

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum

Cross-Sector

Scope

This addendum describes Fitch Ratings' approach to analyzing derivative counterparty exposure in new and existing structured finance (SF) transactions and covered bond (CVB) programs. It should be read in conjunction with Fitch's "[Structured Finance and Covered Bonds Counterparty Rating Criteria](#)."

Key Rating Drivers

Each key rating driver is of equal importance.

Eligible Derivative Counterparty Definition: Fitch's analysis relies on counterparties fulfilling their obligations and meeting the relevant minimum primary or secondary risk ratings specified in *Figure 2*. The criteria are predicated on the assumption that: (i) collateral is posted as an initial mitigant within 60 days of downgrade below the primary risk ratings for operational-continuity banks in SF and 14 days for all other counterparties; and (ii) counterparties providing hedging derivatives will be replaced within 60 days of downgrade below the minimum secondary risk ratings. For termination derivatives, the SF rating can be capped at the counterparty or the charged asset rating. (CVBs do not feature termination derivatives, as defined under [Derivative Provider](#).)

Collateralization Criteria: The availability of collateral is intended as a key mitigant if the counterparty defaults before being replaced (for hedging derivatives) or before the maturity of the transaction (for termination derivatives). Fitch's analysis relies on collateral posting arrangements being documented at the time of transaction closing, even where the counterparty is eligible without posting collateral.

Collateral Amount: As the mark-to-market (MtM) valuation of the derivative can change over time and vary among counterparties, Fitch's criteria include volatility cushions (VCs) and liquidity adjustments (LAs). For termination derivatives, Fitch will determine if the collateral posted is sufficient to fund the counterparties' principal and interest (P&I) obligations upon termination of the swap. VCs contained in this criteria are calibrated for interest rate and currency exposures and are not intended for use with other types of derivative.

Collateral Types, Advance Rates: In Fitch's analysis, collateral is limited to certain sovereign bonds, cash deposits with an eligible bank or other short-term qualified investments. To account for maturity mismatches, the credit given to sovereign bond collateral is subject to an advance rate (AR). Where collateral is in a currency other than the base currency of the credit support annex (CSA), Fitch applies a further AR to address potential currency movements.

Termination Payments: Fitch's analysis relies on termination payments due to an "in-the-money" SF issuer to reflect the role of the derivative (for example, to fund the replacement cost for a hedging derivative). Fitch also analyzes whether the impact of termination payments payable to derivative counterparties is mitigated.

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This criteria report should be read in conjunction with "[Structured Finance and Covered Bonds Counterparty Rating Criteria](#)," published June 2026.

This report replaces Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum, dated November 2023, and Exposure Draft Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum, dated May 2026.

Related Criteria

[Structured Finance and Covered Bonds Counterparty Rating Criteria \(June 2026\)](#)
[Covered Bonds Rating Criteria \(May 2026\)](#)
[Global Structured Finance Rating Criteria \(December 2025\)](#)

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Derivative Provider

Role

Fitch divides derivatives into termination or hedging derivatives, as follows.

- **Hedging derivative:** These derivatives typically provide foreign exchange (FX) or interest rate hedging to the SF transaction, such as currency swaps, basis swaps and fixed-to-floating swaps. An early termination of these derivatives does not end the SF transaction.
- **Termination derivative:** The default of the derivative provider triggers the early termination of the SF transaction – for example, credit default swaps. Fitch’s analysis focuses on the full repayment of the SF bonds, including accrued interest up to the termination.

The remainder of this section focuses on hedging derivatives, which are more commonly used in most SF sectors.

Hedging derivatives pose two key risks to the SF transaction, as follows.

1. Upon default of a derivative provider, particularly for swaps, the SF transaction may be required to make certain termination payments if the derivative is “out of the money”. To address this risk, transaction documents usually provide that these termination payments are junior to payments on the SF bonds in the priority of payments.
2. Upon termination of the derivative, typically due to a default of the counterparty, the rated bonds may remain exposed to FX or interest rate risk. To mitigate this risk, the derivative agreements typically include provisions for collateral posting in an amount expected to be sufficient to finance counterparty replacement (see [Risk Classification](#)).

Termination Payments and Flip Clause

Transaction documents typically provide that amounts payable by the SF issuer to a swap counterparty take priority in the transaction’s waterfall over amounts payable to noteholders. One exception is termination payments owed to a defaulted swap counterparty; these are usually moved to a junior item on the payments waterfall, this change in payment priority is commonly known as the “flip clause”. The flip clause protects noteholders from the loss of cash flows resulting from the default of the swap counterparty.

In jurisdictions where the enforceability of flip clauses was challenged, such as those governed by U.S. laws, Fitch applies higher minimum ratings to reduce the risk that the counterparty defaults in advance of implementing a documented remedy, unless sufficient legal comfort on enforceability is provided. In all other cases, Fitch applies lower minimum rating expectations (see “Valid Flip Clause” in [Figure 2](#)).

Fitch does not estimate possible termination payments. Should termination payments owed to a defaulted swap counterparty rank senior or pari passu to interest or principal payments on the SF bonds, Fitch may cap the SF ratings to the applicable rating of the swap counterparty. Where atypical additional termination events (ATEs) are included in a transaction, Fitch will evaluate these and the likely impact on the rated obligations on a case-by-case basis.

Risk Classification

Fitch’s risk classification for hedging derivatives is shown in [Figure 1](#).

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CVB – Termination Payments

Fitch views termination payments due by the cover pool to a derivative provider as liquidity risk, as they rank senior or pari passu to CVB payments.

For external derivative providers, Fitch views this risk as immaterial, as it would concurrently require a counterparty default, the swap being “out of the money” for the CVB issuer, and inability of the CVB issuer to fund the payment.

For internal derivative counterparties, Fitch expects a counterparty in line with minimum secondary risk ratings, as seen in “No Valid Flip Clause” in [Figure 2](#).

Figure 1

Risk Classification – Derivative Provider

Risk Level	Examples	Remedies
Excessive	Derivatives with nonstandard features or providing nonstandard credit support, to an extent that limits their replaceability under similar terms.	No remedies can address these exposures. The SF ratings will be capped at the higher of the counterparty rating or the maximum achievable rating assuming a standard replaceable derivative.
Primary	Standard and replaceable derivatives. No collateral is being posted.	Eligible counterparty – primary risk ratings in Figure 2, including remedial actions.
Secondary	Standard and replaceable derivatives; the derivative provider has started posting collateral in line with Fitch’s criteria.	Eligible counterparty – secondary risk ratings in Figure 2, including remedial actions.
Immaterial	N.A.	N.A.

N.A. – Not applicable

Source: Fitch Ratings

Immaterial Credit Risk – Derivative Provider

In instances where Fitch does not incorporate the derivative in its rating analysis, or a default of the derivative counterparty is not expected to negatively affect the SF transaction, derivative provider exposures may be considered immaterial.

Primary and Secondary Credit Risk – Derivative Provider

In all instances other than immaterial risk, Fitch considers uncollateralized exposures as a primary risk – upon insolvency of the counterparty, the SF transaction could remain exposed to FX or interest rate risk. However, when the derivative provider has started posting collateral in line with this addendum, Fitch views the exposure as a secondary risk. Available collateral is expected to be sufficient to finance the cost of appointing a replacement derivative provider, if needed.

Figure 2 provides expected minimum ratings by risk level. The column “Valid Flip Clause” refers to transactions where there is sufficient legal comfort regarding the enforceability of flip clause. The minimum ratings shown in the column “No Valid Flip Clause” apply where sufficient legal comfort has not been received on the enforceability of flip clauses.

Eligible Derivative Counterparty

Fitch’s analysis relies on all counterparties having the operational knowledge and ability to perform their contractually required functions. In addition to the functional qualification, to achieve isolation, Fitch’s analysis is based on derivative counterparties meeting certain minimum risk ratings, as outlined below.

Applicable Ratings

References to counterparty ratings throughout this report refer to the Derivative Counterparty Rating (DCR), if a DCR is not available, the Issuer Default Rating (IDR) is the applicable rating.

CVB – Derivatives

CVBs are full recourse obligations of the CVB issuer; thus, CVB bondholders would only be exposed to losses from a defaulting derivative counterparty if the CVB issuer defaulted as well.

Fitch’s collateral posting expectations are lower for CVBs with external derivative providers, compared to those for CVBs with internal derivative counterparties or SF transactions.

