

Views on Securitization When Using an Ippan Shadan Hojin

As part of the reforms of Japan's nonprofit corporation system, General Incorporated Association and General Foundation Law which was promulgated on June 2, 2006 ("the Law") will be enforced on December 1, 2008. As a result, enforcement of the Intermediary Corporation Law (Chukan Hojin Law) will be abolished, and existing chukan hojin will continue to exist as new general incorporated associations (ippan shadan hojin).

Since the enforcement of the Chukan Hojin Law in October 2002, R&I has assigned a number of ratings to securitization schemes that utilize a chukan hojin. Behind these schemes has been the widespread acceptance of the understanding that issuers can utilize a chukan hojin to create issues domestically that achieve the "separation of voting rights and foundation." At an ippan shadan hojin as well, the positions of the fund contributors and the members eligible to exercise voting rights will be organizationally separated, as in the case of a chukan hojin, based on Article 48 paragraph 1 of the the Law that members shall be the only parties having voting rights.

Furthermore, except for large ippan shadan hojin with total liabilities in excess of 20 billion yen or some other kinds, ippan shadan hojin will not be obligated to appoint an inspector. Ippan shadan hojin will now be able to design more flexible organizations overall, such as reducing the number of members that is a condition for dissolution.

R&I investigated whether such existing chukan hojin and newly established ippan shadan hojin can be utilized in a securitization scheme in place of a Cayman SPC or chukan hojin, and issued a report that they basically are acceptable to use (see Note 1).

With the enforcement date of the Law approaching, R&I recently reviewed its views on the points at issue when applying the Law for a securitization vehicle, taking into consideration the characteristics of the Law and a comparison with Chukan Hojin Law.

When assigning a rating, R&I will verify the followings pertaining to matters such as the articles of incorporation and member dispatch agreement, in addition to the points normally considered for a general securitization issue. There is a possibility R&I will revise these contents accordingly in the event of revisions to or changes in the interpretation of the Law in the future.

(Note 1) For details, please refer to *Current Status and Future Outlook for Real Estate Non-recourse Loans* in R&I Monthly Rating Information for October 2006.

1. Purpose of the articles of incorporation

Although the articles of incorporation for a ippan shadan hojin, like those of a chukan hojin, do not include special provisions limiting the ippan shadan hojin's business, the safety of an issue will be improved if the articles provide that the ippan shadan hojin will not undertake any additional business that would have a serious adverse effect on its existence and operation, and measures are taken so more business than required will not be added to the articles of incorporation.

In the case of a holding company SPC (special purpose company), for example, this might include provisions such as "(1) acquisitions of shares held such as the stock of an SPC whose purpose is securitization and (2) activities accompanying such acquisitions".

2. Number of members

R&I believes an ippan shadan hojin that will be used for a securitization issue must have at least two members. If possible, three or more members are preferable. Under the Law, an ippan shadan hojin must have two members at the time of its establishment, which can later be reduced to one member, and the absence of members (i.e. no members) becomes a corporation dissolution event. In this respect, the Law differs from the provisions of the Chukan Hojin Law, under which the presence of only one member becomes a dissolution event.

From the standpoint of improving the stability of a securitization issue, however, the ideal approach, given the possibility of a member shortfall due to a death and other reasons, is to ensure an extra number of members. This is because the Law does not include a provision similar to the "Continuity Provision" in the Chukan Hojin Law (Article 82), and the risk of the number of members to be zero would be substantial.

3. Provision for members to join an ippan shadan hojin

R&I considers all members must give their consent in writing when joining an ippan shadan hojin. Like the Chukan Hojin Law, the Law does not stipulate any provision concerning members who join an ippan shadan hojin. For a securitization, however, member conduct that would result in redemption or repayment of a securitized product subject to a rating, or have a serious adverse effect on the scheme itself must be prevented beforehand. In that sense, an ippan shadan hojin must establish a provision on entry to the ippan shadan hojin in its articles of incorporation, to ensure control over who can and cannot become a member.

In addition, an ippan shadan hojin should set limits concerning the qualifications of members who join the ippan shadan hojin. These will state, for example, that a member (1) is not an executive or regular member of an originator or its affiliates, (2) is not a fund contributor, (3) does not have negative equity in the case of a corporation, and (4) can submit a pledge to not petition for bankruptcy.

