



NEWS RELEASE

February 27, 2009

R&I Eligibility Criteria of Counterparties for Credit-Linked Products (Minimization of Counterparty Risk)

Rating and Investment Information, Inc. (R&I) has summarized its rating approach for Credit-Linked Products that minimize swap counterparty credit risk, commonly referred to as de-linked Credit-Linked Products.

Credit-Linked Products are financial instruments with such structures as investors hold debt securities issued by SPV (Special Purpose Vehicle) while they take risks related to interest rate, exchange rate, credit or other factors by entering swap or other transactions. Typical Credit-Linked Products for which R&I assigns ratings are synthetic CDOs, first-to-default products, single-name Credit-Linked Products and repackaged products. This report summarizes R&I's methodology for minimizing the swap counterparty credit risk of Credit-Linked Products.

For Credit-Linked Products, a swap counterparty default normally constitutes an early redemption event. A "de-linked" product is a Credit-Linked Product that minimizes the risk of bearing loss arising from early redemption as a result of a swap counterparty default. For a "de-linked" Credit-Linked Product, R&I assigns a rating after judging which of the rating trigger substitution measures described below, namely "replacement with a new swap counterparty" or "additional pledge," to assume as the main scenario. Note that, although the term "de-link" conjures the image of severing the risk entirely, any product cannot be insulated completely from the negative consequences from a failure of a party as long as the party is related to the scheme mechanism. For convenience, products not easily affected by the failure of one party to the scheme are referred to as "de-linked," in contrast to products that are easily affected, which are said to be "linked" in this report.

If the rating trigger substitution measures described in this report are set appropriately, R&I may assign a rating to a Credit-Linked Product that is higher than the swap counterparty's rating. In some cases, however, a Credit-Linked Product with a scheme different from the structure illustrated in the text of this report requires different de-link measures. For some Credit-Linked Products, for example, a swap counterparty default does not constitute an early redemption event of the credit-linked product, as in case of Securitized Products. Among the Credit-Linked Products with ratings assigned by R&I, such products are exceptions. De-link measures for this type of Credit-Linked Product also differ from those for Securitized Products and are described at the end of this report (Reference 1).

Furthermore, for Securitized Products such as ABS, CLO, ABCP, RMBS and CMBS, issuers sometimes utilize hedge transactions to adjust the cash flows generated by underlying assets and the cash flow of securitized products. For Securitized Products, the major credit risk depends on the quality of the underlying assets, while swap counterparty credit risk arising from the hedging transaction is regarded as a secondary credit risk. Therefore a Securitized Product generally is structured to ensure that a swap counterparty default does not constitute an early redemption event for the issue. For R&I's eligibility criteria concerning de-link measures for Securitized Products, refer to the report "R&I Eligibility Criteria of Swap Counterparties for Securitized Products" released on July 31, 2008.

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Introduction

Let's begin by clarifying the related parties, and Underlying Creditworthiness (i.e., the group of parties which R&I believes to have a substantial influence on the creditworthiness of a Credit-Linked Product), by using the example of a static-type synthetic CDO issued by a normal SPC (special purpose company) as a Credit-Linked Product.

Credit-Linked Products involve various parties, including the entities composing the reference portfolio, the issuer of the collateral bonds (including bonds transferred under a repurchase agreement), the swap counterparty, the bank where the deposit account in the SPC name is opened (there are also Credit-Linked Products for which such an account is not established; the same applies below), the collateral bonds custodian, the Credit-Linked Product trustee, the paying agent, the SPC administrator and the Credit-Linked Product arranger.

As an agent of the investors in the Credit-Linked Product, the trustee fulfills the role of issuing instructions to parties such as the custodian to protect the investors' interests (Note 1). The trustee, however, is not in a position to exert a direct influence on the creditworthiness of the Credit-Linked Product. R&I confirms that (1) the trustee has a good track record in the market, is well known in the market and is believed to have no particular problems in its ability to execute its duties and that (2) based on documentation such as the Trust Deed (agreement providing the details of the trustee's activities) the creditworthiness of the trustee will not excessively affect the creditworthiness of the Credit-Linked Product.

