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# Country Ceiling for Structured Finance Products

There are cases in which a worsening of creditworthiness of sovereigns or restrictions on conversion of local currencies into foreign currencies/ remittances of foreign currencies may have an impact on principal and interest payments on the relevant structured finance products in terms of the affected countries and regions. JCR takes into consideration an issuer rating of sovereign and country ceiling as described below in rating for structured finance products[1]. This draft is based on assumption that source of cash flows is located in a single country.

1. Sovereign risk

(1) Impact on country's economy

The past examples show that sovereign crises are accompanied by social and economic disorders including deterioration of GDP or unemployment rate, significant fluctuations in prices, and capital drain from a country, despite differences among countries in the situations. The central governments may directly or indirectly impose restrictions on repayment of debts in foreign currencies by private enterprises through deposit blockade or restrictions on taking foreign currencies out of the country mainly for the purpose of stabilizing the country's economy, currency or financial market. As seen in Greece in 2010, there are cases in which the central governments do not restrict foreign currency transactions even after a sovereign falls into default due to progress of globalization.

(2) Impact on creditworthiness of structured finance products

Sovereign crises, often accompanied by worsening or disorder of economic environment, may cause a lowering of creditworthiness of parties to the structured finance product structure, a worsening of the underlying assets' performance, or a suspension of the principal and interest payments due to measures such as restrictions on transactions of the financial system. These impacts, however, differ by the interested parties or types of underlying assets.

This is because structured finance products can flexibly meet various requests and risk tolerances of the interested parties and investors by initial designs of structures including underlying assets' type or diversification, redemption schedule, parties including servicer or financial institutions for opening a bank account, credit enhancement facilities, etc. As shown

[1] This methodology includes ratings for project finance, asset finance and J-REITs. For repacked financial instruments, credit-linked products and fully supported ABCP, JCR applies corporate rating methodology to these ratings, because credit risk of the parties concerned is linked to the rating for structured finance products through weak link approach.

by the past examples, there were cases where structured finance products successfully averted defaults through measures taken under the structures such as setting of flexible redemption schedule.

2. Country ceiling in rating for structured finance products

(1) Sovereigns that should be analyzed

Structured finance products are financial transactions that use structures such as a special purpose vehicle ("SPV") or credit enhancement mechanisms. JCR considers "cash flow analysis," "operational execution capabilities of parties to the structure," and "bankruptcy remoteness" as key points for assessment of these products. More specifically, sovereigns where underlying assets being a source of cash flows, parties to the structure who assume operational execution or credit enhancement mechanisms, and SPV are located, whether it is fully bankruptcy remote or not, come into question.

(i) Country where underlying assets are located

As an occurrence of a sovereign's default will have a significant effect on performance of underlying assets of structured finance products through significant political or economic disorders or weaknesses, JCR first considers effects from a sovereign country in which the underlying assets are located.

(ii) Country where parties to the structure operate

In cases where servicer or financial institution for opening a bank account can no longer work due to economic disturbance or foreign currency restrictions, it may fail to abide by payment by maturity date or timely payment because of cash flow disruption of structured finance products. In cases where such risk comes to the surface, effects from a sovereign country in which it operates its services may be reduced if its operations are transferrable to a backup servicer or other financial institution.

(iii) Country where SPV is located

SPV is an entity holding underling assets, but is only used as conduit under the structured finance product structure. For this reason, JCR considers that effects from a sovereign country in which SPV is located are limited in the following cases:

- The sovereign country is a developed country such as U.S., Eurozone countries, or Japan, which adopts a major currency and has limited risks relating to conversion of local currencies into foreign currencies/ remittances of foreign currencies.
- The sovereign country is an established offshore center like Cayman Islands, which has limited risks of conversion of local currencies into foreign currencies/ remittances of foreign

currencies.

- In cases where risks such as economic disturbance or foreign currency restrictions come to the surface, it is possible that the structured finance transactions are transferrable to another SPV that is established in a different country.

(2) Limitations by sovereign rating

Creditworthiness of structured finance products is directly or indirectly affected by default of a sovereign country in which the underlying assets are located. Political intervention such as debt forgiveness or deterioration in economic environment (GDP growth rate, unemployment rate, interest rates, etc.) after the default lowers in many cases performance of the underlying assets, reducing the repayment source. If deposit blockade occurs due to turmoil of financial system, interest payments and principal repayments by maturity date as scheduled might be difficult even when there are sufficient funds for servicing debts.

