International Capital Market Services Association

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ICMSA Bulletin – Issues that may arise with respect to caps on Trustee fees and expenses

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Introduction

It is noted that, on certain structured finance transactions, caps on the fees, expenses and indemnification payments to certain transaction parties, including the trustee, may be sought.

In this paper, we summarise the approach taken by the major rating agencies (the "**Rating Agencies"**) in respect of such caps on trustees' fees and expenses and note the issues which may arise for trustees when such fee caps are proposed.

Rating Agency approach

Issuers of notes in structured finance transactions will incur liabilities for a variety of payments (such as payments in respect of taxes, amounts owed to parties who provide services to the issuer or the noteholders, such as the trustee, collateral manager and agents and certain administrative expenses) in addition to payments of interest and principal to noteholders. Such payments will generally rank senior to the payments of interest and principal due to noteholders under the pre-enforcement and post-enforcement priority of payment waterfalls for the structured finance transaction (with payments to trustees in respect of their fees and expenses ranking at the top of any such waterfalls).

One Rating Agency states that, as a general principle when rating structured finance transactions, it reviews the transaction documentation and cash flow mechanics to understand how the cash flows generated by the relevant securitised assets will pay transaction expenses, such as trustee fees, as well as paying interest and principal payments to investors[1].

In its most recent paper on the criteria methodology it applies in respect of the fees, expenses and indemnities of service providers on structured finance transactions[2], the Rating Agency states that, in its rating analysis, it will consider the transaction specific provisions for the fees, expenses and indemnities paid to such service providers (including trustees, servicers and agents); acknowledging that such payments may be capped and senior; uncapped and subordinated; or uncapped and senior in the transaction's priority of payments. In its analysis, the Rating Agency will assess whether:

"an appropriate balance has been achieved to promote alignment between key service providers' and investors' interests (e.g., whether the key service providers are adequately compensated and incentivized to perform, and whether the defined fee is sufficient to attract an alternate service provider)."

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[1] *Standard & Poor's: Principles – Based Rating Methodology For Global Structured Finance Securities, 29 May 2007.*

[2] *Standard & Poor's: Ratings Direct: Criteria Methodology Applied to Fees, Expenses, And Indemnifications, 12 July 2012*

The Rating Agency states that where a structured finance transaction has fees, expenses and indemnities that are neither subordinated nor capped, the Rating Agency may assume additional fees, expenses, or other obligation amounts that are senior in the payment priority in the cash flow analysis and an analysis will be used to quantify the impact of total expenses on the available cash flow and credit enhancement supporting the rated notes. When determining the amount of additional fees and expenses to be applied in the cash flow analysis, the Rating Agency will consider a number of factors, such as: typical fees and expenses in a particular sector or country; likelihood of adverse events occurring that would result in extraordinary fees and expenses; current market conditions in the sector; the nature of the fees (e.g. the fee or indemnification is expected to be an incentive for a transaction party to take actions that would likely benefit investors); and the rating assigned to the most senior notes in the transaction.

Other Rating Agencies focus on the potential risks to an issuer's ability to pay interest and principal on CDO notes posed by open-ended or uncapped payment liabilities which are senior in priority to the issuer's obligation to pay noteholders and note that such senior expenses may be capped to deal with the majority of the expenses, with further expenses being payable at a more junior point in the priority of payments[3]. The Rating Agencies express the view that it is difficult for them to analyse the likelihood of such expenses being incurred and/or the quantum of such expenses if they are uncapped which affects their rating of the notes. It is not thought that the amount of the cap, however, is a concern to them; rather that a cap is useful for modelling purposes.

The trustee's concern regarding fee caps

Fee caps are a concern for trustees for a number of reasons:

- while the trustee would be able to quantify its annual fees for an issue, it is not able to quantify what its expenses or the additional remuneration which may be due to it (if it is, for example, asked to undertake duties outside the normal scope) may be at any given time during the life of an issue;
- the trustee's fees and expenses could be significant (and impossible to predict) post enforcement and even at a pre-enforcement stage. In the latter case, for instance, a default may well have occurred (even if enforcement has not) and/or a restructuring or other significant amendments may be proposed or needed for which the trustee may well require external legal advice and independent financial advice; and
- the trustee has a fiduciary duty to act in the interests of the noteholders but also should not be expected to incur costs on behalf of the noteholders for which it is not indemnified. Unless the fees and expenses of the trustee are adequately provided for in the priority of payment waterfalls, the trustee may not be in a position to take action on behalf of the bondholders unless individual bondholders agree to indemnify, secure and/or prefund it (which could lead to delays and to expenses being borne by certain bondholders for the benefit of all bondholders, which may not be recoverable).

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[3] *Fitch Ratings: Structured Finance: Global Criteria for Cash Flow Analysis in CDOs: 17 September 2010.*
Moody's Investors Service: Structured Finance: Rating Methodology: Responses to Frequently Asked CDO Questions: 29 March 2004.