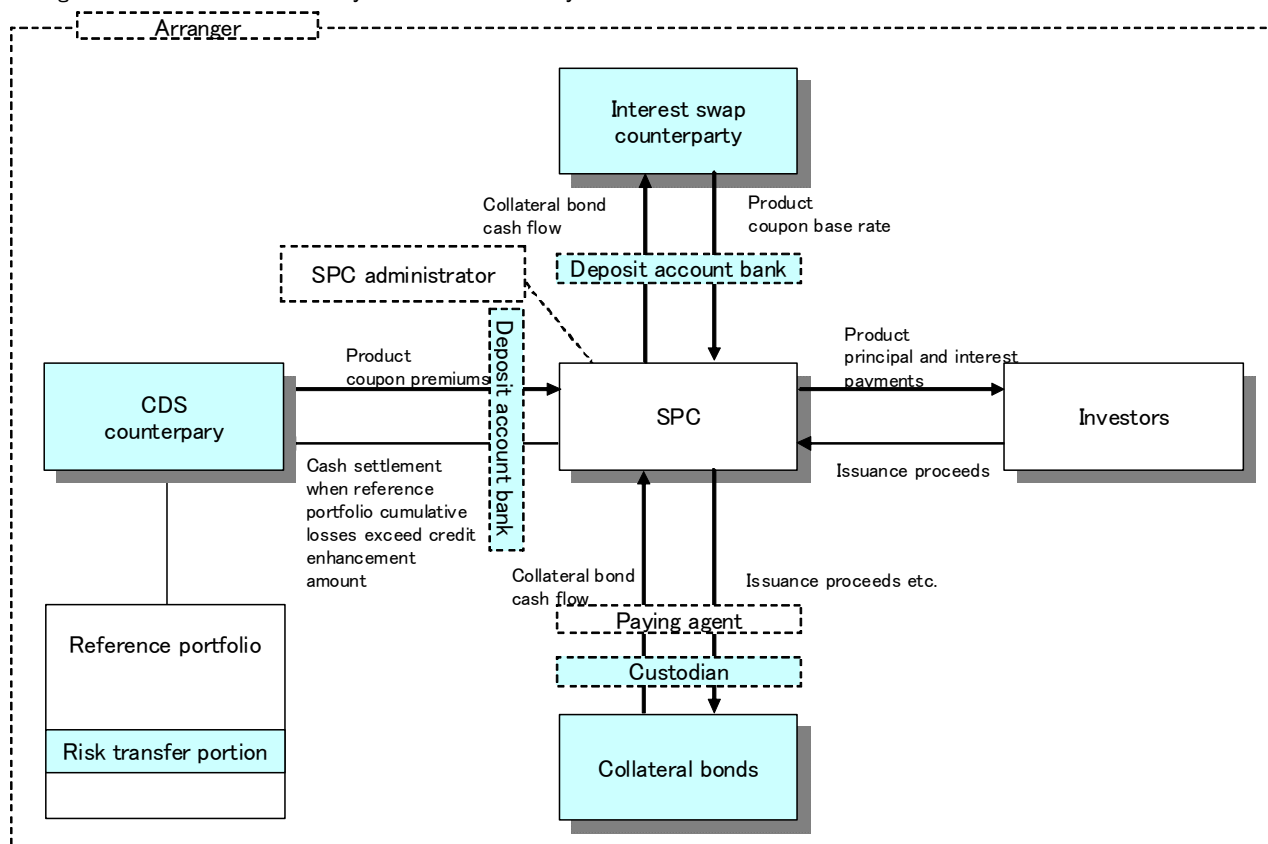
The main role of the SPC administrator is to dispatch directors to the SPC. R&I confirms the SPC administrator's actual results in this activity. The SPC administrator also is not in a position to have a direct influence on the creditworthiness of the Credit-Linked Product.

Consequently, when evaluating the creditworthiness of Credit-Linked Products, R&I focuses mainly on the creditworthiness of the entities composing the reference portfolio, the collateral bonds issuer, the swap counterparty, the bank where the deposit account in the SPC name is opened and the collateral bonds custodian. For the creditworthiness of the bank where the deposit account in the SPC name is held and the custodian of the collateral bonds, however, the credit risk of both parties normally is minimized beforehand by stipulating rating triggers respectively, regardless of whether a scheme is de-linked or not de-linked (Note 2). Moreover, for de-linked products with an AAA rating, R&I requires that the collateral bond custodian shall not be the swap counterparty itself or its affiliated company as described below. In this case, Underlying Creditworthiness that will affect the creditworthiness of a credit-linked product includes the entities composing the reference portfolio, the issuer of the collateral bonds and the swap counterparty.

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■ Figure 1 Basic structure of a synthetic CDO security



This report clarifies R&I’s view concerning the de-link measures (Note 3) to minimize the risk of the Credit-Linked Product principal and the amount corresponding to accrued interest being lost when a Credit-Linked Product is redeemed before maturity because of a swap counterparty event. R&I refers to issues for which de-link measures have been prepared as “de-linked Credit-Linked Products.” For Credit-Linked Products, the concept of the counterparty that exchanges cash flows includes the “repurchase counterparty” in repurchase agreement (repo) transaction as well as the swap counterparty. In this report, R&I refers to both types of entities simply as “the counterparty” as long as the term will not result in confusion. If R&I judges that a de-link measure provided in the agreement functions effectively, R&I may assign the Credit-Linked Product a rating that is higher than the creditworthiness of the counterparty. Furthermore, when judging the effectiveness of the de-link measures, R&I must consider factors such as the effectiveness of the rating trigger and the order for distribution of funds from the SPC to creditors (waterfall). These de-link measures function effectively only by stipulating them in all the relevant documents of the Credit-Linked Product appropriately.

Before summarizing the de-link measures considered by R&I, let’s first clarify the role the counterparty plays in the Credit-Linked Product structure, and the counterparty credit risks taken by investors.

1. Swap Counterparty Credit Risk

With Credit-Linked Products, the issuance proceeds paid by the investors are invested in the collateral bonds (Japanese Government Bonds, corporate bonds, etc.) through the asset swap or invested in a repo transaction (Note 4). The repo's cash flow resembles that of a transaction combining ownership of the collateral bonds with an asset swap position.

