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REQUEST FOR COMMENT

Proposal for Introduction of Counterparty Risk Rating

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Executive Summary

In this request for comment (RFC), we propose the introduction of a new counterparty risk (CR) rating, which will constitute our opinion of the probability of default of certain senior bank obligations and other contractual commitments. We expect to assign this CR rating to legal entities in banking groups. In some instances, we may also use this methodology for other regulated institutions with similar bank-like senior obligations.

The proposed CR rating would be distinct from debt, deposit or issuer ratings in that it: (1) will consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in event of default, and (2) will apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. Beyond this, our approach to establishing the CR rating will build upon the approach we set out for other bank instrument ratings in our proposed bank rating methodology published on 9 September 2014.[1] The CR rating may be used as an input for both long-term and short-term ratings.

We expect that banks in resolution will often maintain certain functions and operations and continue to honor certain payment or funding obligations even while losses are being imposed on senior unsecured debt or deposits. Therefore, the probability of failing to maintain such key operations or of defaulting on such payment obligations (for example, covered bonds and derivatives) could be lower than indicated by the senior unsecured debt ratings and, in some cases, deposit ratings. As a result, the CR rating may be higher than the senior unsecured debt and deposit ratings, reflecting the likelihood that in a banking resolution regulatory authorities will take steps to preserve operations, honor certain obligations and minimize the risk of contagion to other banks.

For banks subject to going-concern resolutions in operational resolution regimes, our starting point will be (as for other rated bank instruments) the adjusted baseline credit assessment (BCA), which represents our view of the bank's probability of failure, incorporating affiliate support. The position of the CR rating relative to the adjusted BCA will depend on the degree to which capital and debt instruments shield counterparty obligations from loss. This protection will in turn depend on a jurisdiction's insolvency and resolution legislation – in other words, the CR rating could have a higher relative ranking (or position in the liabilities waterfall) in some jurisdictions than in others. The CR rating will also incorporate potential government support, which could also result in uplift relative to the BCA.

[1] See Request for Comment: Proposed Bank Rating Methodology, 9 September 2014.

For banks that, in our view, are not subject to an operational resolution regime or would be subject to liquidation or sale in an operational resolution regime, our starting point would be to set the CR rating one notch above the bank's adjusted BCA, reflecting the lower probability of default of these obligations. Where applicable, the CR rating will also incorporate our assumption of government support, based on our joint default analysis.

We present the proposed methodology in draft form during the RFC period and invite market participants to comment on the RFC by February 9th by submitting their comments on the Request for Comment page on www.moodys.com. Upon appropriate consideration of the comments we receive, we will adopt and publish this credit rating methodology.

Related RFCs

Please see the following related RFCs, which propose to use the CR rating as an input to their ratings:

» *Updates to Structured Finance Rating Methodologies Resulting From New Counterparty Risk Measure*, which proposes changes to how we measure the risk of default relative to the exposures of structured finance transactions to financial institutions;[2]

» *Update to Covered Bond Methodology Incorporating Counterparty Risk Ratings*, which proposes changes to how we assess exposures to banks in our covered bonds rating methodology;[3]

» *Application of Bank Counterparty Risk Ratings to Letter of Credit and Liquidity Facility Supported Transactions,* which proposes changes to how we assess exposures to banks under credit support instruments such as guarantees and letters of credit.[4]

Approach for Determining Counterparty Risk Ratings

This proposed methodology will govern how we assign CR ratings to legal entities in banking groups, as well as certain securities firms or other finance companies subject to bank-like regulation.

The CR rating will constitute our opinion of the relative likelihood of default of various senior operating obligations and other contractual commitments that are less likely to be subject to bail-in or the application of other resolution tools to ensure the continuity of operations. The types of obligations and commitments to which this rating could apply include payment obligations associated with covered bonds (and certain other secured transactions), derivatives, letters of credit, third party guarantees, servicing and trustee obligations and other similar obligations that arise from a bank in performing its essential operating functions.

Thus, the CR rating will constitute our opinion of the ability of an issuer to avoid defaulting on its operational obligations, taking into account the issuer's intrinsic standalone strength as well as our assessment of the likelihood of affiliate and government support, and reflecting the anticipated seniority of the obligations in the liabilities waterfall. The CR rating will also take into account other steps regulatory authorities can take to preserve the key operations of a bank in a resolution.

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

This rating approach will apply globally, and will vary depending on an institution's home country and host country regulatory environment, including resolution regimes, as well as the legal and expected priority of claims.

