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Credit-Linked Products

1. Credit-Linked Products

A credit-linked product is a synthetic financial instrument of which credit risk is linked to the credit of the other entity by way of a credit default swap (CDS) agreement. Unless otherwise specified, a single name credit-linked product, for which linked creditworthiness is that of a single entity, is called a credit-linked product here. When the number of reference entity is plural, and senior-subordinated structure is incorporated, it is called a synthetic CDO. The credit linked product is sold to investors in the form of securities (including securities equivalents) such as bonds (credit-linked notes) or beneficial interest or money loan under Financial Instruments and Exchange Act using SPV ("Special Purpose Vehicle") set forth in Table 1 below.

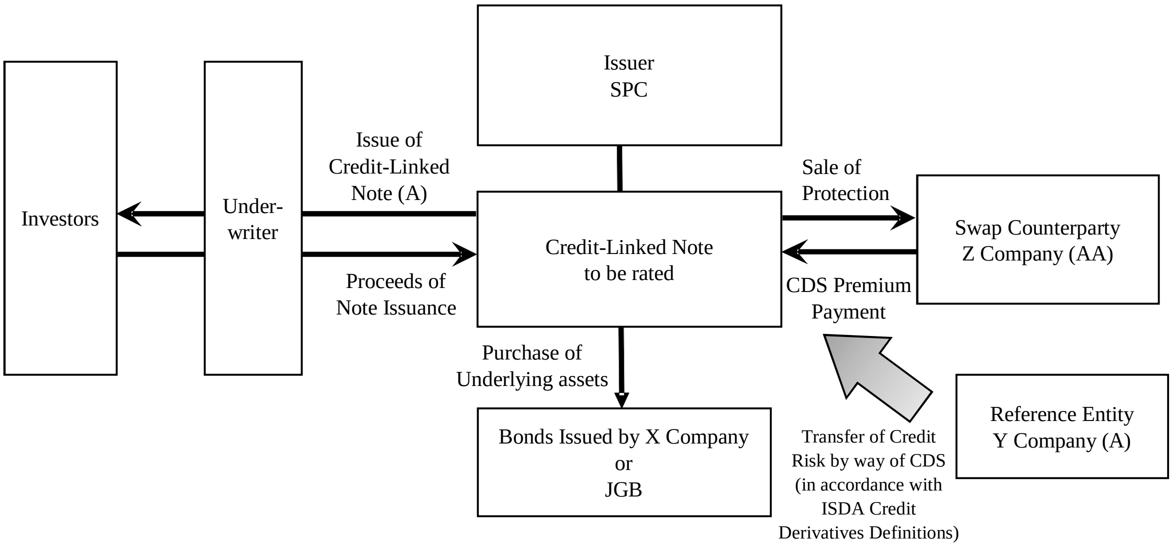
Chart 1 SPV (Special Purpose Vehicle)[1]

- Trust
- Limited Liability Company incorporated in Japan pursuant to the Companies Act
- Special Purpose Company established outside of Japan

Taking a form of note issue by an SPC as an example, the SPC purchases Japanese government bonds or corporate bonds issued by X Company and issues credit-linked notes to investors backed by these bonds. The SPC enters into CDS agreement, in which reference entity is Y Company, with a CDS counterparty Z Company. In case where a credit event occurs to Y Company, the principal shall not be redeemed in full amount but in such an amount determined in accordance with the CDS agreement like market value of liabilities of Y Company, which is a reference entity (sometimes called reference organization).

[1] In addition, a stock company including a special limited liability company under Companies Act, a specific purpose company under Act on Securitization of Assets or a partnership can be used.

Chart 2　Scheme of Single Name Credit-Linked Product



A credit rating of a credit-linked product is determined, similarly to a repackaged financial instrument, based on the results of analysis of contractual aspects relating to the issue[2]. Such as creditworthiness of underlying assets, creditworthiness of reference entity, contract performing ability of parties related to cash flows, legal protection provided in the transaction documents.