As can be understood from Figure 1, timely payment of the Credit-Linked Product principal and interest depends on the counterparty's timely performance of its obligation to the SPC. With a typical Credit-Linked Product, the swap agreement or repurchase agreement (collectively referred to as a derivative agreement) is terminated before maturity if the counterparty defaults and the Credit-Linked Product is redeemed prior to maturity. In this case, the trustee will firstly sell the collateral assets (assets purchased using the issuance proceeds or other funds) in the market and obtain cash. The trustee will then sequentially pay the funds to the parties related to the scheme and the investors, based on the waterfall provided by the agreement. This means that there is a possibility that the funds necessary to redeem the Credit-Linked Product may not be available if the value of the collateral assets has declined. Moreover, a waterfall normally gives payment to the counterparty priority over payments to investors. Consequently there is a possibility the source of funds for redemption of the investors will be reduced further when the obligation to pay settlement funds from SPC to the counterparty is incurred. Thus a counterparty default will actualize the market risk of collateral bonds and derivative agreement. The market risk described above will also be realized even when the counterparty cannot perform the de-link measures provided in the derivatives agreement.

In the sections below, “counterparty event” refers to both a “counterparty default” and “non-performance of the de-link measures by the counterparty.”

2. De-link measures

De-link measures can be roughly divided into (1) measures to ensure substitutability and (2) waterfalls. The de-link measures are completed by providing measures to minimize the negative influence of counterparty credit risk on the rated product for these two factors in the agreement.

2.1. Measures to ensure substitutability

To minimize the negative influence that a counterparty event will exert on a Credit-Linked Product, the “substitution measures based on the rating trigger” described below are provided in the derivative agreement.

■ Substitution measures based on the rating trigger

Implement one of the following measures when the counterparty rating falls below a certain level:

- Choose a substitution counterparty to succeed to the derivative agreement.
- Provide collateral in excess of the amount R&I deems to be necessary on cash or other highly liquid assets.
- Add a guarantee of the derivative agreement from a financial institution R&I deems to be suitable.
- Take other credit enhancement measures deemed to be suitable by R&I.

R&I continually monitors the creditworthiness of counterparties for credit-linked products that have de-link measures applied. Nevertheless, the possibility a counterparty with a high rating might default within a short timeframe cannot be eliminated entirely. Consequently the rating trigger will not function if this risk is actualized. In that sense, de-link measures can be called measures to “minimize” counterparty risk. R&I closely monitors the creditworthiness of counterparties with an eye to preventing actualization of this risk.

R&I evaluates whether the substitution measures can be exercised promptly following a counterparty rating trigger event. On this point, R&I requires the condition that the substitution measures will be triggered by the event that “the Short-term Rating becomes below a-1.”

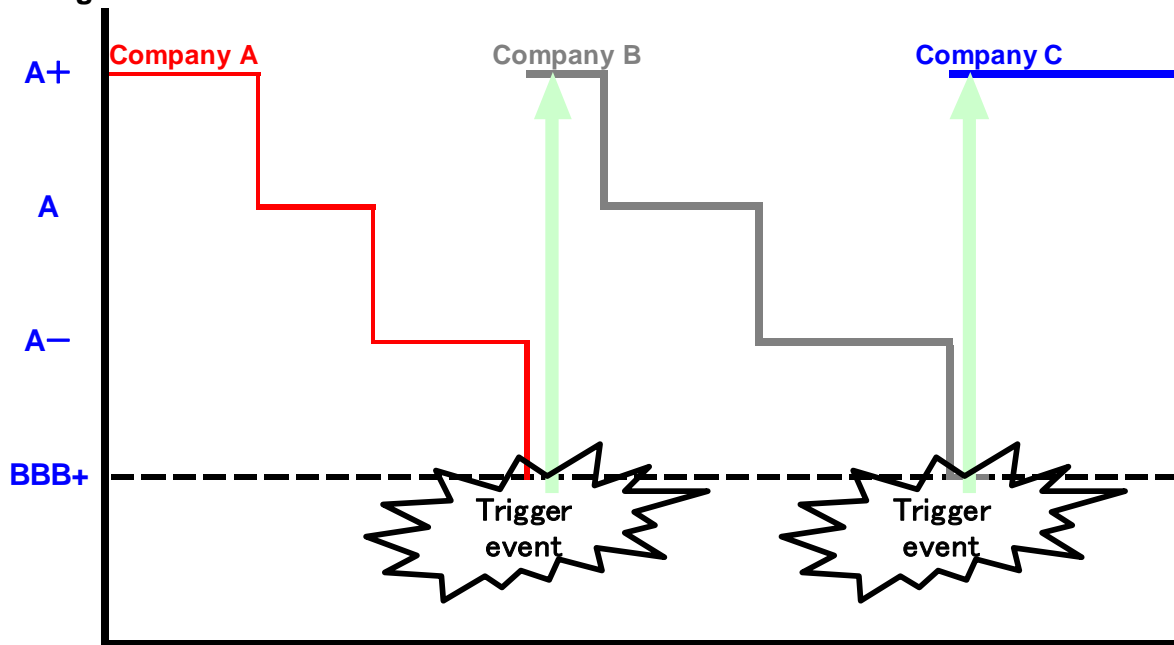
Alternatively, if a Short-term Rating is not assigned to the counterparty by R&I, the trigger event of the requirement is when “the Issuer Rating becomes below A-.”

