Moody’s Proposed Counterparty Risk Rating: Frequently Asked Questions

On January 8, 2015, Moody’s released a request for comment on a proposed new rating framework and associated rating methodology to determine and express the probability that a bank will default on certain senior operating obligations and other contractual commitments, which include the payment or performance of covered bonds, contractual performance obligations, derivatives, letters of credit and liquidity facilities.1

We view the probability of a bank defaulting on these obligations to be lower than for banks’ senior debt instruments, owing to our expectation that authorities would likely ensure that such obligations are honored in the event of a bank failure in order to preserve the continuity of the bank’s key operations, maintain payment flows, limit market disruption and avoid contagion. Our view is based on the implementation of new bank resolution and recovery regimes, as well as insights we gained from the global financial crisis and resolution approaches taken in recent cases of failing banks.

In this report we answer common questions on our proposed approach to determining and assigning counterparty risk ratings.

Counterparty Risk Ratings: Purpose, Design, Coverage and Users

What types of entities will be assigned a CR rating?

We are proposing to assign CR ratings to legal entities within banking groups. In some instances, we may also use this rating methodological guidance for other regulated institutions with bank-like senior obligations, including securities firms and finance companies. We may also assign a CR rating to bank holding companies or nonbank affiliates of banks in cases where they provide critical operating functions to the bank that create operating liabilities under the scope of the CR rating.

To the extent that a given rated bank is a party to a structured finance or PPIF (Public, Project, and Infrastructure Finance) transaction that Moody’s rates via an associated bank exposure (e.g., as a swap provider, letter of credit provider, or guarantor), we would most likely assign a CR rating following publication of the final CR methodology guidance as an input to the rating of structured finance or PPIF transaction.

What does a Counterparty Risk rating (CR rating) capture?

The CR rating is distinct from Moody’s traditional global credit ratings in that it measures only the probability of default (PD) on counterparty obligations and
contractual commitments rather than expected loss (EL), as covered by our debt and deposit ratings. The CR rating is also distinct from the baseline credit assessment (BCA), which is an opinion of issuers’ standalone intrinsic strength and represents the probability of failure, absent any extraordinary support from an affiliate or a government. Rather, the CR rating represents the risk of a bank defaulting on its senior operating and counterparty obligations, which may be preserved even after a bank has failed via a resolution process or through extraordinary government support.

Thus, the CR rating framework recognizes the lower probability of default of such obligations in a resolution while losses may be absorbed by the holders of other securities.

What scale will the CR rating utilize?
The CR rating will be expressed using an alpha-numeric scale which corresponds to that of our global long-term rating scale, with a “(cr)” indicator to differentiate it from our credit ratings. For example: Baa2 (cr).

What types of obligations are captured by the CR rating?
The counterparty obligations and contractual commitments to which this rating will apply include contractual obligations associated with covered bonds (and certain other secured transactions), derivatives, letters of credit, servicing and trustee obligations, funding commitments and other similar obligations that arise from a bank performing its operating functions.

Who will use CR ratings?
The CR rating is intended to address the default risk faced by banks’ counterparties to transactions arising from a bank performing its operating functions such as contractual obligations associated with covered bonds (and certain other secured transactions such as repurchase agreements), derivatives, letters of credit, servicing and trustee obligations, and funding commitments.

This rating will be used as an input to some Moody’s Structured Finance and Public, Project and Infrastructure Finance (PPIF) rating methodologies and global methodologies covering letters of credit, guarantees and similar instruments as outlined in a number of Requests for Comment, proposing revisions to existing rating methodologies. These methodologies generally make use of a single reference point, such as a Senior Unsecured Rating, as a proxy for the risk of default in relation to bank exposures. The CR rating will serve as an alternative or additional reference point to better account for the potential for resolution authorities to differentiate among various bank exposures in structured finance and public finance transactions.

For example, banks perform multiple support roles as contracting parties in structured finance transactions, and the CR rating will serve as an indicator of the default risk of obligations associated with these functions. Some of these roles, such as cash manager, originator, servicer and trustee, involve key operational functions. Others, such as account bank, swap counterparty and liquidity provider, primarily involve payment obligations. Moody’s structured finance ratings typically account for such exposures either in cash flow modeling or by linking the note rating to the bank’s rating. In each case, the rating impact depends, in part, on the probability of default that we assume for the relevant obligations.

The CR Rating Process: Application Across Jurisdictions, Including Under Different Bank Resolution Regimes

When will we assign CR ratings? What will be the process?
We anticipate the publication of the CR rating methodology will coincide with the finalization of an update to our bank rating methodology that was subject to a request for comment published in September 2014. We will assign a CR rating at the conclusion of the review period for any bank whose ratings are placed under review as a result of the release of the updated bank rating methodology and if the rated bank is a party to a structured finance or PPIF transaction that Moody’s rates via an
associated bank exposure. For all other rated issuers which are parties to a structured finance or PPIF transaction that Moody’s rates via an associated bank exposure, we plan to publish a CR rating shortly following conclusion of the final published methodology.

