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Client briefing
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Impact of the U.S. Sovereign Credit Rating Downgrade on ABS with U.S. Exposure and on Cross-Border ABS

On 5 August 2011, Standard & Poor's ("S&P") lowered its long-term sovereign credit rating on the United States of America to "AA+" from "AAA" and affirmed its "A-1+" short-term rating. The outlook for the long-term rating is negative.

Key Issues

Downgrade will only directly impact ABS with exposure to the U.S. government.

At this time, downgrade expected to have minimal impact on most cross-border ABS

S&P criteria for ratings higher than the sovereign may become relevant if the U.S. downgrade were to exceed one notch

A review of documentation of potentially impacted ABS should be considered

Immediate impact

In the asset-backed and mortgage-backed securities (together, "ABS") market, the immediate ratings impact of the U.S. government and mortgage agency downgrades by S&P will generally only be on transactions with direct exposure to the U.S. government or to U.S. government-backed securities, including principal-protected notes, securities defeased with U.S.-issued or U.S.-backed securities, counterparties supported by U.S.-issued or U.S.-backed securities, ABS with significant exposure to "eligible investments" comprised of U.S.-issued or U.S.-backed securities and ABS with ratings directly or in part linked to the rating of the U.S. because such ABS or the underlying collateral is guaranteed by the U.S. or a U.S. government agency (such as the Federal Family Education Loan Programme, Fannie Mae/Freddie Mac and U.S. Export Import Bank, some of which have now in turn have been downgraded in lockstep with the U.S.). However, as industry participants will be aware, there may be significant market impact on a much wider swathe of ABS and other fixed-income securities.

S&P has stated that, as most U.S. ABS are supported by collateral whose credit quality is not directly linked to the sovereign rating of the U.S. government, the ratings on these securities (as well as the ratings on any new issuances of U.S. ABS) "in the short term" should not be directly affected and that, with respect to cross-border transactions, they expect "minimal impact". However, S&P cautions that it would consider transfer and convertibility ("T&C") risks in any ABS transactions linked to the U.S. dollar and that the S&P criteria for rating securities higher than the sovereign credit may become more implicated for U.S. ABS if in the future the U.S. downgrade from "AAA" were to exceed one notch.

S&P approach to country specific risk

Whilst sovereign ratings do not form a rating "cap" for S&P's ABS ratings, there are a number of country-specific risks S&P considers may affect the performance of an ABS transaction and which it considers collectively in the assessment of credit enhancement requirements. Such risks include: T&C, currency depreciation and devaluation, inflation, economic recession, financial system risk, legal and regulatory risks and other sovereign interference risks. In addition, as a target ABS rating approaches or exceeds the relevant government's rating, S&P's related stress assumptions tend to increase significantly. However, S&P has taken pains to note that there are numerous outstanding ABS transactions that are rated higher than the sovereign rating of the country in which the assets are located and that internal credit enhancement can mitigate certain sovereign risks in transactions.

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What can be characterised as relevant credit enhancement?
While internal credit enhancement techniques such as subordination, overcollateralisation, excess spread, and reserve accounts may mitigate some sovereign risks to ABS transactions; structural details for such techniques will be scrutinised by S&P and, as noted above, not all methods will be practical or cost effective for a particular transaction. In addition, certain sovereign related risks require third party or "external" credit enhancement, which may include a letter of credit, a liquidity line or political risk insurance. Where these risks include events (for example, frozen bank accounts or T&C risks) that make the securitised assets or underlying cash flow unavailable (and therefore prevent full or timely payment on the securities), S&P suggests that the structure must allow investors to access the transaction's cash flow despite these events (for example, by funding an appropriately sized offshore reserve account through the transaction waterfall). Otherwise arguably such overcollateralisation or subordination does not assist in mitigating the sovereign risk.

By way of example, currently, a large number of existing ABS transactions in Japan (which is currently rated "AA-" by S&P) have an "'AAA" rating. However, it is not clear the extent to which the level of overcollateralisation required to achieve this rating was impacted by the "AA-" sovereign rating in Japan or whether the level of overcollateralisation in existing U.S. ABS transactions will be sufficient to ensure similar treatment in the event of current or further downgrades.

S&P has indicated that separate releases will follow concerning affected ratings in funds, government related entities, financial institutions, insurance, public finance and structured finance sectors. However, at the time of going to press, Moody's and Fitch have continued to uphold their "Aaa"/"AAA" opinion of the U.S. (despite Moody's having assigned a negative outlook to the long-term rating last week). Whilst the long term effects of S&P's downgrade action remain to be seen, for a market still struggling with the aftermath of the financial crisis, the downgrade and its possible knock-on effects introduces yet another degree of uncertainty going forward.

Next steps
Although in most cases, the impact of the U.S. downgrade on U.S. and cross-border ABS will be limited, market participants will want to give consideration to outstanding ABS transactions to which they are exposed or for which they are otherwise responsible (e.g., as originator, servicer, credit or liquidity enhancer, swap counterparty or otherwise) which may be affected by the downgrade. This may include transactions with high levels of U.S. government securities in "eligible investments", exposure to U.S. government entities as obligors on underlying assets or direct support by way of a guarantee from a U.S. government entity. In addition to the potential for a "knock-on" downgrade, the transaction documentation may require the posting of additional collateral, the occurrence of a "trigger" event (such as early amortisation) or, potentially, the downgrade could result in the conclusion that there has been a "material adverse effect" on the transaction.