R&I assumes the two main substitution measures to be “replacement by a new counterparty” and “additional pledge by the counterparty.” For de-linked products to which R&I has assigned a rating of AAA in particular, the substitution measure for all agreements must be “additional pledge by the counterparty” from the issue date of the product. A summary of the details of each of these measures is provided below.

2.1.1. Replacement by a new counterparty

If a new counterparty is assigned to the derivative agreement following the original counterparty’s rating trigger event, the Credit-Linked Product will not be redeemed early because the derivative agreement is not terminated before maturity. This scenario implies that the creditworthiness of the counterparty incorporated into the Credit-Linked Product will always be maintained above a certain level.

■ Figure 2 Counterparty substitution
Rating



However, the contents of derivative agreements incorporated into Credit-Linked Products are generally more complex than those of derivative transactions traded in the market. Consequently some concern remains regarding whether a new counterparty will succeed to the derivative agreement under the same terms and conditions as the prior and existing agreement. If the original counterparty can fund the additional costs such as the replacement cost and SPC's cost for the new counterparty, this concern will be minimized. The level of the rating which triggers the counterparty substitution reflects this ability of the original counterparty to burden the costs. Furthermore, because of this Credit-Linked Product management problem and cost problem, the SPC must be an R&I De-Linked Vehicle under this scenario. This restriction does not apply, however, when the practicability of the additional pledge measures described in the following paragraph is high (for further details, refer to Section 4).

2.1.2. Additional pledge

When a Credit-Linked Product is redeemed before maturity, the value of the collateral bonds may have decreased to a level that is insufficient to cover the principal and the interest accrued of the product. The potential of losing the principal or the accrued interest will be minimized if the counterparty pledges for the SPC in advance additional collateral corresponding to the amount of the potential shortfall following the counterparty's rating trigger event (Note 5, Note 6) or, from the time of issuance for de-linked products rated AAA (Note 7). R&I judges the practicability of the additional pledge to be high when the collateral amount to be deposited following a rating trigger event has been provided in the initial agreements related to the scheme (Supplemental Trust Deed etc.).

Specifically, for swap counterparty substitution measures, R&I judges the practicability of the additional pledge to be high if it is ensured that a final draft stipulating the CSA (Credit Support Annex) details is prepared in the initial agreement for the scheme (appended to the Supplemental Trust Deed Annex or other document), and that such final draft will be signed following a rating trigger event and the CSA transaction completed immediately. In case of repurchase counterparty substitution measures, R&I will judge the practicability of depositing margin securities, which R&I regards as additional pledge, to be high if the original scheme agreement provides for the purchased securities and margin securities, which R&I regards as collateral assets in this report, to be replaced with assets approved by R&I and for the collateral ratio to be maintained at a level that is more conservative than the level required by R&I when a rating trigger event occurs. Details are explained further in Section 3.

2.2. Waterfall

The Credit-Linked Product will be redeemed by the trustee sequentially distributing to the SPC creditors the funds obtained from the collateral assets, based on the waterfall provided in the agreement. Typically the payment sequence gives priority to the counterparty over the investors. If there are transactions other than hedge transactions covered by a collateral provision like the CDS transaction in Figure 1, this means that if the SPC has an obligation to pay settlement funds of other hedge transactions to the counterparty, a shortfall may occur in the principal and interest to be paid to the investors, even if the funds to pay the Credit-Linked Product principal and interest have been ensured, as illustrated in Figure 3. To prevent this, payments to the Credit-Linked Product investors must have priority over payments to the counterparty when a Credit-Linked Product is redeemed before maturity because of a counterparty event (Note Holder Priority).

As an alternative to adjustment of the waterfall as described above, it is also possible to avoid a shortfall in the source of funds for redemption by adjusting the settlement amount of the derivative agreement to be zero when the Credit-Linked Product is redeemed before maturity because of a counterparty event (Zero Cost Settlement).

Regardless of whether the waterfall adjustment measure is Note Holder Priority or Zero Cost Settlement, prerequisites for the assignment of an R&I rating include (1) obtaining legal opinions stating that the related provisions are lawful and enforceable under the laws of the court jurisdiction applied in the event of counterparty bankruptcy, and (2) a declaration by the parties to the agreement stating that the conditions to ensure the related provisions are lawful and enforceable (e.g.; swap transaction pricing is set based on the assumption the transaction is a de-linked product, etc.) have been fulfilled at the time of issue of the product (section 6).

2.3 Related party conditions

As stated earlier, Credit-Linked Products involve parties other than the counterparty, including the trustee, the collateral bonds custodian, the paying agent and the bank where the deposit account is established. In case the counterparty or its affiliate serves as one of these parties other than the counterparty, there is a risk the Credit-Linked Product principal and interest

payments will be delayed if the relevant party in question defaults because of the default of the counterparty.

Even if it involves a trustee that has a capital relationship with the counterparty, however, a default by the counterparty will not inevitably halt administrative activities. For the deposit bank and custodian, the credit risk is minimized by providing for replacement following a rating trigger event. Especially for a de-linked product rated AAA, however, R&I requires that, at least, the collateral bonds custodian shall not be the counterparty or its affiliate.

■ Figure 3 Coverage of principal and interest at early redemption by setting collateral etc.

