



Methodology

*Canadian Structured Finance  
Flow-Through Ratings*

MARCH 2011



*Insight beyond the rating.*

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## CONTACT INFORMATION

**Jamie Feehely**

Managing Director,  
Canadian Structured Finance  
+1 416 597 7312  
jfeehely@dbrs.com

**Debbie Caruso**

Vice President,  
Structured Finance, Legal  
+1 416 597 7389  
dcaruso@dbrs.com

**Banu Unal**

Vice President,  
Structured Finance, Legal  
+1 416 597 7344  
bunal@dbrs.com

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# Canadian Structured Finance Flow-Through Ratings

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From time to time, DBRS rates a security based on the credit strength of a third-party entity rather than on the credit strength of the issuer. Such ratings are referred to by DBRS as flow-through ratings. In order for DBRS to rate a security on a flow-through basis, there must be certain elements of the transaction structure that justify reliance on an entity that is not the issuer. These elements generally fall into one of two categories: where the third-party entity directly supports the security being issued or where the third-party entity provides all or close to all the cash flow of the issuer that will be relied on to repay the security.

## THIRD-PARTY SUPPORT OF THE SECURITY ISSUED

The most obvious way for a security to benefit from the rating of an entity other than its issuer is for the security to be a direct, legally enforceable obligation of that entity. There are typically two ways this can be accomplished: by way of co-obligor status or by way of a guarantee. Co-obligor status is accomplished when the third party becomes a party to the transaction as a co-issuer or co-obligor. Effectively, this means that the debt obligation is an obligation of the third party, allowing DBRS to look to the rating of the third party to rate the security.

A more common way for an entity other than the issuer to become legally liable to repay a debt security is by way of a guarantee. A properly structured guarantee results in the guaranteed security becoming a legally enforceable obligation of the guarantor, allowing DBRS to flow through the rating of the guarantor. Please see *DBRS Criteria: Guarantees and Other Forms of Explicit Support* at [www.dbrs.com](http://www.dbrs.com) for more details on guarantees.

## STRUCTURED FINANCE FLOW-THROUGH RATINGS

The above situations address circumstances where the rated security is a direct, legally enforceable obligation of a third-party entity. These situations are fairly common and the rating is flowed through from the third-party entity to the security on the basis of a legal analysis. There are situations, however, when it may be appropriate to flow through a rating even though the rated security is not a legal obligation of the third-party entity, but there are structural elements of the transaction that ensure that there will be no interruption of cash flow available to repay the securities issued by the issuer.<sup>1</sup> These ratings, referred to by DBRS as structured finance flow-through ratings, require a careful case-by-case examination of the transaction structure.

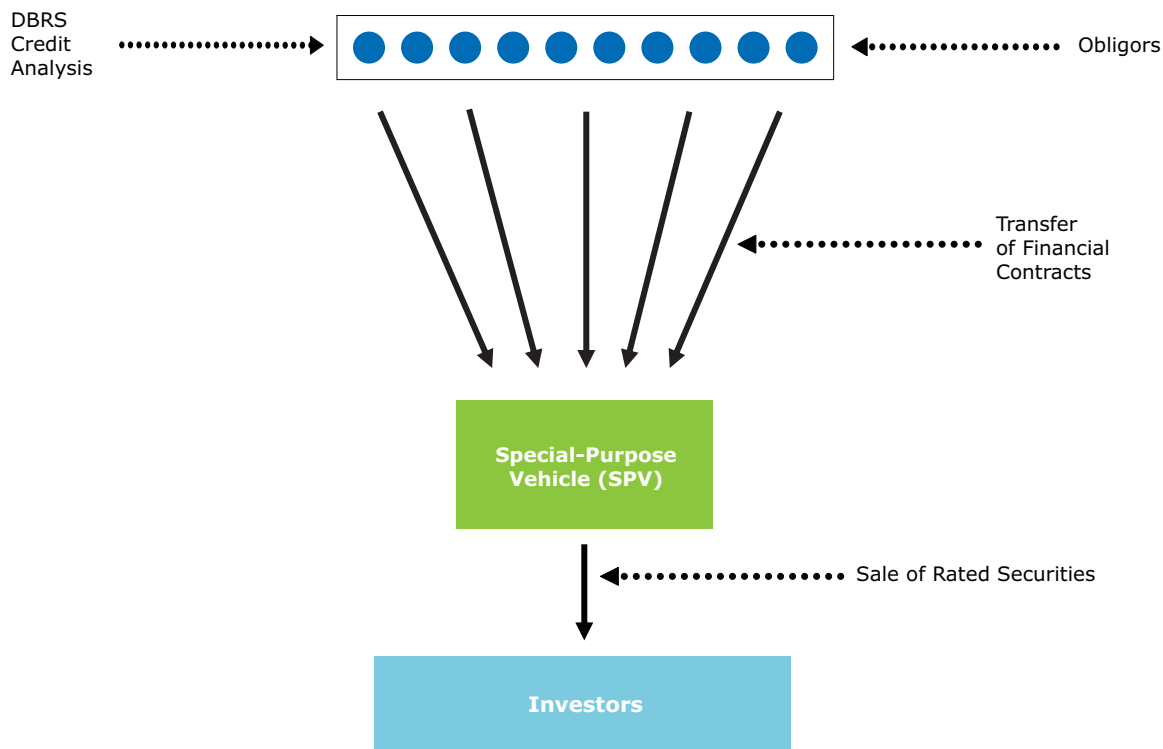
At its most fundamental, the basis of any rating is the issuer's willingness and ability to repay the debt obligation. For the majority of ratings, in particular corporate ratings, this determination takes into account a multitude of business and financial factors, such as revenue, debt service coverage ratios and the position of the company in the marketplace.

