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Commingling Risk Pertaining to Securitization Products

1. Introduction

A benefit of funding by securitization is that a structure backed by only cash flows from assets assigned appropriately to an SPV ("true sale") with bankruptcy remoteness can allow an originator to obtain financing without depending on its creditworthiness. While, in usual, simple assignment of money claims separates credit risk of an assignor from an assignee by transfer of ownership of its assets, in arrangement of securitization transaction, utmost attention is paid to eliminate elements that can threaten validity of the asset transfer, which is a prerequisite for a securitization product, in advance so that legal grounds of the validity cannot be questioned when the assignor, that is, originator, goes bankrupt. Namely, it is generally considered that risks that can be eliminated by measures at the time of structuring should be eliminated as much as possible beforehand for investors for monetary claims who take a credit risk (a certain level of credit enhancement is provided by way of senior-subordinated structure usually) of assigned assets as an aggregate.

Another important issue to prepare for bankruptcy of originator is commingling risk. It is true that it is desirable that the originator continue its service as a servicer after assignment of its claims to SPV in general in light of cost and effectiveness of collection as long as the originator wishes to continue its relations with debtors who are customers in its business and the originator continues its business as before. From this perspective, the originator keeps in touch with the debtors after assignment of receivables usually as an agent for servicing (administration and collection) operation. The originator's position will not change in appearance.

In exchange for this smooth administration and collection operations after assignment of claims in securitization, when the originator goes bankrupt, there is a risk that the collected money from the claims that should belong to SPV or investors eventually will commingle with the originator's inherent cash. As a result, it has been generally thought that it is necessary to take into consideration that SPV might become unsecured general creditor with only right to claim for delivery of collected money against the originator in the worst case scenario. In practice, there has been subordination (credit enhancement) for comingling risk (which depends on collection schedule of securitization schemes, but is often set as an amount of monthly collected money for two months in case of lease receivables) in response to collected money assumed to stay in the hands of the originator in addition to subordination for debtors' default risk in the almost all securitization cases of monetary claims, to which JCR has assigned ratings to date. Bearing in mind the above, JCR made public a report on this issue in April 2006 and then introduced a rating trigger for commingling risk to securitization transactions, in which a nonbank financial institution was the originator, after reexamining measures under the structure and scenarios assumed at the time of the originator's bankruptcy.

2. Rating Trigger for Commingling Risk

Evaluation on probability of redemption of securitization products should be a matter of probability essentially. From this perspective, it is a generally accepted way of thinking that scenario analysis should be relied only on quantitative decisions and that it is necessary that this analysis be separated from qualitative factors. For this reason, it is true that a measure for commingling risk, which is an event that is difficult to be predicted for the happening beforehand, was required to be taken before as an event that can happen always in case of originator's bankruptcy. However, there is room to reconsider a conclusion that it is completely impossible to add any decisions on status of an originator after the originator securitizes its claims.

It is still difficult, however, to evaluate a probability of occurrence of this event as mentioned above. If subordination for commingling risk is not set at the beginning and the rating on the originator lowers later, such subordination needs to be set up. Otherwise, JCR cannot make the same decision on rating on the securitization product as before. JCR examined carefully whether or not JCR can set differences in requirements at the beginning when rating securitization products by way of JCR's evaluations on things centered on rating on originator itself and came to the following conclusions.

(i) In case where a rating higher than a certain level is assigned to an originator, it is less likely that the originator goes bankrupt during securitization time horizon even if its creditworthiness worsens or its rating can be downgraded with a certain probability.

(ii) When a rating on an originator is downgraded, as long as the originator remains at a certain level of rating (Rating Trigger for Commingling Risk), it can be forecast that liquidity that will be required to be contributed pertaining to the securitization product is sufficient at that time.

(iii) For an originator, to whom a certain level of rating is assigned, at time of creating a securitization product, it is normal that JCR judges that the originator has competitive advantage in operating base, etc. over others in its industry. In this case, even if the originator goes bankrupt for some reasons, it is relatively less likely that one-sided proceedings ignoring rights of the securitization product investors will be taken. There are cases where JCR can evaluate a probability of an amicable settlement following a precedent in the rehabilitation-type proceedings. JCR thinks, however, that it is difficult for JCR to incorporate such probability into the rating in effect.

The above standards are based on JCR's views that it is possible to take an approach to reservation at the beginning pertaining to commingling loss that cannot reach a level affecting a rating on a securitization product by way of JCR's decisions on the originator at each point before occurrence of commingling loss upon the originator's bankruptcy. Specifically, JCR allows an originator to reserve setting up subordination for commingling risk until it hits the rating trigger for commingling risk by way of setting up such rating trigger, if the originator can meet requirements for the standpoints below.

(1) Originator, to Which Trigger Applies

JCR sets a standard for an originator, to which this trigger applies, that such originator should be a nonbank financial institution in principle, which receives a certain level of Long-term Issuer Rating from JCR at time of creating a securitization product. In principle, JCR assumes corporations with ratings in the A category and higher than this category. An opinion that it is less likely that a corporation will go bankrupt if it has a certain level of rating at the beginning lies behind this standard. Additionally, this standard reflects that JCR judges that it is less likely that such originator will have to offer a subordination amount later for commingling risk that is reserved at the beginning in the event of hitting the trigger later described below. JCR does not exclude a possibility that qualitative factors such as factors as shown in (2)-(ii) "Setting of Trigger Standard" can be taken into consideration for this initial standard.

(2) Setting of Trigger Standard

In an originator's securitization, to which the above applies, JCR sets the rating trigger for commingling risk when "Long-term Issuer Rating on the originator becomes BBB or lower with Negative outlook in principle." When this trigger is hit, additional contributions for commingling loss need to be made within 30 days as agreed at the beginning or the originator shall pay an approved amount of money by JCR in advance in response to schedule for collected money. While the standard for this trigger is BBB rating in principle, JCR judges a notch difference in a comprehensive way in accordance with the following individual factors and does not deny that such difference might be set.

(i) Degree of Reliance on Securitization in an Originator's Funding Activity

When an originator's reliance on securitization is high, it is likely that higher level of trigger will be applied in view of the originator's funding ability at the time of its hitting the trigger.

(ii) Other qualitative factors such as business base and support from shareholders and group companies.

In case where ratio of an amount of temporarily collected money staying in the hands of the originator to the issue amount of securitization product is extremely high (for example, in case of monthly clear credit card receivables), the above standard may not apply.

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