Measure to set collateral etc.	SPC	
	Underlying assets	SCDO payment
Single prepayment	CDS premium	Amount corresponding to (accrued) interest
Amount corresponding to floating rate interest and mark-to-market portion of collateral bond principal	Amount corresponding to floating rate interest	Principal amount
	Collateral bond principal amount	
Provided collateral amount		

3. Collateral deposited by the counterparty

To enhance the practicability of the additional pledge by the counterparty, the additional collateral amount to be deposited following a rating trigger event (for a de-linked product rated AAA, however, from the time of issuance) must be stipulated in the initial scheme agreement. This section summarizes R&I's view concerning conditions governing the pledge, including the amount of collateral.

3.1. Payment amount at maturity

Here are discussions about the conditions for redeeming the Credit-Linked Product before maturity following occurrence of a counterparty event. Although there is a possibility that settlement costs pertaining to the derivative agreement between the counterparty and the SPC will be incurred, R&I assumes this risk is addressed by the waterfall adjustment described previously. While the collateral assets provide the source of funds for redemption of the Credit-Linked Product, the question is whether the sale proceeds of the collateral assets will be sufficient to cover the amount of the Credit-Linked Product principal and accrued interest (Note 6). Therefore the amount paid from the counterparty to the SPC must be stipulated by the agreement as described below.

Moreover, if the transaction is a CDS transaction like the one shown in Figure 1, R&I assumes the CDS premium will be prepaid in a lump sum at the time of the rating trigger event. Depending on the scheme, the CDS premium can also be incorporated into the secured obligation calculation.

■ Payment amount at termination of hedge transaction

Item	Content
Event	Termination of derivative agreement before maturity following a counterparty event
Creditor	SPC
Obligor	Counterparty
Secured obligation	Credit-Linked Product principal amount and amount corresponding to base rate accrued interest (Note 6) less the sale proceeds of the collateral bond (current market value amount) must be remitted to the SPC.

In practice, the amount will be recovered from the deposited collateral assets because this payment will not be made when the counterparty is in default. The amount of additional collateral is shown below.

Additional collateral amount:

(Credit-Linked Product principal amount + amount corresponding to accrued interest)(Note 6) - Current market value amount of the deposited collateral assets x Collateral Ratio

3.2. Eligible collateral conditions

When a Credit-Linked Product is redeemed before maturity, the trustee will convert the collateral assets into cash in the market and allocate the cash to prepayment of the Credit-Linked Product. Therefore the collateral assets must have as much liquidity as possible, to enable them to be converted into cash. Discussion of this point is challenged by the fact that collateral asset liquidity depends substantially on market conditions. To ensure a certain level of liquidity when the collateral assets are bonds, R&I sets the condition that the bonds must have creditworthiness which satisfies the A rating zone or higher and must not have a complex mechanism that makes calculation of the current market value amount difficult.

If the full amount of the collateral assets is a deposit controlled in an eligible deposit account (Note 2), the collateral assets requirement is satisfied and a pledge of additional collateral is unnecessary.

3.3. Collateral Ratio

Provided establishing requisites for the level of counterparty creditworthiness and other conditions, R&I sets the collateral ratio at a level at which the probability the “risk of counterparty default” and “risk of a decline in collateral asset value” are actualized simultaneously will not be an obstacle to assigning a AAA rating. In this calculation process, R&I must consider (1) the counterparty Issuer Rating, (2) type of collateral assets (Japanese Government Bonds or corporate bonds, rating, domicile, industry), (3) mark-to-market frequency and (4) time required to sell the collateral assets in the market. The Collateral Ratio that R&I requires will vary depending on these conditions. As an example, a summary of the Collateral Ratio is shown below for Japanese Government Bonds as typical collateral assets for the Credit-Linked Product. R&I’s collateral ratio calculation methodology is touched on at the end of this report (Reference 2). The Collateral Ratio percentages shown below are those R&I believes to be appropriate at present for Japanese Government Bonds. R&I will revise these ratios if it has judged the existing Collateral Ratio figures are no longer appropriate because of a change in the market or other reasons. In addition, financial institutions, generally, set minimum level for collateral deposition and avoid delivery of smaller amount of collateral in order to lessen their administrative burden. It is necessary to correct the collateral agreement to eliminate the possibility that the minimum amount may be an obstacle to the additional pledge as required under the Collateral Ratio.

■ Japanese Government Bond collateral ratio

Mark-to-market frequency		Weekly			Monthly		
Collateral asset rating		AAA	AA zone	A zone	AAA	AA zone	A zone
Remaining term (years)	$t \leq 1$	99	98	98	98	98	98
	$1 < t \leq 2$	98	97	97	97	97	96
	$2 < t \leq 3$	97	96	96	96	95	95
	$3 < t \leq 4$	96	95	95	95	92	92
	$4 < t \leq 5$	96	94	93	94	91	90
	$5 < t \leq 6$	95	93	92	93	89	88
	$6 < t \leq 7$	94	92	91	92	87	86
	$7 < t \leq 8$	94	92	91	92	86	86
	$8 < t \leq 9$	93	91	90	91	84	84
	$9 < t \leq 10$	92	90	88	90	83	83

As described at the beginning of this report, even though the expression “de-link” conjures an image of complete severance of risk, the consequences from failure of a party to a scheme cannot be eliminated entirely as long as the party is inherent in the mechanism. In that sense, de-link measures probably should be called measures to minimize counterparty risk. To ensure that the effect of the de-link measure continues to some extent, when calculating the Collateral Ratio R&I sets the prerequisites so that the rating of the Credit-Linked Product will be maintained even if the counterparty is downgraded to BBB- following a rating trigger event. Nevertheless, in some situations R&I will downgrade the Credit-Linked Product rating when the counterparty’s creditworthiness falls below BBB-, because the prerequisites pertaining to the counterparty’s creditworthiness are no longer fulfilled.