**How is the CR rating determined for banks in countries with operational resolution regimes?**

The rating approach will apply globally, with the framework explicitly accounting for home country and host country regulatory considerations, including resolution regimes as well as legal (de jure) priority of claim and expected (de facto) priority of claim.

For operational resolution regimes that include provisions to preserve a troubled bank as a “going concern,” we propose to adapt the Loss Given Failure (LGF) framework to derive CR ratings, and position the CR rating at or above the adjusted baseline credit assessment (adjusted BCA). We expect that in resolution the continued performance of a bank’s operational obligations will be supported by the buffer of loss-absorbing capital and debt instruments in the bank’s liability structure.

The CR rating will be higher than the adjusted BCA where there is a substantial volume of more junior liabilities, the bail-in of which would allow authorities to maintain the principal operations of the bank as a going concern. Essentially, the greater the loss-absorbing buffer of capital and liabilities that support a bank’s operational obligations, the lower the probability that the bank will default on those obligations.

The approach makes use of the LGF approach set out in our proposed bank rating methodology update; but, as a measure of default probability, it focuses solely on the volume of liabilities subordinated to the bank's operating obligations, as summarized in Exhibit 1.

Exhibit 1

**CR rating uplift relative to the adjusted BCA for a bank subject to a going-concern resolution, before incorporating uplift from government support**

<table>
<thead>
<tr>
<th>Subordination to instrument class (% of liabilities)</th>
<th>Notching from Adjusted BCA</th>
</tr>
</thead>
<tbody>
<tr>
<td>≥0.5x</td>
<td>0</td>
</tr>
<tr>
<td>≥0.5x</td>
<td>1</td>
</tr>
<tr>
<td>≥1x.5x</td>
<td>2</td>
</tr>
<tr>
<td>≥1.5x</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service

For example, if our assumed loss rate were 5% of liabilities, a CR rating that benefited from subordination of less than 2.5% of liabilities would be in line with the adjusted BCA, before the addition of government support, if any. On the other hand, a CR rating that benefitted from subordination of 8% of liabilities would be three notches higher than the BCA, before the addition of any government support.

In some jurisdictions, banks are subject to operational resolution regimes but face orderly liquidation or sale rather than preservation as in a going-concern resolution. This approach applies to those banks in the US whose resolution falls under Title I of the Dodd-Frank Act and are subject to receivership at the operating subsidiary level under the Federal Deposit Insurance Act (FDI Act).

However, even in such cases, we believe that the Federal Deposit Insurance Corporation (FDIC) considers the extent to which honoring the failed bank’s operating obligations supports the value of the franchise (and the amount a potential acquirer is willing to pay), thus reducing the cost to the FDIC. In nearly all cases when a US bank has failed and been seized by the FDIC, its operations have been sold to another bank or placed into a bridge bank, with no interruption to the performance on most of its operational liabilities. Therefore, even for failed banks we believe the probability of default on such counterparty obligations is lower than that indicated by the BCA of the operating entity.

We believe that standard notching is more appropriate for determining the probability of default represented by the CR rating for such banks and are proposing to assign a CR rating for such banks at the adjusted BCA + one notch to reflect the lower probability of default.
Lastly, we may incorporate additional uplift to the extent we believe that government support for operational liabilities would be forthcoming. We would make this determination in the same way as proposed in the bank rating methodology update; i.e., through Joint Default Analysis.

Below is a summary of our CR rating approach for banks we deem subject to operational resolution regimes.

» Banks subject to “going-concern” resolutions: \( CR \text{ rating} = \text{adjusted BCA} + \text{uplift owing to subordinated capital and debt instruments} + \text{government support (if any)} \)

» Banks subject to liquidation/sale process: \( CR \text{ rating} = \text{adjusted BCA} + \text{one notch of uplift for a lower PD} + \text{government support (if any)} \)

**What loss rates are used to calibrate the LGF framework?**

Our approaches to loss rates within the LGF framework are detailed more fully in Appendices 7 and 8 of the Bank Rating Methodology Request for Comment.\(^5\)

The proposed framework makes use of two initial firm-wide loss rates:

» 5% of liabilities (or 8% of total assets, when including assumed equity at the point of failure). We apply this rate to banks with lower asset volatility and subject to going-concern resolution techniques likely to preserve enterprise value. This may include receivership of a holding company but not the bank itself

» 10% of liabilities (or 13% of total assets, when including assumed equity at the point of failure). We apply this rate to banks with higher asset volatility or those banks subject to a resolution process involving the bankruptcy, receivership or liquidation of the whole bank, which is less likely to preserve franchise value.