Figure 2
Derivative Risk Rating Table

Category of Highest Rated Note	Minimum Primary Risk Ratings (No Collateral)	Minimum Secondary Risk Ratings (with Collateral Posting)	
		Valid Flip Clause	No Valid Flip Clause
AAA	A or F1	BBB- or F3	BBB+ or F2
AA	A- or F1	BBB- or F3	BBB+ or F2
A	BBB or F2	BB+	BBB or F2
BBB	BBB- or F3	BB-	BBB- or F3
BB	Note Rating	B+	BB-
B	Note Rating	B-	B-

Note: In this report, long-term rating means either DCR if assigned and applicable or IDR (when DCR is not assigned or applicable), and short-term rating means IDR. In the case of third parties guaranteeing the obligations of a derivative counterparty in jurisdictions where the flip clause is enforceable, Fitch considers the highest of the guarantor's IDR and the applicable counterparty's rating. For example, 'AAAsf' bonds can be supported by a 'BBB-' entity guaranteeing a collateralized derivative provider, or post collateral itself.

Source: Fitch Ratings

The minimum primary risk ratings shown in *Figure 2* above apply to hedging derivative counterparties, considering the respective rating of the highest rated note. For example, SF ratings of 'AAA' can be supported by counterparties with a minimum DCR — or IDR if not assigned — of 'A' or a minimum Short-Term IDR of 'F1' without posting collateral.

The minimum secondary risk ratings shown in the column "Valid Flip Clause" apply to derivative counterparties that post adequate collateral and where sufficient legal comfort on the enforceability of "flip clauses" is available. For example, note ratings of 'AAA' can be supported by counterparties with a minimum Long-Term DCR — or IDR — of 'BBB-', or a minimum Short-Term IDR of 'F3' if it posts collateral. In effect, the posting of collateral extends the ability of a counterparty to act as derivative counterparty by mitigating the exposure.

The minimum secondary risk ratings shown in the column "No Valid Flip Clause" apply to derivative counterparties that post adequate collateral, but where no sufficient legal comfort with respect to the enforceability of flip clauses is available.

The rating of the SF bonds for termination derivatives can be capped at the rating of the counterparty, for uncollateralized exposures, or the rating of the collateral, for collateralized exposures. See *Charged Assets* in Fitch's "Structured Finance and Covered Bonds Counterparty Rating Criteria" report for more details.

For the purpose of this criteria report, branches of a rated bank will be considered as an eligible counterparty so long as the applicable rating (DCR or IDR) of the bank of which it is a part, but subject to a cap at the Country Ceiling of the host country of the branch, is sufficiently high to allow for eligibility, per this criteria report. See the report "[Country Ceiling Criteria](#)" for more details. For derivative counterparties, if the derivative is entered into under the International Swaps and Derivatives Association (ISDA) master agreement and section 10 (a) of the schedule applies, the Country Ceiling is not applicable.

The DCR assigned to an institution is not automatically considered for branches operating outside the rated bank's country of incorporation. This will be analyzed on a case-by-case basis.

Remedies upon Losing Eligible Counterparty Status

Figure 3 details expected remedial actions upon a counterparty downgrade below the minimum ratings necessary to maintain the note ratings.

SF Modifier

All ratings referenced in this criteria report are deemed to have the SF modifier attached, except for transaction types that are not considered by Fitch to be SF.

Figure 3

Derivative Provider — Remedies upon Ineligibility

Action upon Downgrade Below Primary Risk Ratings (Figure 2)	Remedial Time Frame
Collateralization including mark-to-market, liquidity adjustment and volatility cushion (operational-continuity banks in SF)	60 calendar days
Collateralization of mark-to-market (all other counterparties)	14 calendar days
Collateralization including liquidity adjustment and volatility cushion (all other counterparties)	60 calendar days
Replacement with a different eligible counterparty, per Figure 2	60 calendar days
Obtaining a guarantee from an eligible counterparty, per Figure 2	60 calendar days
Action upon Downgrade Below Secondary Risk Ratings (Figure 2)	Remedial Time Frame
Collateralization while completing replacement/guarantee, including mark-to-market, liquidity adjustment and volatility cushion (all counterparties)	14 calendar days
Replacement with a different eligible counterparty, per Figure 2	60 calendar days
Obtaining a guarantee from an eligible counterparty, per Figure 2	60 calendar days

Source: Fitch Ratings

To avoid a note rating downgrade, Fitch expects collateral to be posted within 14 calendar days from counterparty downgrade below the secondary risk ratings, per Figure 2, even though the ineligible entity will, ultimately, be replaced or obtain a guarantee within 60 days.

For collateral to be an effective risk transfer, Fitch expects funds to be posted to an account with an entity other than the derivative provider and outside of the derivative provider's banking group.

Fitch notes that covenants in the transaction documents requiring a replacement guarantor within a short time frame may in some circumstances be difficult to comply with. If replacement or guarantor appointment for ineligible derivative counterparties takes longer than anticipated collateralization is likely to be the only viable short-term remedy.

Additionally, Fitch's analysis relies on a CSA or similar documentation to be executed at transaction closing to facilitate prompt collateral posting.

Operational-Continuity Banks in SF

Fitch believes that operational-continuity banks in SF, as defined in its "Structured Finance and Covered Bonds Counterparty Rating Criteria," are more likely to maintain operational continuity during financial difficulties. As a result, Fitch expects collateralization (including mark-to-market, liquidity adjustment and volatility cushion) within 60 calendar days of the loss of primary risk ratings for such counterparties, compared with a remedial period of 14 days for counterparties that do not qualify as operational-continuity banks in SF.

Excessive Credit Risk — Derivative Provider

Fitch views the derivative exposure as excessive if the derivative agreement provides credit support via nonstandard features, or generally provides nonstandard levels of credit support to the SF transaction, to an extent that the derivative provider is unlikely to be replaced under similar terms in the relevant market, even if collateral is available, per Fitch criteria.

When the derivative exposure is considered excessive, Fitch may model the SF transaction using a derivative with standard features that can be credibly replaced in the market, disregarding nonstandard features or support. If no such replacement is available, Fitch will model the SF transaction with no hedging. Ultimately, the SF ratings will be the higher of (i) the maximum achievable SF rating, assuming a standard and replaceable derivative, or no derivative at all if Fitch deems the derivative irreplaceable in the market, or (ii) the rating of the entity providing the derivative considered to be of excessive risk. (Rating means DCR if assigned, otherwise the IDR.)

Collateralization Criteria

Fitch's collateralization criteria focus on replacement costs for hedging-type derivatives. Fitch assesses the calculation of any early termination payment to determine the extent to which it is aligned to the replacement costs (see [Determination of the Termination Payment Amounts](#) below for more detail). The collateralization criteria also provide an additional buffer, consisting of the VC and the LA, which is intended to cover additional costs.

The focus of the collateralization criteria for termination derivatives is the avoidance of allocated losses, rather than the loss of future interest due to an earlier repayment caused by early termination. In particular, any P&L payments due up to the time of contract termination should be covered.

Fitch's analysis relies on collateral for all derivatives being posted in line with the following principles.

- The collateral is for the benefit of the SF transaction or CVB programs, with a counterparty that holds minimum primary risk ratings, per *Figure 1*; or with an independent custodian under a legal arrangement, where the securities are legally isolated from the custodian.
- The market value of the derivative and the amount of any collateral to be posted are determined at least weekly. Fitch's analysis relies on collateral being posted shortly after the valuation day, in line with the market-standard settlement periods for the collateral.
- Where collateral is posted in securities and the securities subsequently become ineligible, e.g. due to a downgrade of the sovereign issuer, Fitch expects the ineligible securities to be replaced with eligible collateral at the next valuation date.
- The CSA or similar documentation is executed at the point of entering into the derivative agreement.
- The CSA provides clarity on the collateral enforcement rights when the counterparty is the defaulting or sole affected party. When collateral arrangements do not follow standardized, industrywide frameworks – for example, those produced by the ISDA – a legal opinion should address the enforceability of the collateral arrangements. Similarly, jurisdiction-specific aspects can require legal analysis to establish the enforceability of collateral provisions.
- Any costs associated with collateral posting and with the appointment of a replacement counterparty or guarantor are borne by the counterparty that becomes ineligible.
- An SF transaction's trustee reports include information on the type and amounts of collateral posted, if any. Based on the provisions of standard CSAs, the collateral amount (CA) should be calculated by the valuation agent in a commercially reasonable manner and acting in good faith. Fitch's analysis relies on the valuation agent to have sufficient operational capacity and market knowledge to perform swap valuation calculations. Fitch may perform a "sense check" of reported collateral posting amounts as part of its surveillance process.
- Certain ARs can apply, depending on the type of collateral.
- Where transaction documents define a threshold amount below which weekly collateral posting adjustments will not be made – e.g. a minimum transfer amount (MTA) – this threshold should not be more than USD100,000 or its stipulated currency equivalent, per transaction. Where MTAs are above this limit, this risk will be assessed in Fitch's rating analysis, depending on its significance for the SF transaction.
- Collateral posting is "one-way" only. Collateral is not posted for the benefit of the counterparty when it is "in the money".

