Last updated: June 1, 2012

# CLOs

## 1. Overview of target products

Collateralized loan obligations (CLOs) are securitized products backed by a pool of multiple loans. Products backed by a pool of multiple corporate bonds are called collateralized bond obligations (CBOs).

## 2. General scheme

Like in the cases of other financial claims, CLOs are often securitized in the form of a beneficial interest in trust. Existing loans are generally added only based on the requirement for claiming rights against a third party through registration, as stated in the special law for transfer, and the requirement for claiming rights against a debtor is reserved. In contrast, when loans are collected for the purpose of issuing CLOs, such as in the case of local government CLOs (sometimes called “collected CLOs”), the requirement for claiming rights against a debtor is generally added from the beginning.

## 3. Key points in rating

(1) Risk of credit decline of underlying obligors

The senior-subordinated structure covers the risk of insufficient funds for principal repayment at the time redemption caused by a default of the underlying obligor.

If the underlying obligors have been rated, the probability of default is determined using the ratings of individual companies. If they have not been rated, shadow ratings are given by the corporate rating staff members. If the underlying obligors are in large numbers, the probability of default of individual underlying obligors is estimated by using the credit risk estimation models of JCR, such as the Corporate Default Rate Estimation Model (for large enterprises) and JCREST, internal ratings provided in the examination of the originator, and methods of mapping with external scores and other data.

Based on the above, the probability of default corresponding to the credit standing of each underlying obligor is identified, which is added with the types of stress scenarios described later. And Monte Carlo simulations are performed to develop the risk curve corresponding to the probability of default of CLO target ratings to calculated necessary subordination ratios.

If there are many underlying obligors in the credit pool to be rated, the “many-small-account” approach used in securitization of lease payments receivable is applied to the analysis in some cases (see “Lease Payments Receivable” for details).

Reference: Corporate Default Rate Estimation Model (for large enterprises)

This model is used to estimate default probability of a corporation from financial information on the corporation. JCR has developed the model using financial data of numerous normal companies and bankrupt and insolvent companies excluding financial institutions such as banks, nonbanks, life and nonlife insurance companies, and part of the non-manufacturing industry (trading, railway, airlines, electricity, and city gas).

Reference: JCREST

This is a credit risk estimation model for small and medium-sized companies." It applies a positive-semi-definite logit model to estimate the probability of bankruptcy in one to three years.

(2) Risk of concentration of obligor attributes

Concentration of underlying obligor attributes may cause a decline in the credit standing of the entire credit pool to be securitized. JCR focuses primarily on the following obligor attributes and responds to the situation by adding the type of stress scenarios that corresponds to the level of concentration.

- Industrial concentration
- Regional concentration
- Concentration of main banks

(3) Prepayment risk

Prepayment made by an underlying obligor reduces the amount of interest on the loan payable by the obligor after repayment, which may result in insufficient funds for interest payments on the securitized products. In the case of collected CLOs, on the other hand, the loan agreement generally includes a provision that prohibits prepayment to minimize such a risk.

(4) Risk of offset

There is a risk of dilution of the credit pool if there is an offset between an adverse claim (e.g., deposits for a bank) against a financial institution that has an underlying obligor as the originator and the loan.

To prevent such a risk particularly in the case of collected CLOs, a provision to prevent the offset is included in the loan agreement signed with the underlying obligors.

## 4. Documents required

(1) Documents concerning the originator

(2) Documents concerning the underlying obligations (individual)

(a) Underlying obligation contract (template)

(b) Information on the underlying obligor

Location, capital, annual turnover, type of business, rating, internal rating by the originator company (or CRD, scores from an external credit bureau, etc.), and main bank

(3) Documents concerning underlying obligations (overall)

Attribute data concerning the underlying obligor (a list of the above (2)-b)

Location, capital, annual turnover, type of business, rating (if any), internal rating by the originator company (or CRD, scores from an external credit bureau, etc.), main bank, and the amount of initial loan

(4) Other

(a) Table of business categories (Tables and other materials used as reference when classifying the business of the underlying obligor)

(b) Overview of the collection of underlying obligations (conditions for examination, credit policy, etc.)

(c) Probabilities of default by internal rating (or CRD, scores from an external credit bureau, etc.)



Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026