

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), trust beneficiary interests, and some trust bonds 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 including Special Limited Liability Company incorporated in Japan pursuant to the Companies Act
- Special Purpose Company established outside of Japan
- Partnership etc.

Characteristics in a repackaged financial instrument are 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. 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 provided in the transaction documents)¹.

¹ In addition, the following rating methodology is applied to obligations with respect to loan participation, money obligations with respect to swap transactions and financial instruments backed by securities lending transactions.

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 with respect to interest payment and principal redemption of a repackaged financial instrument 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”). Therefore, if one element relating to the repackaged financial instrument becomes unable to function, timely payment 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 term². 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.

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.

JCR assigns a rating to repackaged financial instruments attached with a provision, in which it is

² Please refer to “Swap Counterparty”.

stipulated that SPV shall perform obligations by delivery of financial instruments as underlying assets as is if the financial instruments as underlying assets are not redeemed early, as in the case of subordinated bonds, in accordance with weak-link approach also. However, the following should be satisfied to apply this approach: (i) JCR gives a rating of "A" or higher than "A" to the underlying assets (or issuer of such assets or guarantor) at time of initial rating; (ii) The underlying assets are debt financial instruments with definite maturity. As for rating of these repackaged financial instruments, JCR will explain fully the meaning and limit of the rating on them in its press release or reports.

In cases of rating for repackaged financial instruments without swap counterparty (including short-term ABL program), rating on these repackaged financial instruments is converged and linked to the rating on underlying assets (or rating on issuer of such assets or guarantor).

(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. Credit rating of underlying assets (creditworthiness) includes credit rating on issuer of underlying assets and that on debtor or guarantor, or credit rating (creditworthiness) on specific parts of structured finance instruments with senior-subordinated structure, or credit rating (creditworthiness) on borrower of cash loan in securities lending transaction³.

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 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

³ In cases where there is a forward agreement for sale and purchase of the securities, credit rating (creditworthiness) on the forward agreement counterparty can be applied in some cases, provided that an appropriate loan to value ratio is maintained.

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, usually the swap contract will be terminated and the repackaged financial instrument 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 repackaged financial instrument. 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.

(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 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 repackaged 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 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 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.

(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. 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 repackaged financial instruments⁴.

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

(6) 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.

(B) Matching of cash flow

⁴ 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.

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 general criteria of “Eligible Deposit Accounts and Investment Instruments”.

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 after the rating of the weakest entity is changed without delay.

**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)

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