For the purpose of monitoring the posted collateral, investor reports should include details on the CA.

Determining the Collateral Amount

Hedging Derivatives

If a counterparty elects to post collateral and fulfils at least the applicable minimum secondary risk ratings set out in *Figure 2*, Fitch evaluates the amount of the collateral in accordance with the formula set out below. Upon downgrade below the applicable minimum secondary risk ratings, Fitch expects adequate collateral to be posted within 14 calendar days from counterparty ineligibility, even when the ineligible entity will, ultimately, be replaced, or if it obtains a guarantee, within 60 days. Where the counterparty is rated below the applicable minimum secondary risk ratings specified in *Figure 2* at transaction close, Fitch does not view collateral as a viable mitigant to the credit exposure toward the derivative counterparty.

Collateral amount (standard formula) = $\text{Max}[0; \text{MtM} + (\text{LA} * \text{VC})]$

Figure 4

Definitions of Collateral Amount Terms

MtM	The mark-to-market (MtM) value of the derivative at the time of valuation for the purpose of collateral posting. Fitch's analysis relies on the MtM to be calculated by the valuation agent, based on an estimate of the amount that would be payable in the event of a termination of the derivative agreement on the valuation date, taking into account the prevailing market environment. Fitch expects such valuation methodology to be consistent with that which would be applied by an independent market counterparty and, for esoteric derivatives, include the value of embedded optionality. See Determination of the Termination Payment Amounts below for more details.
LA	The liquidity adjustment (LA) is specified separately for each type of derivative, based on the perceived degree of liquidity of the derivative in question. See Liquidity Adjustment below for a classification of derivatives and the corresponding LAs for such derivatives.
VC	The volatility cushion (VC) amount addresses the risk that the market value of the derivative may change before replacement. See Volatility Cushions below.
Notional	The highest notional amount on which derivative payments are based in the current or any future period. Fitch would expect to use the highest notional where the notional differs for each of the legs of the derivative.
DV01	The absolute change in the mid-market value of the derivative resulting from a 1.0-basis point change in the relevant swap curve. In the case of currency swaps where both legs reference floating rates, the applied value should be the greater of the amounts calculated for each of the individual legs of the derivative. See <i>Figure 6</i> for DV01 multiples.
Basis Swap	Floating/floating swaps in which both legs reference standard indices and a horizon of up to 12 months. Standard variable rates (SVRs) are not considered standard indices, as they are lender-specific.
WAL	The weighted average life (WAL) of the derivative assuming non-exercise of any early termination clause, zero defaults and zero prepayments rounded up to the nearest integer.

Source: Fitch Ratings

In Fitch's view, the combination of LAs and VCs provides sufficient protection against both the potential MtM change over the exposure period and potential pricing differences between the original and the replacement counterparty.

The appointment of an eligible counterparty as guarantor or replacement counterparty would be a valid alternative to posting the CA, but Fitch would expect collateral to be posted and remain available until these have occurred.

Derivative market values in favor of the counterparty are defined as negative market values. Collateral should be posted even if the derivative market value is in favor of the counterparty in the event that the VC (including any LA) be greater than the MtM value and, therefore, the result of the collateral formula be positive. Fitch does not expect collateral to be posted where the derivative's market value is significantly in favor of the counterparty and exceeds the VC (including any LA).

The formula assumes that the collateral is posted in cash. In most cases, Fitch expects the termination currency documented in the schedule to the master agreement and the base currency of the CSA will be the same. In addition, the chosen currency should be one of the currencies of the assets or liabilities of the issuer or programme. Where the collateral is not

posted in cash or where currency risk arises as part of the collateralization, Fitch applies ARs to the collateral value, depending on the types of collateral used (see [Collateral Types and Advance Rates](#) below for more detail).

Liquidity Adjustment

Market feedback confirmed that the effort and costs involved in replacing a derivative are strongly influenced by the type of derivative in question, meaning the complexity of the derivative, the degree of optionality and conditionality, and how easy it is for a replacement counterparty to hedge its obligations under the derivative. Fitch, therefore, applies liquidity adjustments for derivatives where liquidity and replacement would be expected to be more challenging.

Liquidity adjustments are specified in the Liquidity Adjustment table below and depend on whether the derivative is balance-guaranteed or references a defined schedule. Balance-guaranteed derivatives incorporate factors beyond the counterparty's control, such as delinquencies and prepayments, and are, therefore, harder to analyze and typically more expensive.

Hybrid arrangements that cap or floor the notional according to certain thresholds, and thereby often create a corridor of notional levels, are treated as balance-guaranteed. Also, swaps with nonstandard elements, such as rates loosely linked to market rates, but containing an element of optionality or discretion by the rate-setting entity, described in this report as "nonstandard indices," are treated in the same way as balance-guaranteed swaps.

Swaps referencing a fixed notional schedule set out for each future period in the confirmation and interest rate caps and floors confirmed as individual instruments and also referencing a fixed notional schedule set out for each future period in the confirmation are not expected to be treated as esoteric.

When pricing derivatives, market participants also focus on the degree of counterparty or credit risk embedded in them. However, Fitch does not consider this a key element in determining the price for most derivatives in SF transactions and CVB programs, as derivative payments rank at the top of the priorities of payment, limiting credit risk to the transaction. The LA can be increased on a case-by-case basis for those derivatives attached to non-senior rated notes, or those that do not have a senior position in the priority of payments.

For long-dated derivatives with a weighted average life greater than 20 years, Fitch expects transaction parties to demonstrate that market liquidity is not reduced. Reduced liquidity for long-duration contracts may result in an increased liquidity adjustment sized on a case-by-case basis.

Figure 5
Liquidity Adjustment

Type	Liquidity Adjustment
1. Derivatives with payment obligations that reference standard indices and a fixed notional/scheduled notional or a notional referencing the balance of a rated note with a "hard bullet" maturity. In this context a "hard bullet" maturity only includes notes where the underlying rating addresses repayment on a given maturity date. The definition of "hard bullet" does not include notes that are rated on the basis of pass-through amortization following a trigger event.	1.00
2. "Esoteric" derivatives, generally those with a notional depending on asset performance, including delinquencies or prepayments. "Balance guaranteed" and/or derivatives referencing "nonstandard indices"; in this context, nonstandard indices include those indices determined according to a basket of bank-specific lending rates or indices that are influenced by a third-party's actions; for example, social housing lending rates. This is not an exhaustive list and other derivatives can be classified as esoteric.	1.25

Source: Fitch Ratings

Volatility Cushions

The VCs calculated by Fitch address the risk of the potential change in the market value of the derivative over the replacement period. Fitch's approach to calculating the VCs and ARs assumes that the derivative exposure addressed by them is not a key risk driver of the

transaction performance, which is the case in the large majority of transactions. [Appendix 3](#) provides a brief description of the methodology used to calculate the VCs.

Fitch views a derivative's dollar value of one basis point (DV01) as the most appropriate measure of interest rate-related market risk. Where a derivative features currency as well as interest rate risk, Fitch views the currency component as best sized as a percentage of the transaction's notional principal amount. Fitch's VC formulae, therefore, contain reference to both a derivative's DV01 and its notional.

The VCs assume standard swap structures. There have been derivative agreements in SF transactions and CVB programs where the payment obligations of one or both parties are defined with esoteric references — for example, the scheduled yield of the securitized asset pool — rather than specific fixed rates or standard floating-rate indices.