■ Counterparty Issuer Rating and rating R&I can assign to Credit-Linked Product

Counterparty rating	Upper limit of the product rating
AAA, AA, A, BBB zone	AAA
BB zone or lower	AA- to BBB+

3.4. Representations and warranties when a collateral agreement is concluded

When concluding a collateral agreement for pledge of additional collateral, representations and warranties that the counterparty is not insolvent (in a state of excess debt) at that point in time are required. This is to avoid the risk of a bankruptcy administrator’s rejection of the relevant agreement following a counterparty failure. (Section 6)

4. Arrangements concerning the issuer

With regard to the rating trigger substitution measure, when it judges the practicability of the additional pledge to be low, R&I requires conditions to the SPC that will issue the de-linked Credit-Linked Product. These conditions are that “an SPC that can issue a de-linked Credit-Linked Product will ensure that R&I can understand the conditions of the bonds issued by or loans borrowed by the SPC, and as a rule the SPC should acquire a rating from R&I for all of its bonds and loans.” This section summarizes the background for R&I’s adoption of such a stance.

4.1. Ring fence assumptions

For Securitized Products rated by R&I, the general rule is that a SPC will issue a single series of bond (there also are issues in which the SPC may raise funds by means of loan. For the sake of

If the initial counterparty Company A fails, under these conditions the multiple non-de-linked Credit-Linked Products (Bond A, Bond B and Bond C) will be redeemed before maturity as a result of the derivatives agreement with Company A being terminated before maturity. In that case, the trustee will convert the collateral assets of the non-de-linked Credit-Linked Products into cash in the market, and distribute the cash to each creditor company of the non-de-linked Credit-Linked Product and redeem the relevant bonds before maturity. Because the de-linked Credit-Linked Product (Bond D) counterparty Company A has been replaced with Company B, it will not be necessary to redeem the de-linked Credit-Linked Product (Bond D) before maturity if the counterparty creditworthiness can be evaluated appropriately. Under a MTN program, an SPC typically will have issued hundreds of series of bonds. Consequently, the trustee's operational risk could be intensified under such condition that various types of bonds exist together.

4.2.2. SPC costs

Normally, an arranger serving also as counterparty (Company A) normally pays the SPC costs (SPC administrative expenses necessary to maintain the product from issuance until redemption and the expenses paid to parties such as the trustee, custodian and paying agent). If Company A has defaulted, as for the bonds from Bond A to Bond C, no problem about SPC cost arises because they will be redeemed before maturity. The de-linked Credit-Linked Product (Bond D) will not be redeemed before maturity, however, because the counterparty has been replaced with Company B. The concern therefore arises about who will burden the SPC costs until the de-linked Credit-Linked Product (Bond D) is redeemed.

4.3 Addressing the concerns using a R&I De-Linked Vehicle

R&I believes the best approach for addressing the concerns discussed in 4.2.1 and 4.2.2 is to standardize the conditions of the bonds issued by the same SPC. Specifically, this countermeasure involves aligning the counterparty rating trigger levels as well as aligning to a certain extent the structures of the bonds issued by the SPC. To ensure this, R&I continues to grasp the conditions of the bonds or loans issued by the SPC. Any SPC that has attained ratings from R&I for all of its bonds has satisfied this requirement.

Furthermore, even when the practicability of additional pledge following a rating trigger event is high, alternatives such as substitution with a new counterparty remain. This is because market-related parties interviewed by R&I have expressed the opinion that preparation of a range of choices for rating trigger alternative measures is preferable from the investors' viewpoint. As a result, R&I's policy is to respond individually concerning an allowance for SPC costs when an issue is being structured as long as "replacement by a new counterparty" can be selected as a sub-scenario.

5. Scope of evaluation when R&I assigns a rating

5.1. Occurrence of a counterparty event

The rating symbol assigned by R&I is an opinion concerning the creditworthiness of the rated product. R&I investigates whether there are legal issues, or any particular problems concerning the administrative capabilities of the parties related to the scheme, at the point in time when it assigns the rating. Nevertheless, there is a possibility the trustee will be unable to administer an early redemption promptly since a counterparty event triggers an extraordinarily large number of activities in a short period, which are required to complete the early redemption. In addition, depending on the bankruptcy laws and legislations that will be applied to the counterparty and other relevant parties, it is possible that disputes over claims could occur and possibly delay the early termination of the swap agreement. Also, disposal of the collateral assets may take longer

time than initially expected. Incorporating such events into the scope of evaluation would possibly result in excessively conservative ratings due to numerous uncertain factors. Therefore, incorporating such events into R&I's evaluation is not necessarily appropriate. In light of this viewpoint, R&I evaluates "the probability that the principal and the interest accrued until occurrence of the counterparty event will be paid at times other than maturity."