4. Provisions on member withdrawal from an ippan shadan hojin and expulsion of members

As a rule, the articles of incorporation will provide for withdrawals from an ippan shadan hojin to prevent members from withdrawing without a previous notice, by including a phrase in the articles of incorporation such as "when the member has notified the ippan shadan hojin by a certain date beforehand". In addition, the ippan shadan hojin will set provisions to ensure individuals will not be expelled easily, using wording in the articles of incorporation such as "approval by individuals holding at least three-fourths of the voting rights of all ippan shadan hojin members shall be necessary when (1) a member has violated the articles of incorporation or (2) there are other proper reasons." These provisions are taken to ensure the ippan shadan hojin cannot easily reduce the number of members as the ippan shadan hojin will be dissolved when the number of members becomes zero.

5. Expenses

R&I will confirm the articles of incorporation provide that members will not bear the expenditures of the ippan shadan hojin. This provision prevents members from having claims against the ippan shadan hojin.

6. Directors

For an ippan shadan hojin, only one director is required when the entity is not a large ippan shadan hojin or some other kinds. For the operations of the ippan shadan hojin, it is preferable to provide for alternate directors to ensure blank periods do not occur.

7. Fund

R&I will confirm provisions have been set in the articles of incorporation that (1) the entity will not pay interest, (2) the entity will not redeem its fund until the ippan shadan hojin is dissolved, (3) transfers and pledging are prohibited and (4) the ippan shadan hojin fund contributors will not petition for bankruptcy of the ippan shadan hojin.

For a chukan hojin, the minimum required fund was 3 million yen. Under the Law, such limitation was abolished. However, in many instances the amount of an ippan shadan hojin's fund can be expected to be set by estimating the costs during the term of the securitization issue, as in the case of a chukan hojin. R&I will therefore confirm whether fund has been prepared to ensure the cash flow of ippan shadan hojin is not exhausted during the term of the facility.

8. Dissolution

To improve the stability of a scheme, no more dissolution events are added than are necessary. Specifically, it is preferable if the number of dissolution events is limited to the details provided for by the Law, for example, such as an insufficient number of members or dissolution under a court order.

9. Other related agreements

When structuring an ippan shadan hojin issue, an ippan shadan hojin typically will enter into a member dispatch agreement, administrative services agreement and other contracts with the entity that will dispatch the members ("dispatching firm"). This member dispatch agreement will stipulate the dispatch of required number of members, and notification to R&I when the agreement is revised, and will include a pledge to not petition for bankruptcy and a recourse asset limitation clause. R&I will basically conduct a due diligence meeting at the dispatching firm, and judge whether the office to which the members will be sent is appropriate as a vehicle for accepting the dispatch of members for the securitization issue.

Similarly, agreements other than the member dispatch agreement to which the ippan shadan hojin will become a party will include a pledge to not petition for bankruptcy and a recourse asset limitation clause.

Furthermore, for all SPC issues, R&I will confirm a pledge to not petition for bankruptcy of the SPC has been received from the ippan shadan hojin members.

10. Notification of accounting results

An ippan shadan hojin will be under obligation to publicly report its accounting results. This obligation will similarly be placed on an existing chukan hojin to become ippan shadan hojin.

Although it is assumed that these methodologies can be met by simple means such as uploading the information on the Internet and disclosing at the main office, R&I must confirm that the methodologies and costs do not become an excessive burden on the ippan shadan hojin's administration and cash flow.

11. Organization design

Depending on the scale of its liabilities and other factors, the organization design of an ippan shadan hojin will differ, and when the appointment of an inspector or accounting auditor is necessary, the organization design can become complex and engender higher costs.

For a borrower SPC in particular, R&I must confirm whether the organization design has been accomplished appropriately and whether the cash flow can absorb the costs.

12. Matters to note when converting from a chukan hojin to an ippan shadan hojin

By the conclusion of its first general meeting of members following the enforcement of the Law, an existing chukan hojin must amend its articles of incorporation to include the words "ippan shadan hojin" in its legal name, and register the amendment. In addition, an ippan shadan hojin (former chukan hojin) that is a holding company also must amend the articles of incorporation of any subsidiary SPC held under its umbrella.

R&I will confirm the details of the change when an ippan shadan hojin amends its articles of incorporation upon transition such as abolishing its inspector.