In a traditional securitization, pools of financial assets, such as residential mortgages, automotive or equipment loans and leases or credit card receivables, are bundled together in a bankruptcy-remote special-purpose vehicle (SPV), with collections generated by the pooled assets used to service and repay the securities issued by the SPV. There are hundreds, if not thousands, of underlying obligors liable under the pooled financial assets. The credit characteristics of the asset pool and the underlying obligors are key factors in determining the rating of the securities, with larger asset pools generally being positive for the rating. These transactions are typically structured so that the securities issued are rated in the highest rating categories.

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1. Please note that this methodology does not address traditional structured finance transactions where a third-party entity, often a parent company, will provide a performance guarantee of servicing obligations or where rating triggers are placed on a third-party entity. While such factors are material to the rating of these transactions, performance guarantees do not typically result in a flow-through of the performance guarantor's rating.

## Simplified Traditional Securitization Transaction Structure



Source: DBRS.

Occasionally, however, a security will be issued by an issuer with only one major asset or a minimal number of assets. The issuers of these securities are usually SPVs that have been formed to finance a project or to securitize a recurring predictable cash flow owed to the SPV. These transactions are best thought of as a type of securitization in which there is only one asset and only one underlying obligor (or, in some instances, a very limited number of assets and a very limited number of obligors). The credit analysis is not applied to a large diverse pool, as it is in a traditional structured finance transaction, but rather to one entity (or a very limited number of entities).

This is a much simpler credit analysis than in a traditional structured finance transaction, particularly if the third-party entity is rated. If the obligations of the third-party entity to the issuer can be satisfactorily linked to noteholders, it may become possible to rate the security at the level of the third-party entity. DBRS examines the structure and documentation carefully and must be satisfied that sufficient structural protection is in place to ensure that the cash flow being relied on to service and repay the debt security is sufficient and cannot be extinguished or interrupted while the securities are outstanding.