2. Key points of a Credit Rating

(1) Framework of a credit rating

JCR generally assigns a credit rating to a credit-linked product, the same as a repackaged financial instrument, based on the weak-link-approach method. In other words, the final credit rating is determined based on the weak-link-approach of the following:

(A) The credit rating of the underlying asset

(B) The credit rating of the reference entity

(C) The credit rating of the swap counterparty

According to the weak-link-approach method, the final credit rating for the credit-linked product shall not be higher than the rating of the weakest element with respect to interest payment and principal redemption of a credit-linked product among numerous elements by which the credit-linked product is backed. In other words, the credit rating of the credit-linked product shall converge and link to the credit rating of the weakest element (hereinafter called the "Weakest Entity"). Therefore, if one element relating to the credit-linked product becomes unable to function, timely payment of principal and interest of the credit-linked product cannot be assured. When the lowest rating among the underlying

[2] In addition, the following rating methodology is applied to obligations with respect to loan participation and money obligations with respect to swap transactions.

assets, reference entities or swap counterparties is revised as a result of a rating review, the rating of the credit-linked product will be revised as well.

As for the foregoing swap counterparty (C), however, if its short-term rating becomes lower than a certain level, it is also possible not to designate the rating of such swap counterparty as an upper limit for the rating of such credit-linked product by incorporating such provisions as (a) replacing the counterparty by another counterparty who fulfills the qualifications, (b) submitting a guaranty which is admitted to be qualified by JCR (c) concluding a collateral contract which covers the necessary amount throughout the contract term[3]. In these cases, although a swap counterparty should, in principle, be limited to whom JCR assigns a rating including "p" rating (rating mainly based on published information), relaxation of such qualifications for a swap counterparty could be considered for each case under the premise that the relevant scheme shall be reinforced.

In case of that the issuer is a financial institution; the credit-linked note becomes a financial institution note containing CDS contracts. Therefore the rating of the credit-linked product shall be determined based on the weak-link approach, i.e. either of

(A) The rating of the issuer of the credit-linked product
(B) The rating of the reference entity

With respect to trust bonds issued under Article 2, paragraph (3), item (xvii) of the Ordinance for Enforcement of the Companies Act, a trustee is liable to perform the obligations by using trust property and its own property in principle. However, the trustee can limit this liability to trust property only by the following two methods: One is a method, by which the trustee shall attach limited recourse clause to the issued trust bonds (Article 21, paragraph (2), item (iv) of Trust Act), and another is a method, by which the trustee shall make a registration of limited liability trusts (Article 21, paragraph (2), item (ii) of Trust Act). For a rating on trust bonds, for which liability to perform the obligations is limited to trust property only, JCR assigns a rating basically in accordance with weak-link approach after checking contents of prospectus.

(2) Credit Rating of Underlying Assets (Creditworthiness)

Various expenses for maintenance of a scheme, interest payment and principal redemption of a credit-linked product are covered primarily by cash flows generated from underlying assets. The credit rating of underlying assets (the credit rating of the issuer of underlying assets or debtor of underlying assets or guarantor) constitutes an element for the final credit rating of a credit-linked product.

[3] Please refer to "Swap Counterparty".

(3) Credit Rating of Reference Entity

If a credit event occurs to a reference entity, redemption of principal in full shall not be made for investors. Therefore, credit rating on the reference entity will be an upper limit on credit rating of the credit-linked product.

As to whether or not the probability of occurrence of the credit event as defined in a CDS contract (at usual case, as per the definition of ISDA) is equal to the default probability assumed for a usual rating, it is necessary to examine individually whether the rating of the relevant reference entities should be adopted without adjustments.

