Methodology

Rating U.S. Structured Finance Transactions Backed by Direct Pay Letters of Credit

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Executive Summary

This summary outlines the DBRS methodology for rating letter of credit (LOC) supported structured finance transactions in the U.S.

The DBRS approach involves reviewing the terms of the LOC and analyzing its structural, operational and legal components.

Under LOC supported transactions, the LOC is an irrevocable obligation issued by a highly rated financial institution as the letter of credit provider (LOC Provider) which obligates the LOC Provider to make payments of bond principal and accrued interest, in addition to redeeming bonds under certain circumstances, and generally to pay the purchase price of tendered bonds, as described herein.

When structured appropriately, an LOC effectively replaces the credit and liquidity risk of the bond issuer (or obligor) with the credit and liquidity risk of an oftentimes higher rated LOC Provider. Therefore, when assigning and monitoring ratings on bonds being issued with this form of credit enhancement, DBRS looks to the long-term senior unsecured rating and short-term rating of the LOC Provider, not the financial strength of the bond issuer or the structured cashflows supporting the bonds.

Direct pay LOC supported transactions have the following features that are covered under this methodology:

• The LOC mitigates credit exposure, bankruptcy preference risk, and default risk related to the issuer by replacing it with the credit exposure, preference, and default risks of a higher rated LOC Provider.
• LOC funds used to pay bondholders are typically maintained in an account which is separate from all other trust held funds and transaction accounts and are free from any liens. This protects bondholders from claims that the funds may be considered assets of the issuer in the case of an issuer’s bankruptcy proceeding.
• Outstanding bonds are purchased by the LOC Provider upon occurrence of certain events, including among them the expiration of the LOC, a change in the interest rate mode of the bonds, or a substitution of the LOC by an LOC issued by another LOC Provider.
• LOCs may be replaced or substituted upon expiration or termination of the LOC, or upon certain reductions in the LOC Provider’s rating.

Analysis of LOC Sizing

It is essential that the LOC is appropriately sized by the issuer in order to cover the aforementioned risks in an LOC supported transaction.

When evaluating the sizing of the LOC amount, DBRS considers (i) whether the LOC is sufficiently sized to cover accrued interest which is due each period over the life of the transaction and (ii) the full balance of the principal repayment obligation.

When analyzing interest coverage, DBRS looks at a number of factors including (i) the amount of interest that can accrue at the maximum possible interest rate of the bonds, and (ii) the longest number of days between interest payments, or longest accrual period, addressed by the LOC. Additionally, DBRS assesses

1. For more information on DBRS legal criteria, see DBRS “Legal Criteria for U.S. Structured Finance Transactions.”
2. In direct-pay LOCs, since bond payments are made by the LOC Provider and not the bond issuer or obligor, there is no preference risk. In standby LOCs, however, there is preference risk as the issuer or obligor makes bond payments directly to investors and such funds may be deemed funds of the issuer in a bankruptcy.
the maximum length of the LOC reinstatement period after an interest draw, as non-reimbursement may trigger an acceleration of the bonds which would typically include accrued interest for the number of days of such reinstatement period.

DBRS also reviews the draw provisions and the reinstatement terms of the LOC. For example, if a draw takes place on the LOC to purchase tendered bonds, DBRS evaluates whether the LOC provides for such draws to be reinstated in an amount equal to full principal plus accrued interest at the correct interest rate and the number of days within which the LOC Provider is required to fully reinstate the LOC. DBRS also evaluates transaction provisions and remedies if the drawn LOC amount is not reinstated and assesses the number of days within which a trustee must draw upon the LOC in the case of a termination of the LOC for default under the LOC Provider’s reimbursement agreement.

It is common for the issuer in LOC supported bond transactions to have an option to change the interest rate calculation from one mode to another. For example, an issuer may decide to change the interest mode from weekly to monthly, quarterly, or semi-annually. The result could be inadequate interest coverage for additional interest accrual days between bond payments. DBRS evaluates if an interest mode change resulting in insufficient interest coverage would result in the bonds being subject to mandatory tender. If there are mandatory tender provisions, DBRS considers if the transaction calls for (i) an increase in interest coverage prior to the bonds being remarketed to new investors or (ii) a substitute LOC which is properly sized.

### Bank Bonds

Most LOCs support variable rate bond transactions, also known as variable rate demand obligations, which are bonds with an interest rate that typically resets weekly and gives investors the option to put their bonds to the LOC Provider if not remarketed by a remarketing agent. This optional tender gives investors the right to full repayment of principal and accrued interest prior to the maturity of their bonds. Investors are usually paid with proceeds from remarketing efforts.

If the remarketing agent cannot find any investors to purchase the tendered bonds, the trustee will make a draw under the LOC to purchase the bonds from the investors at a price of par plus accrued interest. The bonds, now called “bank bonds,” are then owned by the LOC Provider and are usually subject to a higher interest rate, known as the “bank bond rate”.

### Replenishment of LOC Coverage

In the event of a failed remarketing as mentioned above, the stated amount of the LOC will decline by the amount drawn under the LOC to pay the purchase price of the bonds (with such bonds becoming bank bonds). If the remarketing agent successfully remarkets the bank bonds, the LOC Provider receives the proceeds from the new investor(s) which include full principal and accrued interest. DBRS expects that the LOC Provider’s security interest in such bonds will not be released to new investor(s) unless and insofar as the LOC coverage amount is fully reinstated simultaneously with their remarketing.
Termination of the LOC

A typical LOC has an expiration date of about three years, even though the bonds typically mature much later. Prior to the LOC expiration date, the LOC Provider may consent to an extension of the maturity date of the LOC. If the LOC Provider does not wish to extend the LOC and the issuer cannot obtain a new LOC from a new LOC Provider (and does not wish to convert the bonds to a mode that does not require a credit or liquidity facility), the bonds will become subject to mandatory tender in the amount of par plus accrued interest and the DBRS ratings will be discontinued. If the issuer is able to obtain a new LOC from a new LOC Provider, the new LOC Provider’s long- and short-term ratings may differ from the original LOC Provider and DBRS may rate the bonds based upon the new LOC Provider’s long and short term ratings. Once a new LOC is issued, the bonds can be remarshaled with the ratings of the new LOC Provider.

Operational Risks

DBRS reviews the transaction documents to see that they clearly describe and allocate the responsibilities of the trustee, LOC Provider, and remarketing agent. The processes and timing of each party’s obligations, as well as notification provisions, should be precisely spelled out to assure that, if followed correctly, timely payment of interest and principal would not be adversely affected. Draws on the LOC, reimbursement of the LOC Provider, payments to bondholders, remarketing efforts, optional and mandatory bond tenders, and redemptions are all assessed to determine if appropriately coordinated.

Transaction documents should also describe how funds are held and invested. To address risks related to commingling of funds and any potential disruption in bond payments, LOC funds used to pay bondholders should be maintained in an account which is separate from all other trustee held funds and transaction accounts and free from any liens in accordance with DBRS legal criteria. Such funds should only be invested in cash or short-term liquid government guaranteed instruments in accordance with DBRS legal criteria.

Legal Opinions

DBRS reviews legal opinions to ensure that the bonds are the legal, valid and binding obligation of the issuer and that the LOC can be relied upon as a legal, valid and binding obligation of the LOC Provider\(^3\). Additionally, DBRS determines if the LOC Provider’s obligation to pay is enforceable by the trustee on behalf of the bondholders.

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3. DBRS may also review foreign legal opinions when deemed necessary.