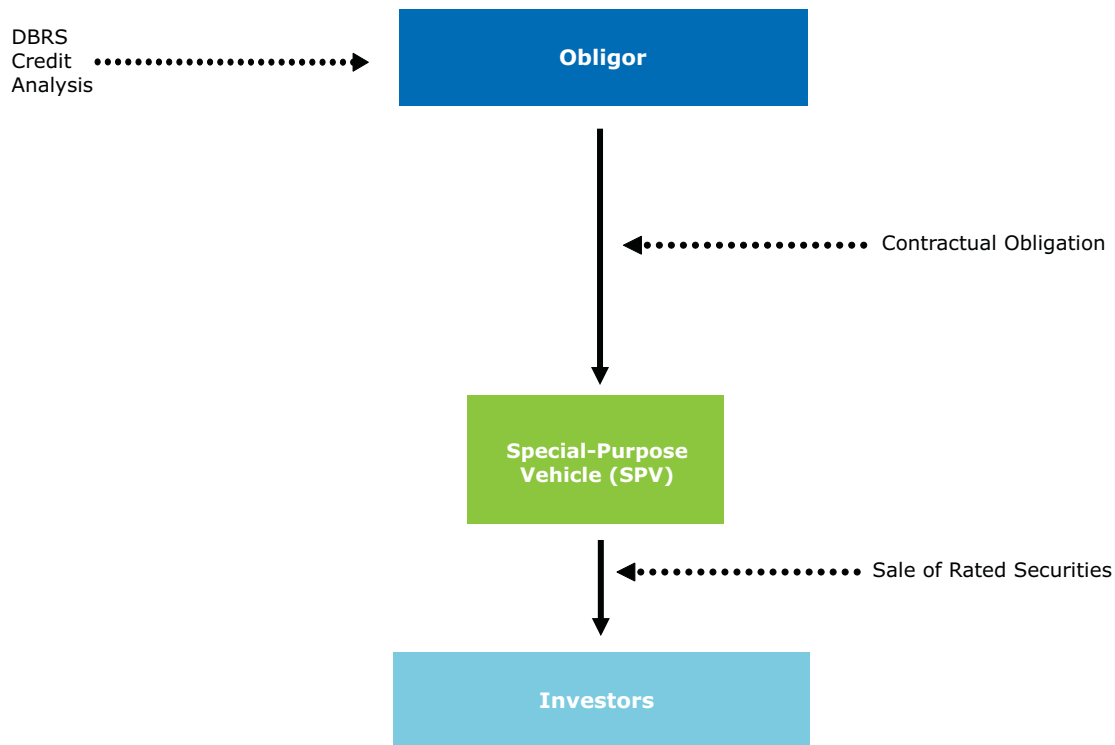
In order to flow through the rating of the third-party entity to the security, there must be a contractual obligation on the part of the third-party entity to pay a predictable and sufficient cash flow to the issuer. Note that this is distinct from the situations described above, where the third-party entity becomes legally obliged to pay the debt obligations of the issuer by virtue of a guarantee. In a structured finance flow-through transaction, the third-party entity has no obligation to security holders but rather is obligated to pay certain amounts to the issuer. Structural protections must then be in place to make sure that this cash flow is available to service the rated debt. The rating that flows through to the security is based on the credit strength of the third-party obligor(s).



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### Simplified Single-Obligor Securitization Transaction Structure

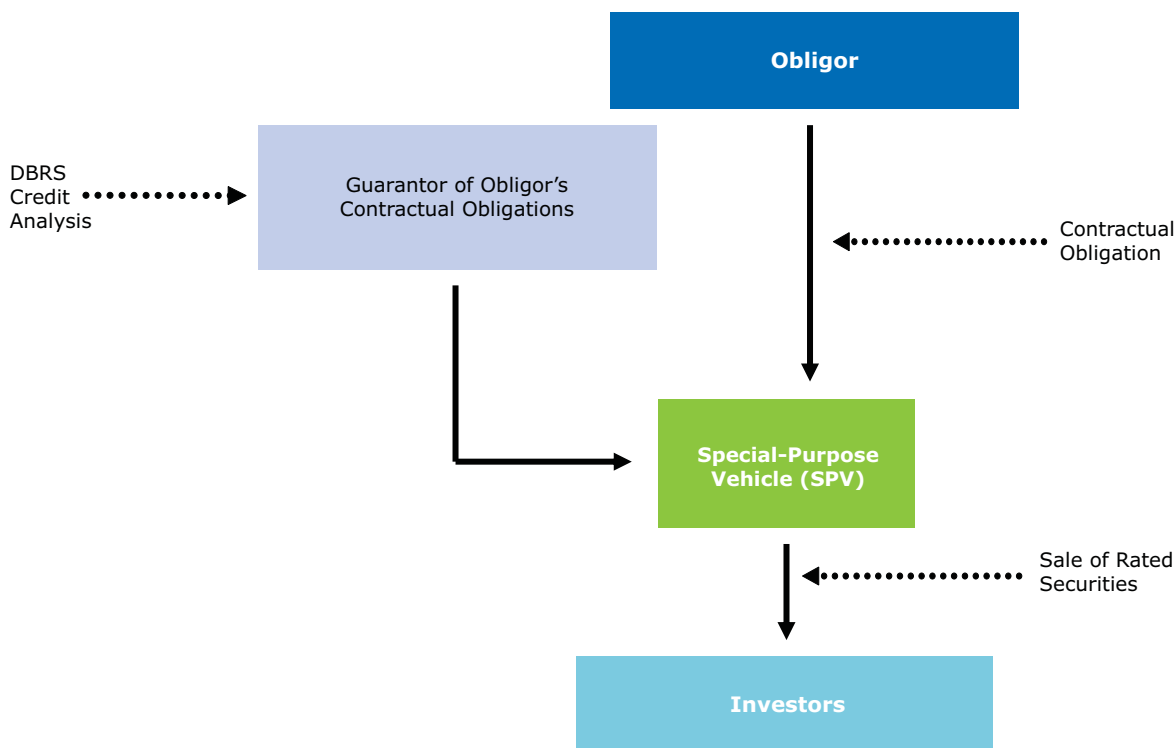
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Source: DBRS.