In such cases, Fitch evaluates the documented VC in comparison to the levels shown in the below table, considering the underlying economic risks within the swap structure. For example, Fitch would expect a combination of the below VCs to be applied where the economic risk is considered one of a fixed/floating exposure on 50% of the asset pool and a basis exposure on the remaining 50% of the pool. Fitch considers the broader replacement prospects of such esoteric swaps in addition to the adequacy of the VC as part of the overall rating analysis.

Where applicable, the formula refers to VCs for pairs of the following currencies only: Australian dollar, Canadian dollar, Swiss franc, Czech koruna, Danish krone, euro, U.K. pound, South Korean won, Norwegian krone, New Zealand dollar, Japanese yen, Swedish krona, Singapore dollar and U.S. dollar. No differentiation is made between currencies because, from a forward-looking perspective, changes in the yield curve are broadly assumed to be equally likely and of similar potential magnitude among the various currencies. Fitch will assess other currencies on a case-by-case basis.

Figure 6

Volatility Cushion Formulae (DV01)

Note Rating ^a Category AAsf or Higher	
Single-Currency Fixed: Floating Swap & Single-Currency Cap/Floors	80 x DV01
Single-Currency Basis Swap	0.75% x Notional
Cross-Currency Swap & Foreign Exchange Options	80 x DV01 + 8% x Notional
Cross-Currency Basis Swap	40 x DV01 + 8% x Notional
Note Rating Category A+sf or Lower	
Single-Currency Fixed: Floating Swap & Single-Currency Cap/Floors	60 x DV01
Single-Currency Basis Swap	0.50% x Notional
Cross-Currency Swap & Foreign Exchange Options	60 x DV01 + 6.5% x Notional
Cross-Currency Basis Swap	30 x DV01 + 6.5% x Notional

^aTimely payment rating level for covered bonds
Source: Fitch Ratings

In instances where for operational reasons the counterparty cannot utilize a formula linked to the derivative's DV01, the percentages set out in the table below multiplied by the notional may be substituted, provided that the derivative has a WAL of 20 years or less. The inclusion of this alternative is not intended to provide optionality in the determination of the collateral amount, and therefore, Fitch expects that documentation will specify a VC calculated either by reference to DV01 as set out in Figure 6 or the alternative as set out in Figures 7 or 8.

Figure 7

Volatility Cushion Formulae (Notional %)

Note Rating^a Category AAsf or Higher

WAL (years)	Single-Currency Fixed: Floating Swap & Single- Currency Cap/Floors (%)	Cross-Currency Swap & Foreign Exchange Options (%)	Cross-Currency Basis Swap (%)
1	0.8	8.8	8.4
2	1.6	9.6	8.8
3	2.4	10.4	9.2
4	3.2	11.2	9.6
5	4.0	12.0	10.0
6	4.8	12.8	10.4
7	5.6	13.6	10.8
8	6.4	14.4	11.2
9	7.2	15.2	11.6
10	8.0	16.0	12.0
11	8.8	16.8	12.4
12	9.6	17.6	12.8
13	10.4	18.4	13.2
14	11.2	19.2	13.6
15	12.0	20.0	14.0
16	12.8	20.8	14.4
17	13.6	21.6	14.8
18	14.4	22.4	15.2
19	15.2	23.2	15.6
20	16.0	24.0	16.0

^aTimely payment rating level for covered bonds
Source: Fitch Ratings

Figure 8

Volatility Cushion Formulae (Notional %)

Note Rating^a Category Asf or Lower

WAL (years)	Single-Currency Fixed: Floating Swap & Single- Currency Cap/Floors (%)	Cross-Currency Swap & Foreign Exchange Options (%)	Cross-Currency Basis Swap (%)
1	0.6	7.1	6.8
2	1.2	7.7	7.1
3	1.8	8.3	7.4
4	2.4	8.9	7.7
5	3.0	9.5	8.0
6	3.6	10.1	8.3
7	4.2	10.7	8.6
8	4.8	11.3	8.9
9	5.4	11.9	9.2
10	6.0	12.5	9.5
11	6.6	13.1	9.8
12	7.2	13.7	10.1
13	7.8	14.3	10.4
14	8.4	14.9	10.7
15	9.0	15.5	11.0

Figure 8

Volatility Cushion Formulae (Notional %)

Note Rating ^a	Category	Asf or Lower	
16		9.6	16.1
17		10.2	16.7
18		10.8	17.3
19		11.4	17.9
20		12.0	18.5

^aTimely payment rating level for covered bonds

Source: Fitch Ratings

Netting of Collateral Amounts

Where more than one derivative exists between the same SF issuer and counterparty, for example, using a single ISDA master agreement with multiple confirmation documents, Fitch reviews the documented netting arrangements for termination payments and collateral posting. Where payments under the different swaps are paid at the same position in the SF issuer's priority of payments and the swaps are confirmed under the same ISDA master agreement, the documentation can provide for the netting of termination payments. Fitch's analysis relies on the collateral posting formula being applied after summing the MtM, VC and LA of each individual swap, to the extent that termination payments are likely to be netted.

The table below demonstrates a netting example. The MtM of swap 1 is assumed to be significantly negative. At the time of the MtM valuation, the issuer has a net obligation toward the counterparty to be paid via future swap payments. If the CA is calculated on an individual basis for each swap, the resulting aggregate CA is 1,375,000, or 0 + 1,375,000. However, if the aggregate CA is calculated on a netted basis, the aggregate CA equals zero, as the negative MtM on swap 1 is sufficient to mitigate the other amounts due to the SF issuer. The LA and VC components are always represented as a positive number and, therefore, no netting between these components is possible.

Figure 9

Netting Example

	Swap 1	Swap 2	Netted
MtM (\$)	-15,000,000	1,000,000	-14,000,000
Liquidity Adjustment (LA)	1.25	1.25	N.A.
Volatility Cushion (VC; \$)	4,700,000	300,000	N.A.
LA * VC * (\$)	5,875,000	375,000	6,250,000
Max (0; MtM + [LA * VC]) (\$)	0	1,375,000	0

MtM – Mark-to-market

Source: Fitch Ratings

Posting collateral on the basis of a netted position assumes that it will be possible to terminate all swaps on a timely basis. In the above example, the proceeds of swap 1 would be required to fund the termination of swap 2. Posting collateral on a netted basis can offer insufficient protection to the SF transaction or CVB program, where there are concerns regarding specific swaps; for example, due to their esoteric nature. Fitch considers the structure to provide insufficient collateral to mitigate the counterparty risk in such cases, and analyzes the transaction on the basis that the derivative counterparty exposure is not consistent with its criteria.

Termination Type Derivatives

Fitch's analysis relies on the CA being sufficient to cover any P&I payments due to the noteholders up to the point of the SF transaction's early termination, following a counterparty's default. Amounts related to the principal are usually addressed by the nature of the structure through a "charged asset" (see *Charged Assets* in "Structured Finance and Covered Bonds

Counterparty Rating Criteria”). Fitch assumes that two coupon periods, which are subject to a minimum of six months, will in most cases be sufficient to cover interest that accrues and remains unpaid upon the transaction’s early termination, following a counterparty’s default.

Collateral Types and Advance Rates

Collateral can often be posted in various currencies referenced in the CSA. Fitch’s criteria assume that the collateral is of such credit quality that it would introduce only limited additional credit risk. Fitch’s analysis relies on collateral being in one of the following categories:

- **Highly rated sovereign bonds:** Fitch believes sovereign bonds rated at least ‘F1’ can provide a suitable source of collateral, subject to the application of appropriate ARs intended to mitigate market value risks. The application of ARs allows the use of collateral with longer-term maturities than included in the qualified investments category. [Appendix 1](#) gives ARs for certain sovereign bonds.
- **Qualified investments:** Such collateral can take the form of investments in securities or certain money market funds of bank accounts, as detailed in “Structured Finance and Covered Bonds Counterparty Rating Criteria.”

Advance Rates

ARs cover the market value risk of any collateral, with the exception of overnight exposures to maturity or FX risk. Fitch defines the actual CA posted for a derivative (CA derivative) to be as follows.

CA Derivative/AR Collateral

The collateral AR addresses the risk of a change in market value of the collateral security over the time it takes to find a substitute counterparty on significant deterioration in creditworthiness, or default, of the counterparty posting the collateral. Fitch’s ARs have been calculated to cover a 30-business day period. Fitch’s analysis relies on the market value of the derivative and the collateral being determined at least weekly. Accordingly, any additional collateral should be posted at least weekly, or returned when the value of the posted amount exceeds the calculated CA.

