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Repackaged Financial Instruments

1. Repackaged Financial Instruments

A repackaged note means the note newly repackaged using derivatives such as currency and interest rate swaps to make cash flows of secondary market notes more appealing to investors. Notes, loans (asset backed loans) and trust beneficiary interests of which the underlying assets, as stated in the table 1, are repackaged by using SPV (Special Purpose Vehicle), as stated in the table 2, are collectively referred to as repackaged financial instruments hereinafter.

Table 1 Underlying Asset

- Notes (including convertible notes and warrant notes)
- Loan Receivables, Leasing Receivables, Installment Claims, Deposit Claims
- Fund Claims to Life Insurance Companies
- Hybrid Instruments issued by Corporation or Financial Institution (like a Preferred Stock)
- Trust Beneficiary Interests composed of the foregoing assets

Table 2 SPV (Special Purpose Vehicle)

- Trust
- Tokutei Mokuteki Kaisha (Special Purpose Company) established in Japan pursuant to the Law Regarding Securitization of Specified Assets by a Special Purpose Company
- Limited Liability Company, Stock Company, Special Limited Liability Company incorporated in Japan pursuant to the Companies Act

The difference between a repackaged financial instrument and CBO (Collateralized Bond Obligation) is that cash flows of a repackaged financial instrument consistently correspond to that of the underlying asset on one-on-one basis although cash flows of the underlying assets are transformed through swaps. On the contrary, CBO has senior/subordination structure (senior note/junior note or senior note/mezzanine note/junior note) as there are plural numbers of cash flows of numerous issues of underlying assets backing up CBO. Accordingly, a credit rating of a repackaged financial instrument is determined based on the results of analysis of contractual aspects relating to the issue (creditworthiness of underlying assets, contract performing ability of parties related to cash flows and legal protection). As for CBO, on the other hand, based on the analysis of an issue structure, and then the actual rating shall be determined after assessing credit enhancing measures.

2. Key points of a Credit Rating

(1) Framework of a credit rating

JCR generally assigns a credit rating to 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 swap-counterparty (or other derivatives-counterparty or the provider of the credit enhancement or liquidity supplement)

According to the weak-link-approach method, the final credit rating for the repackaged financial instrument shall not be higher than the rating of the weakest element among numerous elements by which the repackaged financial instrument is backed. In other words, the credit rating of the repackaged financial instrument shall converge and link to the credit rating of the weakest element (hereinafter called the "Weakest Entity"). If one element relating to the repackaged financial instrument becomes unable to function, timely repayment of principal and interest of the repackaged financial instrument cannot be assured. When the lowest rating among the underlying assets or swap counterparties is revised as a result of a rating review, the rating of the repackaged financial instrument will be revised as well.

As for the foregoing swap counterparty (A), 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 repackaged financial instrument 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.[1] 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 cases under the premise that the relevant scheme shall be reinforced.

(2) Credit Rating of Underlying Assets (Creditworthiness)

Various expenses for maintenance of a scheme, interest payment and principal redemption of a repackaged financial instrument are covered primarily by cash flows generated from underlying assets. The credit rating of underlying assets constitutes a core part for the final credit rating of a repackaged financial instrument.

If a repackaged financial instrument has plural numbers of underlying assets, the asset of which rating is the lowest is focused on. If the elements of creditworthiness of underlying assets are independent, the increase in the number of underlying assets would simply increase the risk for impairing the principal amount. In other words, if even one cash flow of the underlying assets becomes

[1] For details, refer to the report of "On the Structured Products and Creditworthiness of the Swap-Counterparty".

delinquent, the repackaged financial instrument would fall into default or be redeemed before maturity. Hence, JCR considers that the increase in the number of underlying assets would heighten the probability of default and JCR has a policy to assign credit rating in a prudent manner to a repackaged financial instrument which is backed by large number of underlying assets.

In light of statistics, the weak-link approach is premised on that the correlation coefficient of default probability of elements is 1 (i.e. perfectly correlated). If it is presumed that a default of elements occurs at random (i.e. the correlation coefficient is 0), in an extreme argument, the default probability of a repackaged financial instrument could be recognized as “the simple sum of estimated default probability of each element”.

