

JCR Solicits Public Comments on Revisions to Structured Finance Rating Methodology “General Methodology”

Japan Credit Rating Agency, Ltd. (JCR) is considering revisions to the structured finance rating methodology “General Methodology” as described below and solicits opinions on the proposed rating methodology.

1. Outline

JCR is considering entirely revising its structured finance rating methodology “General Methodology” as described in the attachment. Main changes from the previous version are as follows: (1) the use of both Issuer Ratings and Issue Ratings has been made possible for special purpose vehicles (SPVs) that, like investment corporations, substantially have the characteristics of going concerns; (2) the rating framework has been reorganized in light of the possibility that the weight given to the assessment of the likelihood of recovery may increase in the future; and (3) descriptions that do not directly pertain to the rating methodology have been revised.

2. Future Plans

JCR solicits public comments on this matter. Comments will be accepted by e-mail to “Contact Us” on JCR website until June 19. JCR plans to finalize this rating methodology in about one or two months. There will likely be no existing individual ratings that need to be reviewed.

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JCR publishes its press releases regarding the rating actions both in Japanese and in English on the same day. In case that it takes time to translate rating rationale, JCR may publicize the summary version, which will be replaced by the full translated version within three business days. (Regarding Structured Finance products, JCR only publicize the summary version in English.)

Draft for Public Opinions

General Methodology

1. Classification of Structured Finance Products

Structured finance is a financial transaction involving use of a “structure” such as an SPV (special purpose vehicle) or credit enhancement measures, a broad concept that includes securitization transactions. Whereas the definition of securitization transactions under Basel II regulations is characterized by the following two: (1) senior-subordinated structure and (2) transfer of credit risk to a third-party, structured finance is considered to cover a wider range of financial transactions.

JCR broadly classifies the structured finance products into the following two groups.

- (1) Asset Securitization Products (according to the definition by the Cabinet Office Ordinance on Financial Instruments Business, etc. (Ordinance No. 52 of 2007) related to the Financial Instruments and Exchange Act)
 - Securitization products backed by leases, automobile loans, shopping receivables, or loan receivables (narrowly defined ABS)
 - Securitization products backed by housing loans (RMBS)
 - Securitization products backed by real estates (CMBS)
 - Synthetic CDOs
 - Short-term securitization products backed by notes and accounts receivables, or medical remuneration receivables
 - ABCP programs (with internal credit enhancement/ partially supported ABCP)
 - Future Flow Securitization
 - Other instruments similar to the above
- (2) Other Structured Finance Products, etc.
 - ABCP programs (fully supported)
 - Repackaged instruments (single-credit financial instruments where the credit status of the underlying assets is the same in effect as that of the financial instruments in question)
 - Financial instruments for project finance
 - Financial instruments for Asset Finance (Ship finance, Aviation Finance, and ABL (Asset-based Lending))
 - EETC
 - J-REIT
 - Infrastructure Funds (Listed Infrastructure Funds/Infrastructure Funds)
 - Other instruments similar to the above

When determining a rating, JCR studies the structure and characteristics of each structured finance

products, etc. from the viewpoint of whether the product can be deemed in effect a single-credit financial instrument and classifies it into either “Asset Securitization Products” or “Other Structured Finance Products, etc.”

2. Symbols of Structured Finance Rating and Their Definition

The rating symbols and their definition of structured finance products, etc. conform to those for corporate and other credit ratings. More specifically, structured finance ratings are gradings that enable comparisons to be made of probability of the obligations in respect of a particular structured finance product, etc. performing as contracted.

As regards the types of ratings, structured finance products and similar instruments backed by cash flows from discrete asset pools are generally assigned Issue Ratings, which include program ratings for financial instruments issued repeatedly by an SPV pursuant to a comprehensive agreement. On the other hand, for SPVs that can be considered de facto going concerns, where the asset management company exercises broad discretion in fund management and continuously acquires and disposes of assets and raises funds, an Issuer Rating may be assigned to the SPV’s ability to perform its obligations. Furthermore, when the debtor (issuer) subject to rating is legally ensured to be bankruptcy remote from related parties and to have limited recourse, it is recognized not only at the level of the legal entity but also at the level of series, compartments, trust accounts, investment businesses and other units within a multi-issue SPV.

Instead of attaching an additional symbol to the credit rating of an asset securitization product, such as “AAA-sf”, to indicate that it is a structured finance rating, JCR explains the difference between such credit rating and corporate and other credit ratings in its press releases or reports on its website. JCR also assigns ratings to all types of asset securitization products in a consistent manner.