Fitch assumes the collateral to be held in an account either in the name of, or pledged to, the SPV and legally isolated from the derivative counterparty. Fitch further assumes that the enforceability ranking and perfection of the security interests created, or enforceability of any title transfer arrangement, is given when a counterparty collateralizes its position.

[Appendix 2](#) provides a brief description of the methodology used to calculate the ARs.

Rating Impact of Early Termination Payments

Most termination payments, as with other payments due to a derivative counterparty, rank senior in a SF transaction’s priorities of payment/payment waterfall. As a consequence, scenarios where such termination payments can arise and burden the SF transaction need to be considered as part of the rating analysis. Fitch will reflect potential termination payments in its rating analysis as follows.

- Some termination payments are triggered by events outside the scope of Fitch’s rating. This includes, for example, those arising from an illegality or force majeure. Investors should be aware that any risk resulting from this type of termination payment is not reflected in Fitch’s rating.
- Termination payments relating to the non-performance by the SF issuer can be triggered by events within the scope of Fitch’s rating, and the likelihood of their occurrence can be assessed in the rating analysis and the relevant rating scenarios. For example, one part of Fitch’s cash flow analysis is an assessment of whether, during the life of the transaction, sufficient funds are available within the rating stress scenarios to fulfil the SPV’s payment obligations under the derivative. Such payments, where due to the derivative counterparty, can rank senior to payments due to noteholders.
- Termination payments relating to non-performance by the counterparty can also be triggered by events within the scope of the rating analysis, and the likelihood of their

occurrence would, if not mitigated, affect the rating analysis. Typically, the transaction documents require subordination of these termination payments due to the counterparty in the transaction's priorities of payment, which is known as a "flip clause".

- For counterparties affected by the absence of, or potential invalidity of flip clauses with respect to termination payments, Fitch's analysis relies on a replacement within 60 calendar days of any downgrade below the applicable minimum secondary risk rating, indicated as "No Valid Flip Clause," for the respective note rating shown in *Figure 1*. Therefore, collateralization ends as a remedy earlier than for counterparties not affected by this issue. This provision is intended to mitigate the potentially enhanced risk to affected transactions in the event of insolvency of the relevant counterparty.
- Termination payments arising upon occurrence of a benchmark event in relation to the derivative transaction index may be material to Fitch's rating analysis. This risk is considered to be sufficiently remote in cases where the derivative agreement includes fall-back provisions similar to the ISDA Benchmark Supplement. When provisions to find a replacement index are significantly different or they provide the derivative counterparty with the possibility to terminate the transaction if the derivative counterparty does not agree to the replacement rate, Fitch will apply a case-by-case approach to assess the materiality to the notes' rating. Fitch will disclose the approach applied in the respective rating action commentaries, including their effect on the rating where appropriate.

Where Fitch believes the risk of termination payments of uncertain size falling due in priority to, or *pari passu* with, payments to noteholders is not sufficiently mitigated, the ratings of the notes can be constrained by the rating of the counterparty, or Fitch may not be able to assign investment-grade ratings, or any ratings at all.

Derivative Documentation

Derivatives in SF transaction and CVB programs are usually documented under a master agreement published by the ISDA. The master agreement addresses matters such as representations and undertakings by the parties, events of default and other termination events, and payment methods and payment measures arising upon early termination.

Nearly all securitization derivatives use either the Multicurrency-Cross Border version of the 1992 ISDA master agreement or the 2002 ISDA master agreement, rather than the Local-Currency Single Jurisdiction version of the 1992 ISDA master agreement, regardless of the number of currencies or jurisdictions considered. The ISDA master agreement is typically governed by either New York or English law.

The 2002 ISDA master agreement is similar in form and substance to the 1992 version, with many of the substantive differences between the agreements relating to termination. Although the events that can bring about termination are materially consistent, the time in which termination can be effected subsequent to certain events occurring is shorter in the 2002 version, and the payment measure for calculating payments upon termination is different. Fitch will assess whether the derivative contracts follow certain principles, outlined throughout this report, to understand the impact on the rated notes, regardless of whether the 1992 or 2002 ISDA master agreements are used.

In some instances, Fitch has seen master agreements drafted in a local language and governed under local law. Although such local master agreements can simply be a translation of an ISDA master agreement, Fitch nevertheless reviews the relevant derivative documentation, which may require legal analysis, to identify any risks in relation to the application of local law to such an agreement in the context of Fitch's rating analysis.

The master agreement is accompanied by a schedule and a confirmation, which supplement and override, to the extent of any inconsistency, the master agreement. The schedule will apply, supplement or amend certain provisions in the master agreement, and will often introduce ATEs. The confirmation sets out the actual rates and indices governing the relevant derivative, the dates when payments are due and the notional amount for calculating the payments.

In addition, the terms of collateralization as a mitigant to counterparty exposure are typically set out in a CSA, in a form published by ISDA for both English and New York law. Experience with previous

downgrades of market participants suggests that agreeing and putting in place a CSA is a time-consuming exercise. To avoid the possibility that a credit risk could remain uncovered due to failure to put the CSA in place in time, Fitch's analysis relies on the CSAs to be agreed and signed by the initial transaction counterparties when entering into the derivative agreement.

Events of Default and Termination Events

The ISDA master agreement defines events of default (EoDs) and termination events that can bring about the early termination of a derivative. An EoD gives the non-defaulting party the right to terminate all derivative transactions under the master agreement and, where elected, may provide for automatic termination following a bankruptcy EoD. A termination event gives either one or both parties the right to terminate one or more, but not necessarily all, derivatives between them under the master agreement. Fitch views events of default and termination events in a similar manner, as each can bring about a termination of the derivative contract, and therefore each event needs to be considered in the rating analysis.

The table below sets out the events of default in the ISDA master agreement and Fitch's expectations for application in a SF transaction.

Figure 10

Events of Default

Event	Applicable to Issuer	Applicable to Counterparty
Failure to pay or deliver	✓	✓
Breach of agreement	✗	✓
Credit support default	✗	✓
Misrepresentation	✗	✓
Bankruptcy	✗	✓
Default under a specified transaction	✗	✗
Cross-default	✗	✗
Merger without assumption	✗	✓

Source: Fitch Ratings

The termination events set out in the ISDA master agreement are typically supplemented with additional transaction-specific events. The party directly affected by or having caused the termination event is termed the affected party. It is possible that both parties could be affected by the same event. A tax event upon merger adds the concept of a burdened party, which is the party that must make a tax payment or receives a lower payment under the derivative due to tax levied. The party that has the right to terminate the derivative agreement differs depending on the type of termination event.

Figure 11

Termination Events

Event	Potentially Affected Party	Party with Right to Terminate
Illegality	Either party	Either party
Force majeure	Either party	Either party
Tax event	Either party	Affected party
Tax event upon merger	Counterparty	Issuer
Credit event upon merger	Counterparty	Issuer
Acceleration/enforcement notice	Issuer	Either party
Redemption of notes	Issuer	Either party
Credit deterioration	Counterparty	Issuer

Source: Fitch Ratings

Credit deterioration captures Fitch's expectation that an ATE will occur in the event of a failure of the counterparty to comply with the contractual terms, such as the collateral posting and replacement

provisions. Sometimes this obligation for a counterparty is subject to an “efforts threshold.” For example, by requiring only “best efforts” or “commercially reasonable efforts.” Fitch will take rating action on the rated notes if it considers the remedial actions taken by a counterparty insufficient, notwithstanding any efforts thresholds, and notwithstanding any exercise or non-exercise of termination rights following an ATE, and if the insufficiency is material to Fitch’s rating analysis.

This section describes what Fitch typically observes in derivative documentation regarding EoDs and ATEs. If the documentation for a specific transaction deviates materially from this description, Fitch will assess the potential rating impact case by case.

Determination of Termination Payment Amounts

Payments upon early termination are handled differently by the 1992 and 2002 ISDA master agreements and can also receive different treatment if EoDs, termination events or ATEs occur.

The 1992 ISDA master agreement provides for two payment methods — first method and second method — and two payment measures — market quotation and loss. If early termination results from an EoD, the first method provides that payments upon termination will be due only to the non-defaulting party, such that the defaulting party is not due any payment even if it was in the money upon termination. The second method provides that payments upon termination are due to the party in the money upon termination, regardless of whether the party is the defaulting or the non-defaulting party.