5.2. Redemption by physical settlement

For some Credit-Linked Products, redemption before maturity by transferring the collateral assets (physical redemption) rather than paying cash following a counterparty event is set as an investor's option or main scenario. With physical redemption, early redemption can proceed quickly because no time is required to sell the collateral bonds. Physical redemption also has the advantage that investors themselves can choose the timing for converting the physical assets into cash. R&I accepts redemption by transferring physical assets provided the collateral assets are eligible collateral assets that fulfill certain conditions (Note 8). For its evaluation of de-linked products that will be redeemed with physical assets, R&I does not regard such early redemption as a default if a product is redeemed with eligible collateral assets having the same par value with the product. If collateral assets already in default are transferred, however, R&I does not regard such transfer as redemption.

6. Legality

One prerequisite for assigning a rating is that the transaction is fully lawful and enforceable. R&I confirms this based on the representations and warranties and legal opinion submitted. In particular, an explicit ruling or official opinion from authorities concerning the enforceability of the de-link measure in the event of a counterparty bankruptcy is not necessarily available. So long as there are no particular problems, R&I will judge the probability that legality will be denied is not high if (1) the parties to the agreement declare that the preconditions of the legal opinion are fulfilled and (2) a legal opinion can confirm the de-link measure to be enforceable under the bankruptcy laws and legislations that will be applied to the counterparties in question. It is necessary to note, however, that this conclusion will inevitably be influenced by future court decisions, amendments of the law and changes in legal interpretation, etc.

(Reference 1) De-link measures for products without early redemption

Among issues rated by R&I, Credit-Linked Products that are not redeemed before maturity following a counterparty default are rare. When structuring this type of de-linked Credit-Linked product, the interest for the remaining term after a counterparty default would be insufficient without appropriate measures. Provided the counterparty prepays to the SPC in a lump sum the amount corresponding to the remaining future interest that should be paid, either initially or when a rating trigger event has occurred, the SPC will be able to continue paying the interest even if the counterparty is in default. This measure presents two challenges, however, as discussed below.

(1) Possibility a bankruptcy administrator etc. will terminate a derivative agreement

There is a risk the counterparty's bankruptcy administrator or receiver will terminate the underlying derivative agreement when the counterparty is in default, and require the return of lump-sum cash that was prepaid. This risk must be examined carefully based on an attorney's opinion concerning the laws, bankruptcy legislation or other statutes or regulations that might be applied following the counterparty's bankruptcy.

(2) Possibility the cash amount to be prepaid in a lump-sum cannot be fixed

When the product has a floating interest rate, the lump-sum prepayment amount cannot be fixed.

With regard to the problems indicated above, the counterparty credit risk probably can be minimized if R&I can judge the probability of the risk of termination by a counterparty's bankruptcy administrator etc. to be low and the product to be rated has a fixed interest rate.

(Reference 2) R&I's Collateral Ratio calculation methodology

R&I calculates the Collateral Ratio by focusing on the probability of “counterparty default risk” and “risk of a decline in the value of the collateral assets” being actualized simultaneously. The joint probability of these two events must be low enough for R&I to consider the creditworthiness to be AAA. R&I's Collateral Ratio calculation methodology is summarized briefly below, using the example of a Credit-Linked Product in which the issuance proceeds from investors are invested in bonds.

1. Concept

Investors will suffer a loss if the counterparty defaults and the amount from sale of the bonds is less than the sum of the Credit-Linked Product principal and an amount corresponding to accrued interest. R&I establishes the Collateral Ratio at a level at which the joint probability of these events enables R&I to judge the creditworthiness to be AAA.

- | | | |
|------------------|---|---|
| Event A | : | Counterparty defaults |
| Event B | : | Amount from sale of bonds is less than the sum of the Credit-Linked Product principal and amount corresponding to accrued interest |
| Event $A \cap B$ | : | Counterparty defaults, and amount from sale of bonds is less than the sum of the Credit-Linked Product principal and amount corresponding to accrued interest |

R&I defines the events as shown above and designates the probability of each event as $P(A)$, $P(B)$ and $P(A \cap B)$.

2. Collateral Ratio calculation methodology

For calculations of the joint probability $P(A \cap B)$ of two events, R&I uses the Gaussian Factor Copula Model adopted for Tranche Pad, R&I's CDO valuation model. That is, R&I assumes two latent variables that will cause each Events of A and B respectively follows a two-dimensional normal distribution, and expresses each latent variable by breaking it down into a factor common to the two events and a factor unique to each event, based on the factor model. With this model, Events A and B are expressible as events for which their respective latent variable exceeds a certain value (threshold). In this case, the common risk weight of the factor model used for Event A and Event B is expressed using the degree of correlation of the two events. The weighting approach is applied in the same way to the weighting approach of the nationality factor and industry factor in Tranche Pad. The Collateral Ratio is derived through the following three steps.

- Step 1: Determine the threshold of the latent variable of Event B that results in $P(A \cap B)$ being below the Probability of Default (PD) for a AA+ rating (Note).
- Step 2: Determine the probability ($P(B)$) that the latent variable of Event B will exceed the threshold.
- Step 3: Obtain percentile of probability $P(B)$ from historical data for percentage change in bond prices.

3. Preconditions for the calculation

Several preconditions are necessary to analytically solve for the Collateral Ratio. The main preconditions are described below.