There can also be situations where the single obligor is not of sufficient credit quality to support the rating of the issuer's securities. In these circumstances, another entity may execute a guarantee. The guarantee will not be a guarantee of payment on the securities but will be a guarantee of the obligations of the single obligor to the issuer. The guarantor will guarantee the cash flow owed to the issuer that is relied on to repay the securities.

### Simplified Single-Obligor with Guarantor Securitization Transaction Structure



Source: DBRS.

In these circumstances, DBRS looks to the *DBRS Criteria: Guarantees and Other Forms of Explicit Support* at [www.dbrs.com](http://www.dbrs.com) in its review of the guarantee. If structured properly, DBRS may rate the securities issued at a level that reflects the rating of the guarantor.

This structured finance flow-through rating methodology may also be applicable where assets held by an SPV are wrapped by a total return swap (TRS). DBRS will examine the termination events and other terms of the TRS carefully and where satisfied that structural elements are appropriate may flow through the rating of the swap counterparty to the securities issued by the SPV.

Please note that in circumstances where conditions exist that must be satisfied before the obligations of the third party to the SPV are enforceable, it will not be possible to flow through the rating of the third party until the conditions are met.

Structured finance flow-through transactions tend to be unique transactions, tailored to a specific situation. Therefore, they must be examined in detail in order for DBRS to be satisfied that risks are appropriately mitigated. However, DBRS expects these transactions to become more common as an innovative method of financing when there is a predictable cash flow from an obligor of high credit quality.



**Schedule of Summary of Terms of Canadian Structured Finance Flow-Through Ratings Methodology**

Structural Features of Issuance	CSF Flow-Through Ratings Methodology Applies <sup>1</sup>	CSF Flow-Through Ratings Methodology Does Not Apply
<p><b>THIRD-PARTY DIRECT SUPPORT</b>                      Do the notes/securities being issued benefit from a direct, legally enforceable obligation of a third-party rated entity, such that the third party supports payments to note/security holders?</p> <ul style="list-style-type: none"> <li>• Is the third-party rated entity a co-obligor of the issuer? <i>OR</i></li> <li>• Does the third-party rated entity provide an irrevocable guarantee of the issuer's obligations to note/security holders?</li> </ul>	Yes	No
<p><b>STRUCTURED FLOW-THROUGH RATINGS</b>                      Does the issuance of the notes/securities contain structural elements that attempt to ensure that there will be no cash flow interruption with respect to repayment of the notes/securities by the issuer?</p> <ul style="list-style-type: none"> <li>• Are the notes/securities backed by one major asset or a minimal number of assets with receivables payable by one obligor (or a very limited number of obligors)? <i>AND</i></li> <li>• Are there structural protections in place (through contractual obligations) for the third-party obligor(s) to pay a predictable or sufficient amount to the issuer to ensure the issuer will have sufficient funds to pay note/security holders? <i>AND</i></li> <li>• If the credit rating of the third-party obligor(s) is insufficient to support the notes/securities, is an irrevocable guarantee of the obligations of the third-party obligor(s) provided by another rated entity?</li> </ul>	Yes	No
<p><b>STRUCTURED FLOW-THROUGH RATINGS USING A TRS</b>                      Is the issuer of the notes/securities a special purpose vehicle that holds the assets that back the notes/securities, but uses a total return swap in the structure to protect the note/security holders from losses?</p> <ul style="list-style-type: none"> <li>• Is the counterparty to the TRS a rated entity? <i>AND</i></li> <li>• Do the terms of the TRS protect against losses to noteholders?</li> </ul>	Yes	No

1. The rating that flows through to the notes/securities is based on the credit strength of the third-party obligor(s)/guarantor/TRS counterparty, as applicable.

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**Corporate Headquarters**

DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
TEL +1 416 593 5577