The CR rating will generally be constrained by the relevant sovereign rating. However, we do not believe the CR rating should necessarily be capped by its sovereign's rating. In the event of a sovereign default, we believe there is a reasonable likelihood that any coinciding bank failures can be managed in an orderly manner. As such, the CR rating of a relatively strong bank could exceed the sovereign's rating by up to one notch. Where a bank displays substantial business diversification and has low direct exposure to the sovereign, its CR rating could be up to two notches higher than the sovereign's own debt rating.

The counterparty risk ratings will be expressed with a (cr) indicator using an alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale, for example, Baa2 (cr). 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.

Rating Positioning Under Different Resolution Regimes

Operational Resolution Regimes – Going Concern

In our proposed bank rating methodology, we introduced a new approach, that of loss given failure (LGF), which includes a more advanced liability analysis as an important element in assessing risk and determining ratings in systems in which regulators are able to impose losses selectively as part of their resolution authority. The LGF approach provides a framework for recognizing the risk of debt and deposit obligations in accordance with the loss absorption provided by more junior securities in a bank's liability structure, together with the extent of loss dilution provided by the amount (or "thickness") of the instrument in question.

For banks that we would consider subject to an operational resolution regime, we intend to adapt this approach to determine the position of the CR rating relative to the adjusted BCA.[5] Characteristics of operational resolution regimes include: (1) specific legislation that enables the orderly resolution of a failed bank; (2) via legislation, a reasonably clear understanding of the impact of a bank failure and resolution on depositors and other creditors; and (3) a policy and regulatory conviction to utilize enabled legislation and to reduce – and, in some cases, eliminate – the probability of government support. Where these conditions are fulfilled, we will typically designate a bank as being subject to an operational resolution regime.

We expect our initial designation of operational resolution regimes to be limited to the European Union (owing to the adoption of the Bank Resolution and Recovery Directive or equivalent legislation), the US (in recognition of the Dodd-Frank Act Titles I and II) and Switzerland (reflecting the Banking Insolvency Ordinance).

We identify two types of resolution in operational resolution regimes: going concern (in which a bank maintains its critical operations) and liquidation or sale.

[5] The adjusted BCA includes affiliate support.

For going-concern operational resolution regimes, we propose to adapt the LGF framework to derive counterparty risk ratings. We expect that the operational bank obligations to which the CR rating speaks will benefit from the loss absorption provided by capital and debt instruments in the bank's liability structure. This expectation is based partly on the formal position of liabilities in insolvency and partly on our judgment that in practice some obligations will receive preferential treatment regardless of the liquidation hierarchy. For example, deposits in some systems may be "preferred" in resolution even when this is not the case under bankruptcy law.

As our proposed loss-given-failure framework for rating different bank instruments outlines, because the amount of debt subordinated to a given instrument class determines its degree of protection from default, the difference between the CR rating and the adjusted BCA will depend on the level of subordination below it and our analysis of where the liabilities are likely to fall in the waterfall. However, the uplift would be based solely on the volume of liabilities subordinated to the operational obligations, without giving consideration to the amount of liabilities that could be *pari passu* with the operational obligations. This is because the CR rating, as a probability of default measure, is not intended to reflect an expected-loss view for the liabilities to which the CR rating relates. Exhibit 1 illustrates the notching uplift logic.

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

x = average assumed loss rate as % of liabilities, as defined in our proposed banking methodology

Subordination to instrument class (% of liabilities)	Notching from Adjusted BCA
≥0<0.5x	0
≥0.5x<1x	1
≥1x<1.5x	2
≥1.5x	3

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. 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.

The resolution hierarchy or liabilities waterfall is not the same in all jurisdictions. Under this proposed methodology, we would make a judgment based on the legislative framework and expected policy approach as to the appropriate position in the waterfall of the operating obligations the CR rating covers, relative to other liabilities. For current operational resolution regimes, our approach will be as follows.

In the European Union (EU)

The Bank Recovery and Resolution Directive (BRRD) will lead to greater harmonization of the various bank resolution frameworks currently in place in EU countries. The BRRD establishes as a key principle that equity holders and other creditors should bear losses before any taxpayer support is provided and envisages that at least 8% of liabilities (including equity) be written down or bailed in prior to the use of any public funds in a bank resolution.

Although the BRRD does not specifically exempt derivatives or other operational liabilities from the scope of bail-in,[6] we believe that resolution authorities would in most instances use exemption powers to exclude them because the bail-in of these instruments could give rise to financial instability or impede critical bank functions. For this reason we believe that, in practice, for banks subject to the BRRD or equivalent legislation, such counterparty obligations have an effective ranking above junior deposits and our calculation of subordination therefore includes these deposits.

