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R&I View on Commingling Risk of a Servicer that is a Financial Institution covered by the Deposit Insurance System (DIS)

Rating and Investment Information, Inc. (R&I) announced its approach to commingling risk of a servicer that is a financial institution covered by Deposit Insurance System (DIS).

1. Introduction

Credit enhancement for securitized products generally is divided broadly into two factors. The first factor corresponds to the default risk of the assets to be securitized, and the other corresponds to the commingling loss in the event the funds collected from obligors are not remitted to the SPV (Special Purpose Vehicle) in the normal manner and are commingled with the servicer's own funds as the result of a servicer bankruptcy.

In the past, Rating and Investment Information, Inc. (R&I) required measures such as establishment of overcollateralization, or advances of the collected funds triggered by a change in the servicer's rating, as credit enhancement measures to address commingling loss. However, R&I has determined it is not always necessary to require such credit enhancement measures when the servicer is a financial institution covered by the Deposit Insurance System (Note 1), and if the servicer has taken certain measures. This report summarizes R&I's approach.

2. Traditional response to commingling loss

When it has concerns about the occurrence of commingling loss following a servicer bankruptcy, R&I requires credit enhancement measures to offset (avoid) this risk. The assumed loss amount is decided by giving consideration to the collected funds from the obligors accumulated by the servicer, and the servicer's collected funds remittance schedule. The accumulated funds are estimated from expected cash flows, such as scheduled payments from the backing assets, and uncertain cash flows such as prepayments. R&I generally takes the credit enhancement measures based on overcollateralization, such as a subordinated trust beneficial interest. When the servicer's creditworthiness is strong, however, R&I will also recognize enhancement measures based on methods such as setting a rating trigger for the servicer, and requiring advances of an amount equivalent to the commingling risk value or servicer replacement if the servicer's rating is downgraded below the designated rating.

3. The Deposit Insurance System

Japan's Deposit Insurance System serves as a safety net for protecting depositors when a financial institution fails. According to Deposit Insurance Law Article 2, the Deposit Insurance System covers banks prescribed by the Bank Law, long-term credit banks prescribed by the Long-Term Credit Bank Law, shinkin banks, credit unions, credit cooperatives, worker's credit unions, the Shinkin Central Bank, the Shinkumi Federation Bank and the worker's credit unions federation (the Rokinren Bank). As the primary entity for the system, the Deposit Insurance Corporation (DIC) performs activities such as providing financial assistance and making payments of deposit insurance claims that accompany its administration of a failed financial institution.

The DIC sets the "eligible deposits" that are eligible for protection and the "scope of protection for deposits," and provides full protection for deposits for settlement and payment purposes provided such deposits satisfy the three conditions of (a) interests not accruing, (b) being payable on demand and (c) a settlement service being available. Furthermore, as a rule, settlement debts (Note 2) that are not included in the deposits for settlement and payment purposes (specific settlement debts) are also fully protected by deposit insurance, based on Article 69-2 of the Deposit Insurance Law (Note 3).

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There are two procedures used as a deposit protection mechanism when a financial institution fails. Under one procedure, the DIC pays deposit insurance claims directly to depositors (Insurance Pay-Out Method). Under the second procedure, the DIC provides financial assistance when, for example, a financial institution transfers its insured deposits to another, healthy financial institution (Financial Assistance Method).

4. Collected funds for a facility in which a financial institution covered by the Deposit Insurance System is the servicer

R&I interviewed the Financial Services Agency and related institutions concerning their thinking with regard to issues such as the eligibility or scope of deposit insurance protection for the funds collected on securitized facility. As a result, R&I concluded there is a strong probability the collected funds for CLO (collateralized loan obligations) and RMBS (residential mortgage backed securities) facilities for which a financial institution covered by the Deposit Insurance System is the servicer will be recognized as specific settlement debts and thereby be eligible for payment of a deposit insurance claim based on Article 54-2 of the Deposit Insurance Law (Insurance Pay-Out Method) or a capital loan under Article 69-3 of the same law (Financial Assistance Method). R&I also judged, however, it will be necessary to administer the funds collected from obligors as a separate item, such as a specified deposit or a temporary payments receivable.

5. Timely payment concerning delivery of collected funds

Between the Financial Assistance Method and the Insurance Pay-Out Method, there is a possibility for differences in the timely payment to occur. When using the Financial Assistance Method, the DIC will dispose of a financial institution bankruptcy over a weekend, and R&I assumes it will be possible for the DIC to manage the process smoothly to enable the financial institution to return the deposit. When the DIC uses the Insurance Pay-Out Method, on the other hand, there is a concern the remittance of the collected funds will be delayed temporarily, because the DIC will conduct the repayment. Of course, given that the primary intent of the Deposit Insurance System is to protect the funds for settlement, there is a strong probability that repayments will be processed promptly. Nevertheless, against a servicer bankruptcy, R&I believes it is necessary to provide liquidity enhancement beforehand for interest payments on securitized products and payments of the costs.

6. Response to facilities that have retained perfection against the obligors

For facilities that retain obligor approval or notification for transfer of the assets to be securitized, it is necessary to investigate whether the obligation for delivery of the collected funds corresponds to specific settlement debts, or, the deposit corresponds to the deposits for settlement and payment purposes. For such facilities (normally a RMBS), R&I will separately investigate whether credit enhancement is necessary to provide against commingling loss and, if so, how much credit enhancement is required, taking into consideration matters such as the creditworthiness of the financial institution that will be the servicer (Note 4) and the importance of the servicer activity. For CLO, the assets normally are solicited from the beginning for the purpose of securitization, and in many cases approval for the transfer has been received from the obligors. For RMBS, which frequently will securitize existing claims, greater care must be exercised.

7. R&I's approach

Because there is a strong probability the full amount of the collected funds will be protected under the Deposit Insurance Law, and given the period when the servicer holds the collected funds is limited and the provision of liquidity such as interest payments on the securitized product are facility conditions, R&I decided it may assign a rating even if traditional credit enhancement measures such as a rating trigger are not utilized. For facilities that retain obligor approval or notification, however, R&I will consider the response for each facility.

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- (Note 1) The Deposit Insurance System is a system established for the purpose of maintaining confidence and discipline, by protecting depositors and ensuring funds settlement when a financial institution can no longer redeem deposits or other accounts. The organization responsible for management of the system is the Deposit Insurance Corporation, which was established based on the provisions of the Deposit Insurance Law enacted in 1971 and is capitalized through investments by the central government, the Bank of Japan and commercial financial institutions.
- (Note 2) Foreign exchange transactions and other liabilities that financial institutions bear for transactions prescribed by government ordinance as transactions related to the funds settlement of financial institutions (however, excluding transactions paid in foreign currencies, and limited to transactions originating in the consignment of parties other than parties stipulated by government ordinance that are parties managing a financial institution or other financial business and other transactions stipulated by government ordinance).
- (Note 3) Careful attention must be given to the fact that liabilities based on transactions originating in consignment by the financial institution itself or parties managing a financial business do not correspond to “specific settlement debts.”
- (Note 4) When evaluating the creditworthiness of a financial institution, in addition to an analysis of the institution’s business and financial base, an evaluation of the probability of public assistance based on Chapter 7 (Measures Against Financial Crises) of the Deposit Insurance Law and other laws and ordinances also becomes a critical factor.