The market quotation payment measure is defined as an amount determined by reference to the market for an instrument similar to the terminated derivative. The loss payment measure is defined as the sum of total losses and costs suffered by, or gains of, the non-defaulting party upon termination of the derivative, determined reasonably and in good faith by the non-defaulting party.

Derivatives in securitizations using the 1992 master agreement typically use the second method and market quotation.

If early termination results from a termination event rather than an EoD, the course of action depends on whether one or both parties have been affected. If there is one affected party, the payment method is identical to the second method, regardless of whether the schedule calls for the first or second method. The payment measure applied will be market quotation or loss, as set out in the schedule. The affected party is treated as the defaulting party and the party that is not affected as the non-defaulting party, for both payment method and payment measure.

If both parties are affected and market quotation applies, each party obtains a settlement amount through the market quotation method, and the payment amount is equal to half of the difference of the two results. If both parties are affected and loss applies, each party calculates its loss as a result of the derivative’s termination, and the payment amount is equal to half of the difference of the two results.

In the 2002 ISDA master agreement, early termination payment methods do not have to be set out in the schedule, as the agreement calls for the same payment method and payment measure in all events.

If early termination arises by virtue of an EoD, the non-defaulting party determines the close-out amount. This is essentially the amount of losses or costs or gains of the non-defaulting party in replacing or in providing to the non-defaulting party the economic equivalent of the material terms of the derivative.

If early termination results from a termination event, and if there is one affected party, the calculation would be handled as with an EoD, whereby the affected party is treated as the defaulting party and the party that is not the affected party as the non-defaulting party. If both are affected, each party calculates an amount in accordance with the paragraph above, and the payment amount is equal to half of the difference of the two results.

The determination of early termination payments (whether arising from an EoD or a termination event) can have a material impact on the cash flow of transactions and therefore needs to be considered in the rating analysis. Transaction documentation typically follows some basic principles, which include the following.

1. The termination payments are determined by seeking at least three actual quotes from eligible counterparties for derivatives on substantially the same terms as the existing derivative.

2. The quotes reflect the amount the eligible counterparty is willing to pay or receive to execute a replacement derivative, often referred to as the MtM of the derivative.
3. If initially unsuccessful in obtaining these quotes, this process is repeated or documentation facilitates that the settlement amount is determined by reference to the non-defaulting party's loss.
4. Where the replacement occurs, the amount the eligible counterparty pays or receives to execute a replacement derivative is used for determining the termination payment.

Where specific transaction documentation materially deviates from the above principles, Fitch assesses the rating impact on a case-by-case basis.

When Documents Differ from Fitch Criteria

Materiality Assessment

If counterparty exposures and structural remedies differ from the principles outlined in these criteria, Fitch assesses the materiality of the exposure as set out in the "Structured Finance and Covered Bonds Counterparty Rating Criteria." In addition to the consideration set out in that report, the following also apply for derivative counterparties.

Absence of Collateral Posting as Remedial Action

If collateral posting is not envisaged in the transaction documentation, Fitch will assess the materiality of the derivative on the SF ratings. The following examples summarize the most frequent rating analysis outcomes when the SF transaction arrangements differ from the expectations described in these criteria.

- **Basis Swaps:** If the asset pool and the interest on the SF bonds are indexed to different but correlated indices, such as one-month Euribor versus three-month Euribor, or have a similar but not exact reset frequency, such as monthly versus quarterly, the resulting risk is generally not a key driver in an SF transaction. As such, even if Fitch assumes the basis swap cannot be easily replaced, the SF ratings would generally not be constrained by the counterparty's applicable rating, if collateral posting provisions are not envisioned.
- **Interest Rate Swaps:** Interest rate risk is typically a more substantial risk driver than basis risk. Therefore, the lack of posting collateral is credit negative, but the resulting credit profile can still be better than the direct linkage to the counterparty rating. As a result, a committee might conclude that SF bonds could be rated above the counterparty's applicable rating.
- **Cross-Currency Swaps:** Unhedged foreign-currency risk in SF transactions is rarely a marginal rating driver. The absence of collateral posting provisions for derivatives hedging significant portions of the rated obligations, and covering prepayment risk and/or default risk on the asset pool, is, therefore, likely to lead to a cap to the applicable rating of the counterparty or to a very limited uplift from the counterparty's applicable rating.

Insufficient Collateral

In cases where the documented collateral provisions would lead to less posted collateral than what is in line with Fitch's current criteria, Fitch can still rate SF bonds above the counterparty's applicable rating if Fitch concludes that the resulting credit profile is better than an uncollateralized exposure to the counterparty or sufficient CE has built up since the transaction's inception.

When Counterparties Fail to Comply with Documents

Fitch assesses the compliance with the transaction documents as set out in the "Structured Finance and Covered Bonds Counterparty Rating Criteria." In addition to the considerations set out in that report, the following also apply for derivative counterparties.

Where the derivative provider fails to comply with documented remedies and the exposure is material to the rating analysis, the rating of each SF bond will be capped at the higher of the counterparty's applicable rating; or the SF rating that can be supported by transaction cash flows on an unhedged basis.

In the case of a SF transaction with a relatively limited derivative exposure, such as a basis rate swap and/or significant CE levels, the exposure could be deemed immaterial. However, in other

cases, such as fixed/floating interest rate or cross-currency swaps, the derivative is likely to be material to the SF rating.

Covered Bond Derivative Counterparties

This section provides an overview of Fitch's approach to assessing interest rate and cross currency exposures within CVB programs and supersedes analytical steps described in the previous sections of the report for the analytical concepts described in this section. Fitch's analysis relies on such mismatches to be mitigated either by the presence of a highly rated issuer, documented internal derivative arrangements or external derivative arrangements. Where such mitigants do not exist, any interest rate or cross-currency mismatches can constrain the rating of the CVB.

In its quantitative analysis, Fitch will only consider derivative agreements that are in place prior to the insolvency of the issuer and expected to continue following an insolvency of the issuer. Privileged derivatives, entered into between the issuer on behalf of the cover pool, and a derivative counterparty, are designed to survive the issuer's insolvency.

Recovery Uplift analysis is typically not sensitive to derivative counterparty risk, as opposed to programs which are also tested for timely payment of CVB in rating scenarios above the resolution reference point. As a consequence, when CVB programs are tested for timely payments, the left-hand column of figures in this addendum refer to the timely payment rating level, rather than the assigned CVB rating. Generally, derivative counterparties have a preferential claim, ahead of other unsecured creditors of the issuer, against the pool of assets securing the CVB, and commonly rank *pari passu* with CVB holders.

Highly Rated Issuers

For issuers with a minimum Long-Term Rating of 'AA-' or a Short-Term Rating of 'F1+', Fitch does not stress any unhedged interest rate or currency mismatches in its qualitative analyses, as the risk of jump to default is viewed as sufficiently remote. Upon the issuer losing its highly rated condition, Fitch will reflect interest rate and currency risk in its cash flows, should the issuer fail to implement remedial action within the applicable remedy period or should any interest rate and/or currency mismatch remain unhedged.

Eligible without Collateral Issuers

Where the rating of the issuer is sufficient to support the timely payment rating level of the CVB without collateral (as per Derivative Risk Rating Table in *Figure 2*) and the program documents define the conditions of the hedging to be concluded upon the issuer being downgraded below the minimum primary risk ratings, such as contingent swap documents, Fitch will rely on the predefined hedging terms in its qualitative analysis. The issuer's commitment to enter in the preconvened hedging agreement is viewed as sufficiently robust, and the jump to default risk as sufficiently remote, as long as the issuer is considered to be eligible without collateral.

Upon the creditworthiness of an issuer falling below the minimum primary risk ratings specified in *Figure 2*, Fitch's analysis relies on any interest rate and/or cross-currency mismatches being mitigated in accordance with the documented terms within 60 calendar days (14 days for MtM collateral posting where the counterparty is not an operational continuity bank in SF). Fitch will reflect interest rate and currency mismatches in its cash flow analysis should the issuer fail to implement the documented derivative agreement with an eligible external derivative counterparty or an internal counterparty with the required CA, or should any interest rate and/or currency risk exposures remain unhedged.