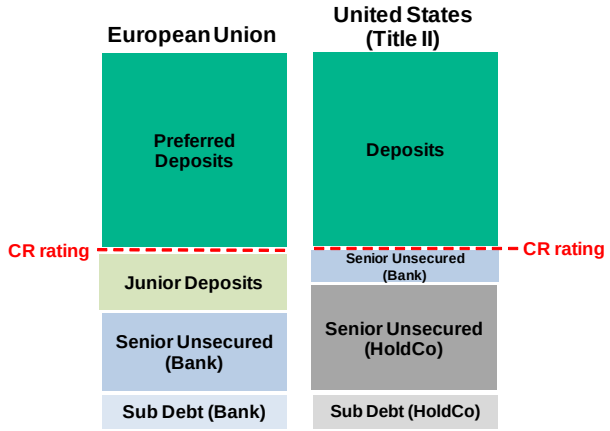
In the United States

Title II of the Dodd Frank Act gives the Federal Deposit Insurance Corporation (FDIC) broad new authority to effect the orderly liquidation of systemically important financial institutions without cost to taxpayers and in a manner to prevent financial instability. The FDIC has indicated that it would implement Title II by using a single-point-of-entry resolution strategy under its Orderly Liquidation Authority. Through single-point-of-entry, the FDIC would put a bank holding company into receivership and bail in the holding company debt in order to recapitalize the banking group's systemically important operating subsidiaries and preserve their operations (including, we believe, derivatives and other operational liabilities). 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

Operational Resolution Regimes – Liquidation/Receivership

Some banks are subject to operational resolution regimes but face orderly liquidation or sale rather than debt bail-in – for example, banks in the US whose resolution falls under Title I of the Dodd-Frank Act and that are subject to FDIC receivership. Here, the FDIC has a narrower mandate of effecting a resolution at the lowest cost. We believe that the FDIC, in fulfilling this mandate, will consider the extent to which honoring the failed bank's operating obligations supports the value of the franchise in receivership (and the amount a potential acquirer is willing to pay), thus reducing the cost to the FDIC.

[6] However, derivatives that are subject to margin requirements under a credit support annex (CSA) or under the rules of a central counterparty (CCP) are exempted from bail-in.

Based on our view of the likelihood that the FDIC will honor operating obligations to preserve value and minimize losses to the FDI fund, the CR rating of these operating obligations would be one notch higher than the adjusted BCA of the operating entity.

Lastly, we incorporate our assessment of potential government support, which we will determine in the same way as in our proposed bank rating methodology update, i.e., similarly to our current joint default analysis.

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

» European banks subject to the BRRD or equivalent legislation: adjusted BCA + uplift owing to subordination from capital and debt instruments + government support (if any). The approach to subordination reflects our view that, in a resolution, operational obligations would have priority over "junior" depositors. Therefore, the CR rating will not be lower than junior deposit ratings.

» US Title II: adjusted BCA + uplift owing to subordination from capital and debt instruments + government support (if any). The approach to subordination reflects our view that, in a resolution, operational obligations would have priority over other senior unsecured liabilities. Therefore, the CR rating will not be lower than the senior unsecured debt rating.

» US Title I: adjusted BCA + one notch of uplift to reflect a lower probability of default + government support (if any). Therefore, the CR rating will not be lower than the senior unsecured debt rating.

Non-Operational Resolution Regimes

In many banking systems globally, going-concern bank resolutions are not part of the public policy framework; we thus do not consider these to be subject to operational resolution regimes. In these cases, resolution procedures are used on occasion but tend to be defined ad-hoc rather than being clearly defined ex ante. Government support – or, alternatively, bankruptcy – remains a more likely outcome for a failed bank than a going-concern resolution. For banks in such systems, a clear view of the impact of failure on the different debt classes is unlikely. For this reason, we would determine our instrument ratings without the liability-side analysis we described above.

In assessing the CR rating for such entities, we would take into account the likely objective of all regulators to manage failed banking institutions with the goal of containing contagion, minimizing losses and avoiding disruption of critical functions. Our view is, in practice, operational liabilities will be preferred to other senior unsecured liabilities. Therefore, the CR ratings of these operating obligations would incorporate rating uplift of one notch above the adjusted BCA of the operating entity. Lastly, we would incorporate our assessment of potential government support, which we would determine in the same way as in our proposed bank rating methodology, i.e., similarly to our current joint default analysis.

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

» CR rating = adjusted BCA + one notch of uplift for a lower PD + government support (if any).

This configuration will result in the CR rating being at a higher level than the senior unsecured rating.

Approach to Assigning CR Rating to Bank Holding Companies

We may also assign a CR rating to bank holding companies. In these cases, the CR rating will reflect the extent to which the holding company provides critical operating functions that could create operating liabilities under the scope of the CR rating. Generally, 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 performed typically 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.

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