In cases where the rating of the sovereign country in which the underlying assets are located is low and likelihood of the default is increasing, rating on the structured finance products is subject to limitations by the sovereign rating. Propriety of a rating on the structured finance products can exceed the sovereign rating will be individually determined by consideration of their sensitivity to the changes in environment following the sovereign's default. For the structured finance products, of which tolerance to such changes is considered low such as asset-backed securities backed by consumer loans to individual customers with low creditworthiness, namely non-prime loans, or collateralized loan obligations backed by loans to corporations whose sales activities are limited to the country only, it is less likely that their ratings will be higher than that of the sovereign country in which the underlying assets are located, even if the sovereign rating is high.

If country of parties to the structure or country of SPV is different from that of underlying assets, JCR will consider limitations by sovereign ratings for these criteria along with limitations by sovereign rating for the underlying assets.

(3) Limitations by country ceiling

In light of relations between rating for structured finance products and country ceiling, it is necessary to assess measures in the structure for the risk of the relevant country's conversion of local currencies into foreign currencies/ remittances of foreign currencies, except in cases where the structured finance transaction is completed in a single country and the structured finance product is the country's domestic currency-denominated one, because if conversion of the local currency into foreign currencies or overseas remittance of the currency is restricted, interest and principal payments on foreign currency denominated debts might be difficult. Such risk can be reduced by the following measures in the structure:

- Offshore creation of reserve account
- Offshore foreign currency swap or third-party guarantee/ insurance
- Flexible interest payment/ redemption schedule

  It is difficult to predict what kind of restrictions can be imposed in the future in a uniform manner, because the regulations imposed in the past sovereign or financial crises differ from country to country and from age to age. The rating for structured finance products therefore in principle does not exceed the country ceiling for a country where the underlying assets are located. However, if the risk of the relevant country's conversion of local currencies into foreign currencies/ remittances of foreign currencies is judged as reduced as a result of assessment of the measures for such risk in the structure, a rating exceeding a country ceiling in relation to underlying assets may be exceptionally possible.

(Reference) JCR's Views on Sovereign Rating and Country Ceiling

Excerpt from Rating Methodology - Sovereign and Public Sector Entities (Last Updated: November 7, 2014)

- Sovereign Credit Rating

An issuer rating of the sovereign shows the government's ability and willingness to fulfill its debt obligations by grading in the rating scale. A sovereign borrower is usually the government or the central bank, although it could vary depending on the legal norm defined by each country. Major difference between the sovereign and the corporate is that the former has the power to levy taxes and the right of issuing currency. It does not abide by the bankruptcy laws and could not disappear like the latter, either. All of which are attributable to the fact that the government has sovereignty of a country. An individual bond rating may be different from the issuer rating as the bond could have degrees of certainty in the repayment depending on its signed contracts, and could default selectively. Rating symbols for sovereigns is used according to JCR's "Types of Credit Ratings and Definitions of Rating Symbols".

- Local Currency Rating and Foreign Currency Rating

A sovereign debtor has the power to levy taxes that can allow it to ensure financial sources for fulfilling its debt obligations and the right of issuing currency. For the payment of foreign currency debts, the debtor needs to convert its local currency to a foreign currency or to procure a foreign currency in the markets. The payment of local currency debts is hence less constrained. Considering such difference, JCR may assign different ratings to the local currency rating and the foreign currency rating. In normal cases, the former is higher than the latter. The following factors are taken into account for notching the difference: financial and monetary conditions of the sovereign that can affect effectuality in the use of power to levy taxes and the right of issuing currency; degree of development of the domestic financial markets; level of foreign exchange reserves; and monetary union or adoption of a pegged exchange rate regime, which could abate constraints on foreign currencies.

- Country Ceiling

A country ceiling reflects JCR's assessment of authorities' likelihood to impose restrictions on foreign currency transactions made by a corporate entity in the country to fulfill its debt obligations, such as conversion of local currency into foreign currency and remittance of foreign currency outside the country. It serves as a maximum limit for the entity's foreign currency rating and in most cases is higher than the sovereign foreign currency rating.

A country ceiling only applies to a foreign currency rating. This is mainly because authorities generally have limited capability to procure or issue foreign currency as compared to local currency. Therefore, authorities sometimes impose restrictions on foreign currency transactions of an entity in the country when they run into difficulties financing repayment of its debt in foreign currency.

A country ceiling will be determined, based on the overall assessment of the currency in circulation, foreign exchange regime, trade settlement and capital control, economic policies and foreign debts as well as responses to crises. In most cases, a country ceiling will be increased by zero-three notches from the sovereign foreign currency rating. However, countries like the US and Japan or in the Euro area may not come under the above criteria mainly because they adopt hard currencies and therefore have only limited likelihood to restrict foreign currency transactions.

In most cases, a country ceiling is a maximum limit for the foreign currency rating of an entity in the country. However, there may be some exceptions when agreements are in place among countries such as multilateral development banks and when strong support is provided to the entity by its parent company outside the country.



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