3. Types of Financial Instruments, to Which Structured Finance Rating is Assigned

Structured finance ratings are assigned to securities (including securities equivalents) under Financial Instruments and Exchange Act such as bonds, commercial paper, trust certificates (or trust beneficial rights) and electronically recorded monetary claims and claims pertaining to monetary loan as well as financial instruments defined individually by Rating Methodology for each asset class¹.

4. Structured Finance Rating Methodology

(1) Rating Methodology and Periodic Review

Structured finance rating methodology is established in accordance with JCR’s rating policies and methodologies, and JCR periodically reviews the structured finance rating methodology.

When assigning a credit rating for an asset securitization product, JCR discloses sufficient

¹ Included are trust bonds, for which liability to perform the obligations is limited to trust property only under Article 2, paragraph (3), item (xvii) of the Ordinance for Enforcement of the Companies Act, bond-type beneficial interests and special bond-type beneficial interests (Islamic bonds) under Act on Securitization of Assets, obligations with respect to loan participation, security token (electronically recorded transfer right) and other related money obligations.

information regarding analysis of loss, cash flow and sensitivity for changes in assumptions for credit rating on such asset securitization product so that investors intending to purchase the product can learn the grounds for the credit rating. However, short-term asset securitization products (less than one year) are not subject to the sensitivity analysis unless such analysis is deemed appropriate.

JCR's structured finance rating is not statements of opinion regarding price fluctuation risk, liquidity risk and other risks. It does not take into consideration unforeseeable risks including undetermined modifications to legal or taxation system.

(2) Basic Analytical Methodology

While designs of structured finance products, etc. differ from product to product, points to be considered in assessment of structured finance products, etc. can be summed up in three key concepts: "Bankruptcy Remoteness," "Cash Flow Analysis," and "Operational Risk of Transaction Parties." It is necessary to look at quantitative and qualitative aspects in order to assess these three key concepts comprehensively, and the structured finance rating is determined through analysis of quantitative and qualitative assessment. Therefore, even when a structured finance product, etc. is considered to deserve a AAA rating from a quantitative perspective only, the rating may become lower as a result of the qualitative assessment.

Structured finance rating indicates basically the probability of debt default. However, when assigning a rating that takes into account the likelihood of recovery after the payment due date under certain conditions, JCR includes an explanation for investors to understand the fact. So it does by its news release or report to make clear the whole implication and limitation of given ratings, if and when JCR assigns ratings to structured finance products, etc. that allow debt payment in kind by way of making delivery out of the underlying assets as they are, in such a form as monetary assets or financial instruments, providing that the assets' creditworthiness is at a certain level or higher.²

[Key Assessment Points]

(i) Bankruptcy Remoteness

Under a structured finance where an originator assigns assets to an SPV, legal structure that separates assets or receivables from the credit risk of the originator is necessary. Such SPV is required to be isolated from parties to the scheme so that it is unlikely to become the subject of bankruptcy proceedings owing to factors except for factors of its owning receivables and assets securitized. These arrangements, called Bankruptcy Remoteness, are prerequisites for cash flow analysis.

(a) True Sale

² For structure finance products, etc., of which the accumulated amount of negative interest rates is adjusted for principal reduction on the maturity date with zero interest payments on the interest payment dates, if contracted interest rates become negative during period, this principal reduction is not considered default. JCR describes explanations on this point in reports for each rating.

One of the requisites for bankruptcy remoteness is separation of receivables or assets securitized from the originator in economic and legal terms. The assignment should be structured so that the transaction is not recharacterized as a secured financing and so that the validity of the assignment is denied in the event of an originator's bankruptcy under any bankruptcy law ('true sale'). As principal and interest payments of structured finance products rely on cash flows generated from assets or receivables or their values, denial of true sale or change in schedules for principal and interest payments would adversely affect the transaction. Therefore, it is essential to structure the transaction so that the assignment is a true sale and not a transfer that serves merely as collateral security. A judgment on whether the transaction is a true sale or not is made by taking a look at the content of receivables or assets securitized and the entire structure in a comprehensive manner. Another point kept in mind is that the transfer of receivables or assets should not be subject to fraudulent act, preference or repudiation.

(b) Perfection

In the event of an originator's bankruptcy, creditors such as banks or suppliers would claim their rights to preserve or collect their claims and take various steps (which are not limited to legal measures). In bankruptcy proceedings, the court may impose significant restrictions on exercise of the owner's rights. For this reason, whether the assignment is perfected against third parties needs to be verified so that the owner of these receivables or assets securitized can claim that he or she is an owner legally and so that the transfer of such receivables or assets to an SPV is not affected by the originator's bankruptcy in addition to the requirement that assets or receivables are validly transferred to the SPV.