**Will the position of the CR rating relative to deposits in the liability waterfall be the same across all going-concern resolution jurisdictions?**

The positioning of the CR rating relative to deposits may vary due to differences in the resolution hierarchy or liability waterfall across jurisdictions. Under this proposed methodology, we would make a judgment based on the legislative framework and expected policy approach as to the appropriate position of the operating obligations the CR rating covers relative to deposits in the waterfall. For current operational resolution regimes, our approach will be as follows.

In the European Union, the Bank Recovery and Resolution Directive (BRRD) specifically exempts covered bonds from the scope of bail-in. While derivatives and other unsecured operational liabilities are not specifically exempt, we believe that, in the event of bail-in, resolution authorities would in most instances exclude them, since the bail-in of these instruments could give rise to market disruptions or impede critical bank functions.

In contrast, the BRRD specifically allows for the bail-in of junior deposits, and in some cases may even require it given the requirement that a certain percentage of liabilities be bailed in before any government support can be provided. For this reason we believe that counterparty obligations will effectively rank above junior deposits for banks subject to the BRRD or equivalent legislation. We therefore propose that in determining the CR rating positioning for such banks, junior deposits be included within the stack of liabilities that are subordinated to a bank’s operational liabilities.

In the United States, Title II of the Dodd Frank Act gives the FDIC authority to effect the orderly resolution of systemically important financial institutions. Through single-point-of-entry (SPE) resolution, the FDIC would put a bank holding company into receivership and bail in holding company debt in order to recapitalize the group’s systemically important operating subsidiaries and preserve their operations (including, we believe, derivative transactions and other operational liabilities) without placing the subsidiaries themselves into receivership.\(^6\)

Even where such debt bail-in under SPE is insufficient to fully recapitalize the subsidiaries which must then be placed into receivership under the FDI Act, the FDIC will, as with Title I banks, consider the extent to which honoring the failed bank’s operating obligations supports the value of the franchise and reduces systemic risk.
Thus, in our view, these counterparty obligations should rank above senior unsecured debt at the same legal entity, but not above deposits, given the explicit depositor preference in US law.

Exhibit 2 illustrates the position of the CR rating in a given liabilities waterfall in certain operational resolution regime jurisdictions.

Exhibit 2
Position of the CR rating in a Given Liability Waterfall

Source: Moody’s Investors Service

What jurisdictions do you expect to include as going-concern Operational Resolution Regimes?
We expect banks in the EU, Norway, Liechtenstein, Switzerland and the US (Title II banks only) to be considered part of going-concern Operational Resolution Regimes.

What assumptions will be made in the EU as to the amount of junior (versus preferred) deposits?
As discussed in the proposed bank rating methodology, in establishing a bank’s liability-side balance sheet, we consider the role of deposit preference. In particular, we distinguish between deposits that rank pari passu with senior unsecured debt (“junior deposits”), and those that are preferred and thus rank senior.

The proportion of EU bank deposits benefiting from preference is unclear, due to a general lack of disclosure on the part of banks, deposit guarantee schemes and regulators. Ultimately, we expect public disclosures to improve to allow us to calculate the relevant deposit base from verified bank-specific data. In the meantime, we have proposed using an EU average (74%) of the proportion of deposits eligible for guarantee schemes to determine those deposits preferred under the BRRD. For certain institutions that we judge to have deposit bases essentially retail in nature, we assume that 90% of total deposits are preferred.

How is the CR rating determined for banks in countries that do not have operational resolution regimes?
In assessing the CR rating for banks in countries that do not have operational resolution regimes, we would take into account the likely objectives of all regulators in managing failed banking institutions; namely, containing contagion, minimizing losses and avoiding disruption of critical functions. Our view is that, in general practice, operational liabilities will be preferred to other senior unsecured liabilities.

Therefore, the CR ratings for these firms would incorporate uplift of one notch above the adjusted BCA of the operating entity. We would then incorporate our assessment of potential government support, which we would determine through joint default analysis as detailed in our proposed bank rating methodology.

Thus, \[ CR \text{ rating} = \text{adjusted BCA} + \text{one notch of uplift for a lower PD} + \text{government support (if any)} \]

Compared to the proposed approach for banks in going concern ORRs for which we have better clarity on how the liabilities waterfall will be affected in resolution, the CR rating method for non-ORRs reflects the more limited certainty and...
predictability around bank resolutions in such regimes. Nonetheless, regulators are still likely to act to preserve a bank’s operational activities in a failure, and hence the starting point for the CR rating should be higher than the adjusted BCA.

