termination. The economic effect on the investment that remains as the result of a swap termination is mainly driven by market forces and not credit considerations. Because default ratings are not designed to measure market risks, the existence of a market-sensitive swap agreement should not have an effect on the credit quality of the swap-independent synthetic security. DISCLOSURE REQUIREMENTS Given the complexity of swap-independent synthetic securities, and the accompanying issues related to investor knowledge and disclosure, Standard & Poor's will rate these transactions only if they are privately placed with sophisticated investors. In a public transaction, Standard & Poor's will only rate swap-dependent synthetic securities. In addition, Standard & Poor's has certain disclosure guidelines for swap-independent synthetic securities. First, the cover of the offering memorandum must clearly disclose that the rating does not address the likelihood of a swap termination event. The cover also must disclose that the rating addresses the likelihood of receiving on each payment date either swap enhanced cash flows, or if payments from the swap counterparty are not received timely, cash flows from the underlying collateral. Similar information will be contained in Standard & Poor's rating letters. Standard & Poor's permission to disseminate the rating is conditional on having a copy of the rating letter accompany any secondary market transfer of the securities. ADDITIONAL CONSIDERATIONS Commingling risk. In swap-independent transactions, the swap counterparty may not commingle underlying collateral payments with its own funds. In general, this commingling risk usually is covered by matching the swap payment dates to the underlying collateral payment dates or by retaining underlying collateral payments at the issuer level until the swap payment date. For example, if the underlying collateral pays interest quarterly on Jan. 1, March 1, June 1, and Sept. 1 and the swap pays semiannually on Jan. 1 and June 1, Standard & Poor's requires that the March payment from the underlying collateral will be returned by the trust and be paid to the swap counterparty on or immediately prior to its swap payments on the synthetic security on June 1. This payment restriction protects investors from the insolvency of the swap counterparty if the swap agreement terminates. Because the investors own the underlying collateral, they should not have to wait to receive their March payment from the swap counterparty after its insolvency proceeding is resolved. Market index. Standard & Poor's does not rate swap-independent transactions based on the rating of the underlying collateral if payments from the swap counterparty are based on a credit-related index. Payments must be based on a market index. A market index is an index that can be reproduced by a third party, is publicly available through readily accessible means, and is easily verifiable. Examples include interest rate indexes, currency exchange rates, or even a pool of equity securities. A credit index would be an index that is predominantly dependent on an identifiable credit (the price performance of a particular corporate debt instrument). Standard & Poor's will rate a transaction in which the payments are based on a credit index only as a swap-dependent transaction, and the rating will be the lower of the rating of the identifiable credit embedded in the index, the underlying collateral, or the swap counterparty. Transaction expenses. Ongoing transaction expenses should be prepaid by a third party or a party rated as highly as the transaction. Because the trust does not incorporate any credit enhancement and the assigned rating addresses the credit quality of the underlying collateral, the trust does not have resources to pay fees to the various entities involved in the transaction. Therefore, a third party, such as the sponsoring investment bank, should prepay all fees and expenses to any entity that provides services in the transaction. If a third party fails to pay these fees, the trustees and the agents should not be relieved from performing their obligations according to the operating documents of the transaction.

Extraordinary expenses. Any transaction expenses other than ordinary expenses such as trustee fees or paying agent fees are considered extraordinary expenses. These extraordinary expenses for the duration of the transaction also should be covered by a third party. Otherwise, the trustee's claim for extraordinary expenses should be subordinated to investors' claims to the trust property. It also is essential that if at any time the trust terminates as a result of a swap termination, the trustee's obligation to distribute the underlying collateral and any related cash flows to the investors, if investors vote for this action, is fully enforceable without interference from any third party. Bankruptcy-remote issuer. The issuer of the swap-independent synthetic security should be structured as a bankruptcy-remote entity in which the purposes and the powers of the trust are primarily limited to: Acquiring and holding the underlying collateral, Issuing synthetic securities, and Entering into various legal agreements. Legal opinions. Appropriate legal opinions, such as true sale, tax, enforceability, and preference opinions should be delivered in connection with each synthetic security issuance.