Dilution risk that the amount of the initial receivables decreases due to cancellations and discounts, and offsetting risk that the amount of the initial receivables decreases when the obligor offsets the securitized receivables against the receivables owed by the originator are a problem in the securitization of the receivable to a single debtor in particular. In order for the rating of such securitization products to exceed the rating of the originator, the assignment needs to be perfected against the obligor upon the transfer of the receivable by way of notifying the obligor by the originator or obtaining the consent of the obligor. In addition, it is necessary to take measures against the above risks, such as by obtaining a document waiving the rights of defense from the obligor.

(c) Structure of SPV

In the event of an originator's bankruptcy, an SPV itself needs to be unlikely to become the subject of bankruptcy proceedings and the transfer of assets or receivables to the SPV needs to be unlikely to be affected by the bankruptcy proceedings. JCR considers the following the criteria for structuring a bankruptcy remote SPC.³

³ In some jurisdictions, directors are obligated to initiate bankruptcy proceedings against the company in certain circumstances.

- Restriction on business
- Neutral and independent director(s)
- Separation of capital relationship with the originator (avoidance of unjust exercise of shareholders' rights)
 - In the case of an SPC incorporated in the Cayman Islands, it is necessary to establish a charitable trust with the SPC's voting shares as a trust property estate and a local charitable organization as a beneficiary. In the case of an SPC incorporated in Japan, it is necessary for parties to the transaction not to have voting rights in the SPC by way of the entire capital contribution being held by a Cayman SPC, *Ippan Shadan Houjin* (general corporate judicial person) or *Tokutei Mokuteki Shintaku* (specified equity trust).
- Prohibition of bankruptcy petition by creditors

(ii) Cash Flow Analysis

Levels of credit enhancement and liquidity support are examined based on legal risk analysis of a structure, performance evaluation of assets or receivables or asset valuation, and other considerations. These levels are primarily determined in light of the following:

- Characteristics of assets or receivables (level of excess spread, treatment of cancellation and prepayment, marketability)
- Historical Performance (default rate, delinquency rate, and eligibility criteria for securitized receivables)
- Considerations on legal risks, fraud risks, etc. (resultant risks of the interest rate lowered, the paid proceeds returned, etc.)
- Cash flow generation capacity and stability of project or business (feasibility of business and operator's capability)
- Cash flow distribution method (sequential pay, fast pay, etc.)
- Redemption method of structured products (pass through or bullet redemption)
- Other (substitution of servicer, interest rate movements, operational cost during period)

(a) Credit Risk of Obligor

First, underlying asset or reference entity can be classified as "single-obligor" or "multi-obligor". They are then classified into whether they are subject to "law of large numbers approach" or "CDO approach" depending on the number of obligors. As a general rule, when the number of obligors who constitute the receivables pool is more than 300 and ratio of each obligor's amount

In the case of an SPV established in such a jurisdiction, JCR examines the details of measures to prevent the SPV from becoming insolvent and the prospect of recovery in the event of bankruptcy proceedings against the SPV (Are there bankruptcy laws that allows the creditor who has mortgage rights on all or substantially all of the SPV's property to collect their claims without being involved in the bankruptcy procedure?) and then judges the adequacy of protection of securitized assets in accordance with the circumstances in such jurisdiction.

to the overall amount (obligor concentration) is below a certain level, JCR adopts law of large numbers approach and makes analysis based on this approach and adopts CDO approach in other cases. In the case of multi-obligor assets, analysis focuses on how the risk of obligor default and delinquency can be quantitatively figured out and then how such risk can be absorbed or avoided. Credit enhancements such as overcollateralization or senior-subordinated structure are often taken against these risks.

Law of large numbers approach assumes that all of the small obligors who constitute the receivables pool have the same attributes. JCR then estimates attributes of the receivables pool from the historical data, securitization period, etc. and calculates the required subordination ratio.

In law of large numbers approach, the base case default rate for obligors in the pool of receivables is determined by examining the historical data. Next, JCR conducts stress testing by applying stress scenarios with respect to the rates of default, delinquency and prepayment to the expected cash flows during period, and calculates a required subordination amount. The rate of stress to be loaded is determined on the assumption of a standard case subject to the attributes and credit standing of a given obligor. Load is added if the credit standing of transferred claims deemed, from the attributes and historical data, to be lower than that of the originator's entire claims, or the amplitude of change in the default rate is expected to be greater than usual judging from the obligors' attributes or economic/business environment at the resident country of underlying assets.

In cases where the number of obligors in the pool of receivables to be securitized is small, or in cases where obligor concentration is high, JCR adopts CDO approach. In CDO approach, JCR allocates a default probability to each obligor unlike in the case of law of large numbers approach, and carries out Monte Carlo simulations based on this probability in order to calculate a subordination level.