A first-to-default note is the note which about 5 to 10 entities are selected as reference entity and when even one corporation falls into default, the note shall be redeemed at the market value of the relevant failing corporation's debt (or redeemed in kind)[4]. In case of a first-to-default note, the weak-link approach shall not be adopted unlike the case of a single name credit-linked product. In turn, as the synthetic CDO without subordinated portion, the rating methodology for the synthetic CDO shall be adopted by taking into account the creditworthiness of reference entities (current rating or historical rating transition), correlation in default probability (analysis in light of regional, industrial and systematical aspect), the number of reference entities[5]. This is because an increase in the number of reference entities can raise a possibility of default on a first-to-default note when a factor of creditworthiness of a reference entity is independent from one another, because a first-to-default note can fall into a default when a credit event occurs to even one reference entity.

(4) Rating of Swap Counterparty (Contract Performing Ability)

If an event of default occurs to the swap counterparty, usually the swap contract will be terminated and the credit-linked product should be redeemed before maturity at less than the principal amount, which would jeopardize interests of investors. Therefore, the rating (contract performing ability) of the swap counterparty is the element of creditworthiness bracing up a credit-linked product. In the case that JCR does not assign a rating to the swap counterparty, and estimation of the contract performing ability is difficult (e.g., swap house subsidiaries of large financial institutions), a guaranty of a parent company will be usually furnished for swap obligations. In these cases, JCR uses the rating of the parent company (the guarantor) after checking contract terms.

(5) Assurance of cash flows for investors

Whether cash flows from a SPV (from underlying assets in actuality) to investors are practically or legally secured will be confirmed.

To assess the assuredness of cash flows in practice, the foregoing rating of underlying assets and

[4] Refer to the report "Q&A: what is a First-to-Default Note" April, 2004.

[5] For the details of the rating methodology of a synthetic CDO; refer to the report "Corporate Value Model and Synthetic CDO, Quantitative Analytical Method"

the rating (contract performing ability) of other parties involved with the cash flows (swap counterparty or etc.) should be assessed, and for the purpose of a swap contract, whether the date and the amount of principal and interest payment from a SPV to the swap counterparty and the payment received from the swap counterparty match those of the payment regarding the credit-linked product will be confirmed. On the other hand, it is necessary that a credit-linked product should be structured so that a bankruptcy of any of the other related parties involved with cash flows would not exert adverse impact on them. In the case of deposit claims, if underlying assets are subject to a withholding tax with respect to their interest payment, it is essential in its scheme that the cash flows from the underlying assets do not cause any discrepancy on its schedule with the cash flows of the credit-linked product (e.g. conclusion of a cash flow swap contract for replenishing an equivalent amount of the withholding tax or establishing a credit facility).

Concerning a credit-linked note or loan using SPV, provisions related to cash flows in a contract should be confirmed for judging whether cash flows are secured for investors from legal aspects.

The summaries of checking points are as follow.

(A) Whether or not the cash flow is rigidly segregated for each series of issues which are rated (in case where the SPV is a Multi-Issue Company that issues plural numbers of structured finance instruments).

(B) Whether or not the cash flow from underlying assets leaks out in the midst of the fund flow.

In the case that a Cayman SPV is a note issuer, conditions satisfying the above (A) are that the cash flow from underlying assets (repayment source) is secured individually, and that the default of other series of issues by the identical SPV will not exert adverse impact on the cash flow from the series of issues covered by the relevant rating (the creditors' right to claim for payment related to other notes will have no impact from practical and legal aspects on the cash flow of the series of issues covered by the relevant rating, that is a Ring Fencing). About a credit-linked note issued in Euro market, provisions concerning a Ring Fencing are stipulated in Trust Deed, Agency Agreement and Swap Agreement, etc.

If there are series of issues in the past by such SPV, whether all of such series satisfies the conditions for a Ring Fencing will be confirmed by directly checking the transaction documents of the existing series, or by checking opinions or letters submitted by legal counsel, etc. Further, as long as rated series are outstanding, the same conditions should also be satisfied by any additional series to be issued in the future, and director's letter satisfying the aforementioned conditions for (A) should be submitted. Same as a securitizing instrument issued in the domestic market, pledging collateral over the underlying assets in favor of the investors in a credit-linked product is not always an essential condition, but it is desirable to pledge collateral if other conditions allow.