**Relationship of CR Rating to Moody’s Other Bank Ratings**

**Will CR ratings be assigned to holding companies?**
We do not expect CR ratings for holding company obligations to be common, given that the operational liabilities to which the CR rating speaks are related to activities typically performed by the banking and other operating subsidiaries in a banking group. Because we do not assign a BCA to holding companies, in most cases the CR rating will be at the same level as the holding company’s senior unsecured debt ratings. Any uplift to the CR rating from the senior unsecured ratings level will depend on our view of the likelihood that these operating obligations will receive preferential treatment relative to the senior unsecured debt in their resolution regimes.

**Will the CR rating be constrained by the sovereign rating?**
Yes, but the CR rating will not be capped at the level of the sovereign rating. Even in the event of a sovereign default, we believe there is a reasonable likelihood that bank failures can be managed in an orderly manner, and as such the CR rating may exceed the sovereign debt rating by up to one notch for a bank. In addition, where a bank displays substantial geographic business diversification or if the bank has low direct exposure to the sovereign, then its CR rating could be up to two notches higher than the long-term debt rating of the sovereign.

**Where will the CR rating be positioned relative to the senior unsecured debt rating?**
The CR rating may be higher than the senior unsecured debt rating. We expect that, in a resolution, authorities will ensure that certain functions and operations are maintained and certain payment or funding obligations honored, even while losses are being imposed on senior unsecured debt or even in some cases junior or institutional deposits. Therefore, the probability of failing to maintain such key operations or of defaulting on such payment obligations could be lower than indicated by the senior unsecured debt ratings.

**Where will the CR rating be positioned relative to the deposit rating?**
While the CR ratings in a going-concern ORR will be calibrated using the volume of subordinated liabilities, deposit ratings may benefit from both the volume of subordinated liabilities and the volume of those of the same rank. Therefore, in a situation where Moody’s believes that CR obligations have the same ranking in the liability stack as deposits, while the assumed PD may be the same, the deposit rating may be higher due to a lower expected loss-given-default rate.

**Will there be short-term CR ratings?**
The CR rating may be used as both a long-term and a short-term rating input. The short term rating input will be derived from the CR rating based on the guidance in Moody’s Cross Sector Global Short-Term Ratings methodology.

**What is the relationship of the CR rating to an Issuer Rating?**
The CR rating does not replace an issuer rating. In contrast to the CR rating, which represents a probability of default assessment, issuer ratings represent an expected loss measure to senior unsecured financial counterparties. Historically, the issuer rating has been used to represent a “placeholder” for a senior unsecured debt rating when no senior unsecured debt instruments are outstanding at an entity.
Moody’s Related Research

Request For Comments:
» Application of Bank Counterparty Risk Ratings to Letter of Credit and Liquidity Facility Supported Transactions, January 2015 (178464)
» Proposal for Introduction of Counterparty Risk Rating, January 2015 (178450)
» Update to Covered Bond Methodology Incorporating Counterparty Risk Ratings, January 2015 (SF390257)
» Updates to Structured Finance Rating Methodologies Resulting From New Counterparty Risk Measure, January 2015 (SF392314)
» Proposed Bank Rating Methodology, September 2014 (171718)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
Endnotes

1 See Proposal for Introduction of Counterparty Risk Rating, 8 January 2015.

2 See Updates to Structured Finance Rating Methodologies Resulting From New Counterparty Risk Measure, 8 January 2015; Update to Covered Bond Methodology Incorporating Counterparty Risk Ratings, 8 January 2015; and Application of Bank Counterparty Risk Ratings to Letter of Credit and Liquidity Facility Supported Transactions, 8 January 2015.

3 See Proposed Bank Rating Methodology, 9 September 2014.

4 While we propose to use the LGF methodology for Title I banks for their debt and deposit ratings, which are an expected loss measure, we believe that standard notching is more appropriate for determining the probability of default represented by the CR rating. The LGF methodology for debt and deposit ratings highlights differences in loss-given-default measures across liability classes. In contrast, the probability of default is not transformed through the different liability tranches (as opposed to going-concern resolutions, in which probability of default is reduced by bail-in of debt with a goal to preserve ongoing operations).

5 See Proposed Bank Rating Methodology, 9 September 2014.

6 DFA Title II does not exempt any obligations from bail-in; however both Title II and the FDI Act provide for a short-term stay on terminating derivative obligations in the event of receivership. This “stay” provision is an additional regulatory effort, in line with the Financial Stability Board’s global initiatives, to enable for more orderly and less systemically contagious resolution, and further informs our view that default risk on operational obligations such as derivatives is lower than default risk on senior unsecured debt.
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