To estimate a “default correlation” between several underlying assets at pinpoint preciseness is considerably difficult, but in general, in case of a repackaged financial instrument with several underlying assets, the credit worthiness of such repackaged financial instrument ranks in between “the weak-link” and “the simple sum”. When the correlation coefficient of default probability is high, it is much appropriate to adopt the “Weak-Link “and the “Simple Sum” is suitable for the case of a low correlation coefficient. The rating should be conducted in a prudent manner under the foregoing premise.

(3) Rating of Swap-Counterparty (Contract Performing Ability)

If an event of default occurs to the swap counterparty, the swap contract will be terminated and the repackaged financial instrument should be redeemed before maturity, which would jeopardize interests of investors. In case where the cash flows from underlying assets are to be transferred before the receipt of the counter value by the SPV, if the swap counterparty falls into default before the SPV receives such counter value, the cash flow of a repackaged financial instrument would be impaired. Therefore, the rating (contract performing ability) of the swap counterparty is the element of creditworthiness bracing up a repackaged financial instrument. In the case that JCR does not assign a rating to the swap counterparty, or 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.

(4) 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 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 repackaged financial instrument will be confirmed. On the other hand it is necessary that a repackaged financial instrument 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, fund claims to life insurance companies or preferred stocks, if underlying assets are subject to a withholding tax with respect to their interest or dividend 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 repackaged financial instrument (e.g. conclusion of a cash flow swap contract for replenishing an equivalent amount of the withholding tax or establishing a credit facility).

Provisions related to cash flows in a contract should be confirmed for judging whether cash flows of a repackaged financial instrument 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 repackaged financial instruments).

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

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 repackaged financial instrument 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 legal opinions, etc. Further, while an unredeemed balance remains for the series covered by the rating, the same conditions should also be satisfied by any additional series to be issued in the future. Same as a securitizing instrument issued in the domestic market, pledging collateral over the underlying assets in favor of the investors in a repackaged financial instrument 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 repackaged financial instrument 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 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. Otherwise, it is also necessary to confirm that lawyer consultation fees or charges shall not run short.

(5) 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 Repackaged Financial Instrument, Prohibition of Incurring Debts other than the Repackaged Financial Instrument, 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 repackaged financial instrument, 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 repackaged financial instruments to prevent third persons from initiating unpredictable bankruptcy proceeding, and if a SPV 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 financial instruments, cash flows of such repackaged financial instruments will never be influenced by it. In assigning a credit rating, it is important to verify whether legal measures are taken to enable a SPV to smoothly move ahead with the issuance, interest payment and redemption of repackaged financial instruments.[2]

One of the way to cut-off the voting right of a special purpose vehicle, 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 (excluding preferred stocks of the SPV, same as following). 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

[2] For example, in case of a repackaged product 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.

stocks of the domestic SPV. The necessary conditions for bankruptcy remoteness shall be individually examined for each case by procuring legal opinions.

(6) Application mutatis mutandis to Single Debtor Type Credit-Linked Note and Loan