Concerning above (B), for the case of a credit-linked note issued in Euro market, a custodian separately controls the underlying assets for each series of issues, and whether the underlying asset is strictly segregated from the deposits of other customers even if such custodian falls into bankruptcy should be checked. The custodian's obligations are usually stipulated in Agency Agreement. The agreement must include provisions which grant solely to the Trustee, as a representative of beneficiaries, the right to exercise claims against the SPV. Such Trustee monitors SPV's compliance with covenant clauses. It is also necessary that lawyer consultation fees and other charges will not run short.

(6) Bankruptcy Remoteness of SPV

Table 3 Main Measures to Assure Bankruptcy Remoteness
(A) Measures to Prevent Bankruptcy: Prohibition of Businesses other than Issuance of the Credit-Linked Product, Prohibition of Incurring Debts other than the Credit-Linked Product, Cut-off of the Voting Right from the Principal Entity,
(B) Measures to Prevent Commencement of Bankruptcy Proceedings: Independent Managers, Non Petition Clause, (in the case of a Multi-Issue Company) Ring Fencing Clauses, etc.

Bankruptcy remoteness of a SPV is also an important matter in examining assuredness of cash flows for investors. Businesses of a SPV should be limited to a purchase of underlying assets, issuance of notes, interest payment and redemption of them, and execution of swap contracts (or execution of other derivative contracts, credit/liquidity enhancement contracts). More specifically, for the purpose of protecting investors, a SPV must not be liable for any risks other than those related to the issuance of such notes to prevent third persons from initiating unpredictable bankruptcy proceeding. In assigning a credit rating, it is important to verify whether contractual measures are taken to enable a SPV to smoothly move ahead with the issuance, interest payment and redemption of credit-linked products[6].

One of the way to cut-off the voting right of a limited liability company, stock company (including special limited liability company) incorporated in the domestic domicile (hereinafter called a "Domestic SPV") from the principal entity of the domestic SPV is to let a Cayman SPV holds the whole stocks of the domestic SPV. And further it includes not only the way in which a charitable trust holds whole ordinary stocks with voting right of the relevant Cayman SPV but also such way in which an Ordinary Incorporated Association established under the OIA Act (including Incorporated Association transformed from the *Chuukan Houjin* as a result of the revision of the relevant laws) holds whole stocks of the domestic SPV. The necessary conditions for bankruptcy remoteness shall be individually examined for each case by procuring legal opinions.

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[6] For example, in case of a credit-linked note issued in Euro market, the scope of limited activities of SPV shall be confirmed by the TRUST DEED.
In general, main restrictive activities* are as follows:
- ■ Establishment of subsidiaries (branches) and merger with other company
- ■ Bearing of liabilities other than those for issued notes**
- ■ Dividend payment, distribution of earnings
- ■ Additional issuance of stocks
- ■ Disposition of assets and earnings

* Not so if agreed by Trustee.
** Multi-Issue Company is allowed to perform additional issuance of notes and related businesses.

(7) Other points

(A) Matching of cash flow

Terms for the issuance of an underlying asset and a credit-linked product should be confirmed particularly to see if there is any difference between each of provisions related to a cash flow such as redemption method. If there are any different provisions, measures (agreements) responding to such points of difference including those of preventing some additional risk derivation are necessary to be covered by agreements related to a credit-linked product.

(B) Eligible bank account

Rating criteria for the bank with which a SPV should keep its accounts are referred to in the general criteria of "Eligible Deposit Accounts and Investment Instruments".

3. Monitoring Criterion

Since the rating of a credit-linked product is converged and linked to the rating of the weakest entity, for a rating review of a credit-linked product, in principle, the rating committee of the credit-linked product shall be held after the rating of the weakest entity is changed without delay.

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