Last Updated: May 11, 2007

Repackaged Notes

1. Repackaged Notes

A repackaged note means the note newly repacked using derivatives such as currency and interest rate swaps to make cash flows of secondary market notes more appealing to investors. Underlying notes (collateral notes) are transferred to an overseas SPC and new notes are issued backed by them.

The difference between a repackaged note and CBO (Collateral Bond Obligations) is that the cash flow of a repacked note consistently corresponds to that of the collateral note on one-on-one basis although the cash flow of the collateral note is transformed through swaps. On the contrary, CBO has preference/subordination structure (senior note/junior note, senior note/mezzanine note/junior note) as there are plural numbers of cash flows of numerous issues of collateral notes backing up CBO. Accordingly, the credit rating of repackaged notes is determined based on the results of analysis of their issue structure (creditworthiness of collateral notes, contract performing abilities of parties related to cash flows and legal protection). For CBO, on the other hand, the target rating is once set forth based on the results of issue structure analysis, and then the actual rating is determined after establishing excess collaterals and assessing credit enhancing measures consistent with such target rating.

2. Features of Repackaged Notes

Some of notes issued in the past are not attractive any more at present due to changes in interest rate levels and share prices. Repackaged notes transform cash flows of such existing notes corresponding to various needs of investors (periods, interest rates, currencies, or redemption methods, etc.) and in many cases they are offered as customized products.

Types of collateral notes have diversified to foreign currency denominated notes, EX warrant notes (bond portion excluding warrant from warrant bond), convertible bonds, etc. and newly emerged also were an arbitrage bonds which enable the replacement of collateral notes under certain rules. The number of cases to obtain credit ratings has increased as well (although not published), as investor base has broadened since the latter half of 2000.

3. Key points of Credit Rating

(1) Framework of credit rating and necessary data (materials)

JCR generally assigns credit ratings to repackaged notes based on a weak-link-approach method. The final credit rating for a repackaged note will not be higher than the rating for the weakest element among (i) collateral notes and (ii) swap-counterparties which back repackaged notes. If one element backing the note becomes unable to function, timely repayment of principal and interest of the repackaged note cannot be assured. When the lowest-rating among collateral notes and swap-counterparties are revised as a result of review, the rating of the repackaged note will be revised as well.

As to a swap-counterparty mentioned in the above (ii), however, it is also possible not to designate the rating of such swap-counterparty as an upper limit for the rating of such repackaged notes by specifying in an initial contract that a party which has a short-term rating equivalent to J-1 or higher shall be initially designated as a qualified party, and that if its short-term rating becomes less than J-1 equivalent, expenses for each term should be made in advance, and if it becomes less than J-2 equivalent, expenses of whole terms shall be made in advance. In these cases, although swap counterparties should, in principle, be only those covered by JCR's ratings including "p" rating (mainly ratings based on published information), the relaxation of such qualification for swap counterparties could be considered for individual items under the premises that the scheme is reinforced by hypothecation, etc.

(2) Creditworthiness of collateral notes

Various expenses for the maintenance of interest payment, redemption and structure of repackaged notes are covered primarily by cash flows generated from collateral notes. Creditworthiness of collateral notes constitutes a core for final credit ratings of repackaged notes.

If a repackaged note has some collateral notes, the note of which rating is the lowest is focused on. If the elements of creditworthiness of collateral notes are independent, the increase in the number of collateral notes would increase risks. If even one cash flow of collateral notes becomes delinquent, repackaged notes would fall into default or be redeemed before maturity. Therefore, JCR considers the increase in the number of collateral notes would heighten the likeliness of default and it has a policy to treat credit ratings with caution for repackaged notes backed by large number of collateral notes.

(3) Contract performing ability of swap counterparty

If general default events occur to the swap counterparty, the swap contract will be suspended and repackaged notes should be redeemed before maturity, which would jeopardize interests of investors. In case where cash flows from collateral notes are deposited before the value to be swapped is received, if the swap counterparty falls into default during a period until receiving such value, cash flows of repackaged notes would become impaired. Therefore, contract performing ability of the swap counterparty becomes one element of creditworthiness backing up repackaged notes. If it is difficult to judge creditworthiness of a counterparty itself, or its contract performing ability is low (e.g., domestic banks' subsidiaries in London), guaranty of a parent company will be usually furnished for swap obligations.

(4) Assurance of cash flow for investors

Whether cash flows from an overseas SPC (from collateral notes in actuality) to investors are practically or legally secured will be confirmed.

To assess the assuredness of practical cash flows, previously mentioned creditworthiness of collateral notes and contract performing ability of parties concerned involved with cash flows (overseas SPC and swap counterparty) should be assessed, and for the purpose of a swap contract, the date and the amount of principal and interest payment from an overseas SPC to a swap counterparty and whether the value received from a swap counterparty is consistent with cash flows of collateral notes and repackaged notes will be confirmed. Otherwise, there are parties involved with cash flows, including main paying agents, custodians, euro securities clearing institutions and trustees. Repackaged notes should be structured so that bankruptcy of any of these parties would not exert any impact on them.