Internal Derivative Counterparties

Fitch defines an internal derivative counterparty as either the same entity as the issuer or one that is closely related, such as a wholly owned subsidiary. Fitch's analysis relies on internal counterparties to meet the standard definition of an eligible derivative counterparty, as set out in Derivative Risk Rating Table (*Figure 2*), in line with SF transactions.

Fitch believes internal derivative counterparties do not provide incremental protection to CVB investors against interest rate and currency risk as there is no benefit from a dual recourse to the issuer and to the derivative counterparty. However, the formalization of derivative agreements consistent with these criteria is a useful interim step toward the appointment of an external derivative counterparty, should the creditworthiness of the issuer deteriorate further,

such that the upfront formalization of derivative arrangements, including collateral posting arrangements and replacement language, offers some protection to CVB investors.

Where any aspects of internal derivative structures give rise to concerns regarding the ability to obtain an external replacement, Fitch will assume a standard replaceable hedging instrument, partial or no hedging in its cash flow modelling.

External Derivative Counterparties

An external derivative counterparty is defined by Fitch as an entity that is unrelated to the issuer. In Fitch's opinion, the dual recourse to the issuer and an eligible external derivative counterparty leads to a lower degree of reliance upon the derivative counterparty compared with a SF transaction, which has no such dual recourse. Fitch looks at both the issuer and the counterparty creditworthiness relative to the CVB timely payment rating level. This is based on the payment obligations of both the issuer and the derivative counterparty, as CVB investors would only be exposed to losses from a defaulted derivative counterparty if the issuer defaulted as well.

The definition of counterparty eligibility for external counterparties is consistent with the definition of an eligible internal counterparty, and replacement relies on counterparty ratings per the Derivative Risk Rating Table in Figure 2. For an external counterparty, the replacement thresholds are always those of the "valid flip clause" column. However, Fitch's collateral posting expectations are generally lower for CVBs with external derivative counterparties and issuers rated at least 'BBB-' or 'F3', compared to those for CVBs with internal counterparties and SF transactions, as defined in the table below.

Figure 12

Collateral Posting Formulas for Minimum External Counterparty Long-Term Ratings or Short-Term IDRs when Issuer Is Rated at or Above BBB- or F3

CVB Timely Payment Rating Category	No Collateral	Base ^a	Standard Formula
AAA	A or F1	A- or F2	BBB- or F3
AA	A- or F1	BBB+ or F2	BBB- or F3
A	BBB or F2	BBB- or F3	BB+
BBB	BBB- or F3	N.A.	BB-
BB	N.A.	N.A.	B+
B	N.A.	N.A.	B-

^a Base formula: Collateral Amount = Max (0; Mark-to-market).
Source: Fitch Ratings

For issuers rated below 'BBB-' and 'F3' the standard collateral posting formula will apply.

Events of Default and Early Termination Events

Some standard ISDA events of default and termination events should not be applied to the CVB issuer to safeguard the continuity of the derivatives after issuer insolvency, as in SF transactions. Fitch does not expect failure to pay, bankruptcy and any other events directly applicable to the CVB issuer to lead to early termination of derivatives.

Where the CVB issuer has been established exclusively to purchase cover assets and issue CVBs, a failure to pay by the issuer is equivalent to an inability to make timely payments on the CVBs; that is the case for issuers of French "obligations foncières" and "obligations de financement de l'habitat" and Norwegian covered bonds issuers. The derivative arrangements may therefore include termination events linked to the issuer's performance without affecting the rating of the CVBs.

Senior or Pari Passu Termination Payments

If a swap is terminated, in addition to leaving the cover pool unhedged against future rate movements, a senior or pari passu ranking termination payment due from the covered pool to the counterparty can cause a liquidity stress for the CVB issuer that could affect the ability to make payments to bondholders.

Transaction documents can require subordination of termination payments in the priority of payments when the derivative counterparty is the defaulting party, which is a flip clause. In some covered bond regimes, such as French “obligations foncières” and “obligations de financement de l’habitat” and German Pfandbriefe, derivative termination payments rank pari passu with the CVB payments.

Default by External Counterparty

A termination payment for derivatives with external counterparties failing would only affect CVB holders if the following is true: the counterparty defaults, triggering the termination payment; the CVB issuer has also defaulted and is unable to fund the payment; the swap is not replaced on a timely basis; and the swap is out of the money for the CVB issuer. Fitch considers this combination of events sufficiently remote and generally does not modify its rating analysis of a CVB program with external derivatives with senior or pari passu termination payments.

Default by Internal Counterparty

A default of the counterparty and the CVB issuer would coincide for derivatives with internal counterparties and, therefore, Fitch regards the risk of a termination payment falling due to the counterparty as less remote than in the scenario of an external counterparty.

As with SF, the risk can be mitigated by applying an adjusted eligibility threshold to the derivative counterparty, on the basis that an earlier trigger for replacement action will reduce the likelihood of the internal counterparty defaulting in advance of replacement. The applicable eligibility thresholds are shown in the column “No Valid Flip Clause” in *Figure 2*.

Alternatively, for CVB programs with unsubordinated termination payments, internal counterparties and no other structural mitigants, Fitch can link the rating of the bonds to the rating of the CVB issuer, if it considers the liquidity risk, stemming from the termination payment falling due, to be material and insufficiently mitigated.

Variations from Criteria

Fitch’s criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis and full disclosure via rating commentary strengthens Fitch’s rating process while assisting market participants in understanding the analysis behind the ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their effect on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of these criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch’s Rating Definitions, available at www.fitchratings.com/site/definitions.

Data Sources

Fitch’s analysis is based on information provided by the issuer or the arranger (if any). The rating process can also incorporate publicly available information or information provided by other third-party sources. If material to the rating, the agency will disclose other relevant sources.

Appendix 1 – Advance Rates

The ARs shown in below table apply where the collateral is posted in the base currency.

Figure 13

Advance Rates for Sovereign Bonds Rated at Least F1

Sovereign Bond Issuer	Sovereign Bond Maturity	Highest-Rated Note AA-sf or Higher (%)	Highest-Rated Note A+sf or Lower (%)
Australia and New Zealand	<1 Year	99.0	99.0
Australia and New Zealand	1–3 Years	98.0	98.0
Australia and New Zealand	3–5 Years	96.5	97.0
Australia and New Zealand	5–7 Years	95.5	96.5
Australia and New Zealand	7–10 Years	94.5	95.0
Australia and New Zealand	10–30 Years	90.0	91.5
Denmark, Sweden and Norway	<1 Year	99.5	99.5
Denmark, Sweden and Norway	1–3 Years	98.0	98.5
Denmark, Sweden and Norway	3–5 Years	97.0	97.5
Denmark, Sweden and Norway	5–7 Years	96.0	97.0
Denmark, Sweden and Norway	7–10 Years	95.0	95.5
Denmark, Sweden and Norway	10–30 Years	84.5	88.0
Eurozone	<1 Year	99.0	99.5
Eurozone	1–3 Years	98.0	98.5
Eurozone	3–5 Years	97.0	97.5
Eurozone	5–7 Years	96.0	97.0
Eurozone	7–10 Years	95.0	96.0
Eurozone	10–30 Years	89.5	91.5
Japan	<1 Year	99.5	99.5
Japan	1–3 Years	99.0	99.5
Japan	3–5 Years	98.5	99.0
Japan	5–7 Years	98.0	98.5
Japan	7–10 Years	97.0	97.5
Japan	10–30 Years	94.5	95.5
Singapore	<1 Year	99.5	99.5
Singapore	1–3 Years	98.5	99.0
Singapore	3–5 Years	97.0	98.0
Singapore	5–7 Years	96.0	97.0
Singapore	7–10 Years	94.0	95.0
Singapore	10–30 Years	88.0	90.0
Switzerland	<1 Year	99.0	99.5
Switzerland	1–3 Years	98.5	98.5
Switzerland	3–5 Years	97.5	98.0
Switzerland	5–7 Years	97.0	97.5
Switzerland	7–10 Years	96.0	96.5
Switzerland	10–30 Years	88.0	90.0
U.K.	<1 Year	99.0	99.5
U.K.	1–3 Years	98.0	98.5
U.K.	3–5 Years	97.0	97.5
U.K.	5–7 Years	96.0	97.0
U.K.	7–10 Years	95.5	96.0
U.K.	10–30 Years	91.5	92.5
U.S. and Canada ^a	<1 Year	99.0	99.5

Figure 13

Advance Rates for Sovereign Bonds Rated at Least F1

Sovereign Bond Issuer	Sovereign Bond Maturity	Highest-Rated Note AA-sf or Higher (%)	Highest-Rated Note A+sf or Lower (%)
U.S. and Canada ^a	1–3 Years	98.0	98.5
U.S. and Canada ^a	3–5 Years	97.0	97.5
U.S. and Canada ^a	5–7 Years	95.5	96.5
U.S. and Canada ^a	7–10 Years	94.5	95.5
U.S. and Canada ^a	10–30 Years	89.5	91.0

^a The U.S. and Canada advance rates are also applicable for Hong Kong.