(b) Commingling Risk

Funds collected from the securitized receivables are remitted to the SPV after staying at the servicer for a certain period. Should the servicer go into bankrupt, there could be a risk of commingling of the collected money with assets of the servicer and consequently failing to remit the money as scheduled. As a general rule, JCR sets the largest amount to be expected to become uncollectible due to the servicer default at any time after commencement of securitization as a required credit enhancement amount for commingling risk.

(c) Cash Reserve (Liquidity Support)

It is necessary in light of rating to reserve funds as cash reserve as required during the period until the servicer hands over the collection operations to the backup servicer and collected proceeds are credited again to the SPV when the servicer falls into such situations that disable implementation of normal collection operations due to bankruptcy and any other reasons.

(d) Risk of Fluctuations in the Value of Underlying Assets

In cases where proceeds from the sale of underlying assets are assumed to be the primary source of debt repayment, it is important to assess asset values (the present values and future values) and to provide credit enhancement against the risk of fluctuations in value. In the case of real estate, for example, JCR assesses the final asset value after making analyses on general and individual factors based on the following points:

- Market Analysis
- Quality of Real Estates
- Property Management Capability
- Tenant Statuses (Quality of Tenants and Degree of Their Diversification)

Furthermore, for the assessment of the extent of credit enhancement against the risk of fluctuations in the value of underlying assets, LTV (Loan To Value), which indicates the ratio of debt to asset value, serves as a key indicator. JCR makes final rating decisions based on the LTV level while also considering various risks that could cause fluctuations (decreases) in “net operating income” and “future sales price” until the maturity date; for example, risks involved in real estate include declines in rent income, fall of land price and deterioration of buildings.

(iii) Operational Risk of Transaction Parties

Under securitization of granular monetary receivables, the originator usually serves as a servicer to whom collection services are entrusted from the SPV. In majority of such securitization transactions, an originator’s continuation of its services of collection from obligors is better than other ways for the reasons that the originator has know-how and experiences in collection fit for nature of the receivables and that it can maintain relations with its customers. Therefore, it is general that an originator serves as an initial servicer. However, it is necessary to appoint a backup servicer beforehand or define clearly procedures and framework to be required for servicer substitution in preparation for a situation where the servicer can no longer conduct collection services owing to bankruptcy and any other reasons.

(3) Structured Finance Products, etc. with Market Risk

Concerning a structured finance product, etc. with market risks whose interest or principal payments are determined by a certain calculation formula depending on market prices or indexes such as stock price, interest rates, exchange rates, JCR analyzes in what way the market risk varies the interest and principal amounts and determines a rating based on the probability of the obligations in respect of such structured finance products, etc. performing as contracted. In the case where the market risk affects such probability, JCR determines a rating, factoring in the effects of the market risk. In the meantime, rating may become lower or may not be assigned at all as to a structured finance product, etc. if the market risk can cause a substantial principal loss.

(4) Structured Finance Products, etc. with Deferrable Interest or Dividend Clause

Some of ratings on structured finance products, etc. with deferrable interest or deferrable dividend clause for the bonds or trust certificates do not address timely payments of interests or dividends excluding cases where such structured finance products, etc. to be rated are the most senior tranche of publicly-offered multiclass securities. In this case, JCR describes explanations on this condition in reports for each rating in order for investors to understand this condition.

As for these structured finance products, etc. with deferrable interest or deferrable dividend clause, deferment of interest payments or dividend payments does not fall under default on contract. Thus, in the case of the ratings which do not address timely payment of interests or dividends, JCR does not rate these structured finance products, etc. at "D," with just the fact that the interest payment or dividend payment has been deferred.

(5) Structured Finance Products, etc. with Ratings for Principal Redemption or Interest Payment Only

As for structured finance products, etc. without predetermined amount of interest or dividend payments but with dividend payment based on actual results, rating addresses probability of principal redemption (repayment) only and does not address probability of payments of interest or dividend. JCR describes explanations on this condition in reports for each rating in order for investors to understand this condition.

In rating RMBS's or other securitization's tranches consisting entirely of cash flows of interest payment, JCR assesses certainty of contractual interest payment based on priority of payments and credit enhancement level for such tranches, assuming sufficient mitigating measures in interest rate risk have been taken.

(6) Sovereign Rating and Country Ceiling

The ratings on structured finance products, etc. are constrained by the sovereign rating of the resident country of their underlying assets. It is determined individually whether or not the rating of given structured finance products, etc. can exceed the sovereign rating. When the product is denominated by a currency foreign to the resident country, the ratings thereof are in principle equal or lower than the country ceiling that is determined in consideration of the likelihood that the government authorities might impose a foreign exchange control.

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