Provisions related to cash flows in a contract will be confirmed to make judgment of whether cash flows of the repackaged notes are secured for investors from legal aspects. The summaries are as follows.

(i) Whether or not cash flows are rigidly sorted out for each notes to be rated (in case where an overseas SPC is a Multi-Issue Company that issues plural numbers of repackaged notes).
(ii) Whether or not cash flows from collateral notes leak out in a mid stream.

Conditions satisfying the above (i) are that collaterals (repayment source) are secured individually, and that default of other series issued by the identical overseas SPC will not exert any impact on cash flows of series of notes covered by credit ratings (right to claim for payment of creditor related to other notes will have no impact from practical and legal aspects on cash flows of series of notes covered by credit ratings, that is a ring fencing). Provisions concerning ring fencing are specified in Trust Deed, Agency Agreement and Swap Agreement).

If there are series of notes issued in the past by such SPC, whether all of such series satisfy requirements of ring fencing will be confirmed through legal opinions, etc. Further, while unredeemed balance remains for series covered by credit ratings, the same requirements should also be satisfied by any additional series that will be issued in the future.

Concerning above (ii), a custodian separately controls collateral notes for each series (tranche), and whether collateral notes are strictly segregated from deposits from other customers even if such custodian falls into bankruptcy should be checked. The custodian’s obligations are specified in Agency Agreement. The agreement must include provisions granting rights to exercise claim rights against overseas SPC only to a Trustee who, as a representative of beneficiaries, monitors overseas SPC’s compliance with covenant clause. Otherwise, it is also necessary to confirm whether or not lawyer consultation fees or charges run short.

(5) Bankruptcy remoteness of overseas SPC

Bankruptcy remoteness of an overseas SPC is also an important matter in examining assuredness of cash flows for investors. Businesses of an overseas SPC should be limited to the issuance of repackaged notes, interest payment and redemption of them, purchase of collateral notes, and execution of swap contracts. More specifically, for the purpose of protecting investors, an overseas SPC is not liable for any risks other than those related to the issuance of such repackaged notes to prevent third persons from initiating unpredictable bankruptcy proceeding, and if a SPC bears other liabilities (in case of Multi-Issue Company), measures are required to be taken so that even if any event of default occurs to debts other than such repackaged notes, cash flows of such repackaged notes will never be influenced by it. In assigning credit ratings, it is important to verify whether legal measures are taken to enable an overseas SPC to smoothly move ahead with the issuance, interest payment and redemption of repackaged notes, and the scope of limited activities of the overseas SPC is to be confirmed through Trust Deed. Main prohibited activities* in general are as follows:

- ■ Establishment of subsidiaries (branches)
- ■ Bearing of liabilities other than those for issued notes**
- ■ Dividend payment, distribution of earnings
- ■ Additional issuance of shares
- ■ 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.

(6) Other points

(i) Issues related to Money Lending Business Control and Regulation Law and Law on Bond Issuance for Financial Companies

There is a scheme to use loan receivable instead of secondary market bonds as collateral notes as a modified form of repackaged notes. In such case, a SPC is regarded as a money lender specified in Paragraph 1 of Article 2 of the Money Lending Business Control and Regulation and it is possible that it is required to complete money lending business registration. Further, if SPC is recognized as a money lender, it is not unlikely that it is required to register in accordance with the Law on Bond Issuance for Financial Companies since this is a scheme for the SPC to issue corporate bonds for the purpose of raising funds for its lending. Cautious examination is needed to see if the overall scheme is aiming to virtually circumvent the foregoing two laws.

(ii) Matching of cash flow

Prospectuses for the issuance of collateral notes and repackaged notes should be confirmed particularly to see if there is any difference between each of provisions related to cash flows such as redemption methods. If there are any different provisions, measures (agreements) responding to such points of difference including those of preventing risk derivation are necessary to be covered by agreements related to repackaged notes.

(iii) Risk of a bank maintaining an account

Creditworthiness of a bank with which an overseas SPC keeps its account must remain in a sufficient level comparing with credit ratings of repackaged notes.

Materials requesting to submit in assigning credit ratings for repackaged notes

1. **Program Setting Up**

- Memorandum and Articles of Association
- Declaration of Trust
- Board Resolutions
- Management Agreement (Administration Agreement)
- Principal Trust Deed
- Offering Circular (Information Memorandum, Programme Memorandum)
- Agency Agreement
- Custody Agreement
- Dealer Agreement

2. **Each Series**

Repackaged notes

- Supplemental Trust Deed
- Pricing Supplement (Supplemental Offering Circular, Supplemental Programme Memorandum)
- Swap Master Agreement (with Schedule) and Confirmation
- Supplementary Agency Agreement
- Dealer Confirmation
- Signing and Closing Agenda

Collateral notes

- Offering Circular (Information Memorandum)