Source: Fitch Ratings

The FX ARs shown in the Advance Rates for FX Mismatches table below apply, in addition to those shown in the Advance Rates for Sovereign Bonds Rated at Least 'F1' table whenever a currency mismatch is present between the currency of the collateral and the base currency. If foreign currency government bonds are provided, both the AR for FX risk and the security AR will be multiplied. The FX ARs are applicable for currency pairs within Australian dollars, Canadian dollars, Swiss francs, Czech koruna, Danish kroner, euros, U.K. pounds, Norwegian kronor, New Zealand dollars, Japanese yen, Korean won, Swedish kroner, Singapore dollars, Hong Kong dollars and U.S. dollars.

Figure 14

Advance Rates for FX Mismatches

	Highest-Rated Note AA- or Higher (%)	Highest-Rated Note A+ or Lower (%)
Advance Rate (%)	92.0	93.5

Source: Fitch Ratings

Appendix 2 — Validation of Advance Rates

ARs are designed to provide coverage for movement in a collateral's market value over time, or the collateral's market value risk. For instance, for a collateral security with a 95% AR, 105.3% of securities would be posted to cover the potential exposure. ARs are a function of the exposure period, which is taken to be 30 business days, the time assumed to be needed to terminate a derivative transaction following a counterparty default. Fitch's analysis relies on at least weekly collateral valuation and posting.

Fitch has developed the ARs through historical worst-loss stress testing during the exposure period. Fitch performs an annual review of the ARs using the methodology described in this report. Fitch's AR determination for 'AAAsf' and 'AAsf' note ratings is primarily based on the 97.5 percentile (95.0 percentile for note ratings at 'Asf' category and below) of historically observed losses for each collateral type, as observed through benchmark government bonds starting from Jan. 1, 2000 onward where available. To promote stability in its ARs, Fitch will only reduce ARs to the level covered by 99% (97.5% for Asf category notes and below) of observations while increasing them such that at least 97.5% of observations are covered (95.0% for Asf category notes and below).

Fitch can provide ARs case by case for collateral types other than those included in [Appendix 1](#). Fitch assumes collateral will be posted in the base currency, which is usually the same currency as assets or the notes issued by the SPV. Where the collateral is denominated in a different currency to the base currency or where FX risk arises for other reasons, Fitch's analysis relies on both the specific currency AR and the specific collateral AR to be applied where the collateral is denominated in a different currency to the note currency or where FX risk arises for other reasons, by multiplying both ARs.

Quantitative Analysis and Modeling

Fitch considers historical losses for benchmark government bonds calculating the loss that would be made on collateral posted on day 1 and disposed of at the lowest market price in the subsequent 30 business days. ARs are set at one minus the relevant percentile loss rate rounded down to the nearest 0.5%. Where ARs are set for a group of government issuers (e.g. eurozone), the ARs are calculated as an average of the component issuers.

Foreign exchange ARs are set using a similar methodology referencing the exchange rates of seven major currencies (JPY, GBP, CHF, AUS, CAD, NZD and EUR) against the U.S. dollar. Data for foreign exchange (FX) rates are sourced from the Bank of International Settlements.

Volatility

Fitch's analysis of a given government bond category is based on the percentile of loss experienced, given a 30-business day exposure period. The analysis uses historical price data drawn from a series for each issuer's benchmark maturity bonds. For individual sources, see the table Validation of Advance Rates: Data Sources. Series used have at least 15 years of available data.

Liquidity

Fitch views market liquidity in periods of stress to be particularly relevant for ARs. However in light of Fitch's definition of qualified investments (see "Structured Finance and Covered Bonds Counterparty Rating Criteria" for more detail) and the resulting eligible collateral, Fitch assumes liquidity to be available in most cases and, therefore, applies no additional stresses.

Figure 15

Validation of Advance Rates: Data Sources

Sovereign Bond Issuer	Data Source (via Haver Analytics)
United States of America	U.S. Treasury
Canada	Bank of Canada
United Kingdom	Bank of England
Australia	Reserve Bank of Australia
New Zealand	Reserve Bank of New Zealand
Switzerland	Swiss National Bank
Singapore	Monetary Authority of Singapore
Denmark	Tullett Prebon Information
Sweden	Sveriges Riksbank
Norway	Tullett Prebon Information
Japan	Ministry of Finance Japan
Austria	London Stock Exchange Group
Belgium	Banque Nationale de Belgique
France	Banque de France
Germany	Deutsche Bundesbank
Netherlands	Tullett Prebon Information
Source: Fitch Ratings	

Appendix 3 – Validation of Volatility Cushions

VCs for interest rate and cross-currency swaps are intended to protect against the risk that after a counterparty default the MtM amount posted is insufficient to cover the replacement cost of a derivative due to a change in the market value of the swap since the most recent collateral posting date.

Fitch assesses interest rate risk in its volatility cushion as a multiple of DV01, which quantifies the change in a derivative contract's mid-market value as a result of a one basis point change in the underlying swap curve. To set the DV01 multiples used in the VC calculation, Fitch considered the theoretical loss that would have been achieved over a 30-business day period by taking the maximum deviation over the period from the market rate on day 1. This approach assumes that the termination was made on the day in the observation period that resulted in the largest loss. Fitch used market data for swaps in USD, EUR, GBP and AUD with maturities of 2, 5, 10 and 30 years as its dataset. Fitch compared contracts both where the issuer paid or received the fixed leg, although in SF, the issuer typically pays fixed and received floating.

Fitch assesses currency risk using the same currency pairs and historical price data as for its AR calculation. Currency risk is expressed as a percentage of the notional principal amount of the derivative contract. Currency risk is typically larger than interest rate risk due to the greater volatility in FX rates compared to interest rates.

Fitch used the 97.5 percentile of the theoretical loss values to define its VC for note ratings in the 'AAsf' category and above, and the 95.0 percentile for those in the 'Asf' category and below for both interest rate and currency risk.

For single-currency basis swaps, Fitch considers that the change in value of both legs is likely to be closely correlated where the relevant reference interest rates are related. Fitch, therefore, considers that it is appropriate to take a simplified approach for these transactions and applies a fixed notional multiple, regardless of a transaction's maturity, as the close correlation means that maturity is not a significant driver of additional market risk.

For currency basis swaps, Fitch recognizes that there is a correlation between interest rates in different currencies and that the interest rate risk is correspondingly lower than for a fixed-to-floating swap. Fitch tested the correlation of term interest rates over a long period (15+ years) in currencies (USD, EUR, GBP and AUD) and found that it consistently exceeded 50%. Fitch, therefore, reduces by half the DV01 multiple for these derivatives compared to those for fixed-to-floating swaps.

Fitch derived its assumptions from historically observed movements over a 30-business day period. However, Fitch recognizes that actual termination timings can vary after a counterparty default. Fitch intends to monitor and update its VCs by referencing to updated market data and following the approach described above. To promote stability in its published VCs through time, Fitch will consider the current applied value against both the 99.0 percentile and the 95.0 percentile (for assumptions relevant to AAsf rated notes and above) and against both the 97.5 percentile and 90.0 percentile (for assumptions relevant to Asf rated notes and below). Fitch intends to update the published VC only if the calculated value moves outside of these ranges, but it reserves the right to do so otherwise if it deems such a revision appropriate.

In certain historical observations, observed FX and swap curve movements have exceeded those assumed in the derivation of the VCs. In light of the secondary nature of the risk, such that the counterparty is primarily responsible to fund the replacement cost, Fitch excluded the worst 2.5% of observations when validating the 'AAsf' and above scenarios and 5.0% of historical observations when validating the 'Asf' and below scenarios. If a counterparty default coincides with an extreme movement in interest or FX spot rates, the amount of collateral can prove insufficient to fully offset the derivative MtM because of the exclusion of extreme scenarios.

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