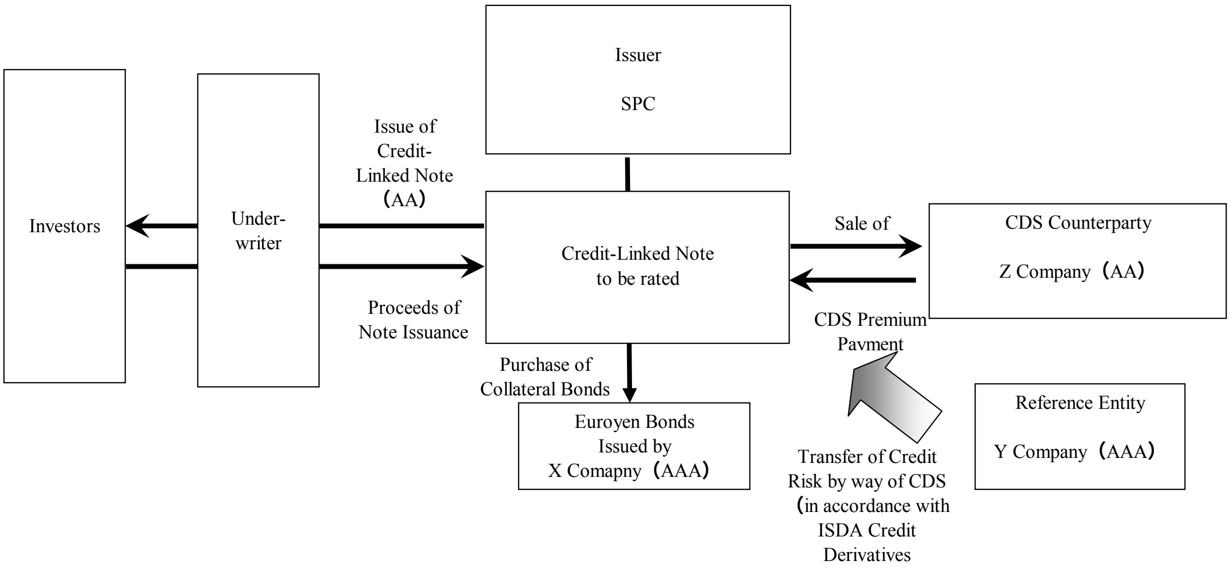
■ Brief Description of Single Debtor Type Credit-Linked Note and Loan

Credit-Linked Note is the note of which a credit risk of the relevant issued notes is linked to the credit of the other corporation by way of a credit default swap contract (“CDS contract). In case of that the number of the corporation to which the note is linked is single, it is hereinafter called a “Single Debtor Type Credit-Linked Note and Loan” (in case of plural corporations and structuring with senior and subordination tranches, it is called a “Synthetic CDO”).

In the case that a SPV is an issuer, the SPV purchases Euro Yen notes issued by X Company and then the SPV issues a Credit-Linked Note and Loan to investors by pledging such notes as collateral. Also the SPV concludes CDS contract in which Y Company is referred to with Z Company, being a CDS counterparty.

When a credit event occurs, the principal shall not be redeemed in full amount but in such an amount based on the pre-agreed value like as then current value of the liabilities of Y Company as the reference entity.

Sheme of Single Debtor Type Credit-Linked Note


Issuer
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Z Company （AA）
CDS Premium
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Reference Entity
Y Company （AAA）

■ Rating Methodology of a Single Debtor Type Credit-Linked Note and Loan

In principle,

(A) The rating of underlying assets

(B) The rating of a reference entity

(C) The rating of a CDS counter party

Among which, the rating shall be determined according to the weak-link approach. In other words the rating shall be converged and linked to that of the weakest element.

However, whether or not the probability of occurrence of the credit event as defined in a CDS contact (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 an individual contract. It is individually examined whether the rating of the relevant reference entities should be adopted without adjustments.

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 note and loan shall be determined based on the weak-link approach, i.e. either of

(A) The rating of the issuer of the credit-linked note and loan

(B) The rating of the reference entity

A first-to-default note is the note which about 5 to 10 large corporations 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).[3] In case of a first-to-default note, the weak-link approach shall not be adopted unlike the case of a single debtor type credit-linked note and loan. In turn, the rating methodology for the synthetic CDO shall be adopted by taking into account the number of underlying assets and following factors, i.e. a credit worthiness of referring entities (current rating or historical rating transition), correlation in default probability (verification in light of regional, industrial and systematical aspect).[4]

(7) Other points

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

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

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

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

(B) Matching of cash flow

Prospectus for the issuance of an underlying asset and a repackaged financial instrument 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 repackaged financial instrument.

(C) Eligible bank account

Rating criteria for the bank with which a SPV should keep its accounts are referred to in the report of "An eligible bank account for collection and an eligible investment instruments and settlement deposit in securitization" December 2006.

3. Monitoring Criterion

Since the rating of a repackaged financial instrument is converged and linked to the rating of the weakest entity, for a rating review of a repackaged financial instrument, in principle, the rating committee of a repackaged financial instrument shall be held at the same time of that of the weakest entity.

Materials requesting to submit in assigning credit ratings for repackaged notes to be issued in Euro Market

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**

(1) 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

(2) **Collateral notes**

- Offering Circular (Information Memorandum)