

## Swap Counterparty

In many securitization products or repackaged bonds (hereinafter referred to as “structured products”), if a financial institution participates in the scheme as a swap counterparty, there are cases where creditworthiness of the swap counterparty may have an impact on the structured products themselves.

In rating for a structured product, JCR has been adopting in principle the “weak link approach,” in which the rating is linked to the weakest of the ratings on the underlying assets of the structured product or the rating on the counterparty, because a default of counterparty has been taken as a cause for winding-up of the swap contract itself in the ISDA-based swap contracts, etc. JCR will explain the way of factoring in creditworthiness of a swap counterparty in rating for structured products in a comprehensive manner below.

### 1. Swap Counterparty in Structured Products

In a structured product, a swap can be used mainly in credit-linked products or repackaged products. A swap here is a swap, which exchanges only interest rates between the two parties (fixed-for-floating interest rate swap or interest rate swap in different currencies), a swap exchanging not only interest rates but also the cash flow from collateral assets at the time of redemption, or a credit default swap in which one party provides an economic effect similar to “guarantee” for specific credits referring to corporations to another party.

### 2. Way of Factoring in Creditworthiness of Swap Counterparty in Rating

In rating for a structured product, JCR adopts the weak link approach in principle, in which the rating is linked to creditworthiness of swap counterparty. For this reason, it is a fundamental rule that a rating exceeding the rating on the swap counterparty cannot be given to the structured product.

### 3. Special Provisions with Swap Counterparty

There are cases where special provisions are attached in order to reduce impact of loss with respect to structured products owing to default of swap counterparty described above at the request of investors primarily. As examples of such provisions, products providing security based on a Credit Support Annex (CSA) and products, for which investors take priority over swap counterparty at termination of swap payment owing to default of the swap counterparty known as flip clause can be listed.

These provisions in general can produce a certain effect on probability of recovery by investors for the structured products when the swap counterparty defaults. JCR thinks, however, that provisions used ordinarily fail to ensure a timely payment that is required for rating of structured products, and JCR applies the weak link approach to rating for structured products mostly.

However, application of the weak link approach shall be avoided by taking “de-linking measures”

below.

#### 4. De-linking Measures

(1) In Case Where the Rating on the Structured Product is above AA-

With a swap counterparty with a Long-term Issuer Rating of above AA- (equivalent to J-1+ for a short-term rating) being an eligibility requirement initially, at least one of the following measures shall be specified to be taken in the initial swap contract:

If the rating becomes below AA- (equivalent to below J-1+ for a short-term rating),

- Replacement of the counterparty with another counterparty which meets the eligibility requirements.
- Provision of a guarantee which JCR accepts as eligible.
- Establishment of a security agreement that can cover the required amount during period.

In addition, in case of a simple swap contract where cost for replacement is considered relatively low, JCR applies the following requirements:

In case where a rating on a structured product is above AA-, with a swap counterparty with a Short-term Issuer Rating of above J-1 (above A- for a long-term rating) being an eligibility requirement, one of the following measures shall be specified to be taken in the initial swap contract:

If the short-term rating becomes below J-1,

- Replacement of the counterparty with another counterparty which meets the eligibility requirements.
- Provision of a guarantee which JCR accepts as eligible.
- Establishment of a security agreement that can cover the required amount during period.

In particular, in a case as in the case of a credit default swap where a swap counterparty shall pay only a predetermined amount in each period, one of the following measures shall be specified to be taken in the initial swap contract:

If the short-term rating becomes below J-1,

- Replacement of the counterparty with another counterparty which meets the eligibility requirements.
- Provision of a guarantee which JCR accepts as eligible.
- Payment in advance equivalent to payment for one period of the entire period.

In addition, if the short-term rating becomes below J-2,

- Replacement of the counterparty with another counterparty which meets the eligibility requirements.
- Provision of a guarantee which JCR accepts as eligible.
- Payment in advance for the entire period in full.

(2) In Case Where the Rating on the Structured Product is above A- and below AA-

With a swap counterparty with a Long-term Issuer Rating of above A- (equivalent to J-1 for a short-term rating) being an eligibility requirement, at least one of the following measures shall be

specified to be taken in the initial swap contract:

- If the rating becomes below A- (equivalent to below J-1 for a short-term rating),
- Replacement of the counterparty with another counterparty which meets the eligibility requirements.
- Provision of a guarantee which JCR accepts as eligible.
- Establishment of a security agreement that can cover the required amount during period.

As in the case of (1) above, for a swap contract where cost for replacement is considered relatively low, JCR shall examine its handling individually.

The Issuer Ratings on the counterparties here are in principle intended for only the entities rated by JCR. As for other eligibility requirements for the counterparties by alternative reinforcement measures in schemes including provision of collateral, JCR shall examine the conditions for each structured product. The evaluation is hence required to be of greater conservatism than usual cases of CSA stipulating on the rate of collaterals, minimum amounts of delivery and frequency thereof, etc., especially in the above mentioned de-linking measures, which therefore makes a subject of careful examination.

The above de-linking measures are based on the assumption that a probability that the swap counterparty goes into default all of a sudden and then it gives up its fulfillment of the swap contract falls within a range of default rates estimated from the rating on the structured product.

For a financial institution to become a counterparty, JCR also examines whether or not it has an ability to conduct in an appropriate manner its workflow associated with measures predetermined for a situation if its creditworthiness worsens and it hits the downgrade trigger set in the structured product, in addition to its creditworthiness represented by its rating, to determine the suitability as a counterparty finally.

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