- R&I assumes the counterparty Issuer Rating is BBB- and uses the threshold of the probability of default for $P(A)$ with a remaining term of five years.
- The bond mark-to-market frequency is weekly (5 business days) or monthly (20 business days)
- Time required to sell the bonds in the market is 20 business days, etc.



NEWS RELEASE

For details concerning Tranche Pad (including the set values for probability of default), please refer to the report “R&I Tranche Pad Version 1.0 Technical Document” (only available in Japanese) on R&I’s website.

(<http://www.r-i.co.jp/jpn/rating/st/detail/j07-a-041-rm.pdf>)

(Note) R&I sets the simultaneous probability in Step 1 above at the AA+ level based on its monitoring methodology for CDO. Under the precondition described above in which the counterparty Issuer Rating is assumed to be BBB-, the simultaneous probability $P(A \cap B)$ before the occurrence of a rating trigger event will be lower than the AAA probability of default, but in some instances will exceed the AAA probability of default when R&I downgrades the counterparty rating and $P(A \cap B)$ increases. Under R&I’s CDO monitoring methodology, to manage ratings stably R&I will revise a rating when the probability of default for the Credit-Linked Product has reached the probability of default of the rating one notch lower than the current rating. To maintain the AAA upper limit of the Credit-Linked Product under conditions in which the counterparty Issuer Rating is BBB- or higher, R&I must set the collateral ratio so the simultaneous probability $P(A \cap B)$ does not exceed the probability of default for AA+, one notch below AAA.

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(Reference 3) Legal risks related to early termination of swap transactions

Early terminations of swap transactions involve the following legal risks.

(1) Disputes over settlement amount

Occurrences of disputes over swap settlement amount are not limited solely to de-linked product. Generally, terminating swap transactions before maturity due to the bankruptcy of one party under the ISDA Master Agreement requires the occurrence of Events of Default of the party. Also the non-defaulting party must send the defaulting party the prior notice that states the Event of Default and the Early Termination Date (within 20 days since the prior notice becomes effective). As the potential swap settlement amount fluctuates significantly, depending on the Early Termination Date during the market is volatile, a non-defaulting party with “out of the money” swap transaction, who wants to avoid the cash out resulting from early termination, could have a disincentive to send such a prior notice. This may cause disputes. For several kinds of bankruptcy, however, applying Automatic Early Termination in the agreement enables to make the time of each prescribed event an Early Termination Date. For the swap agreements underlying de-linked products, this approach is believed to enable settlement to proceed comparatively smoothly. This does not eliminate the risk of a dispute entirely, however.

(2) Legality of water fall adjustments

Depending on the bankruptcy law or legislation applied to the counterparty, there is a possibility the legal effectiveness of waterfall adjustment measures in the form of Note Holder Priority or Zero Cost Settlement of swap transaction may be questioned. No actual examples of this risk being actualized have been noted in Japan.

(3) Incentive to breach a non-petition agreement

In case of a defaulting counterparty with “in the money” swap transactions, the counterparty’s bankruptcy administrator has an incentive to petition for the bankruptcy of the SPC when the positive position of the swap is not expected to be covered by the cash remaining after allocating collateral bonds sale proceeds to the investors in accordance with the Note Holder Priority. The reason is that, while any unredeemed amount will be forgiven if the limited recourse provision is followed, the enforceability of an agreement to waive the right to petition for bankruptcy (non-petition provision) has always been in doubt. Because a counterparty is considered to have sufficient knowledge concerning financial transactions, however, R&I believes a non-petition provision is effective to a certain extent.

(Actual example of an incentive to breach a non-petition provision)

SPC		Creditor Contents of claims
Assets	Liabilities	
100	100	Investors Credit-Linked Product principal and interest
	40	Counterparty positive swap position

Counterparty (bankruptcy administrator etc.) loses full amount if no measures are taken.

Counterparty (bankruptcy administrator etc.) is able to collect some amount if it petitions for bankruptcy of SPC and the allocation of SPC assets are prorated among investors.

(Reference 4) Points to consider concerning occurrence of a counterparty event

Even for a trustee judged as having no particular problem in terms of ability to perform its functions, the large volume of early redemption administrative activity that must be undertaken in a concentrated timeframe when a large-scale counterparty failure occurs inevitably means a certain amount of time will be required for the trustee to perform. Other risks are the risk that the disposition of collateral assets cannot be processed due to provisional measures under bankruptcy laws and legislation, and the risk that disputes will occur. Particularly when a dispute occurs, time will be required to settle the dispute, and there is a possibility the trustee will withhold disposition of the collateral bonds during this period. As a result several months might be required for early redemption settlement after a bankruptcy, and in this case the investors will face restrictions from the standpoint of liquidity.

There also is a possibility, other than disputes, that replacement of parties such as the calculation agent and the collateral bond sales agent will be required (frequently cases where a counterparty serves concurrently in another capacity). When the collateral assets are securities issued outside of Japan, process of foreclosure may require an attorney in some instances.

Investors need to be aware of the possibility that they may have to bear the additional expenses related to these series of actions by the trustee (including legal fees).

- (Note 1) The role of the trustee is especially important when a counterparty event has occurred. The trustee is responsible for the mailing of the notifications necessary for execution of early redemption activities, revision of the agreement and, sometimes, coordination among concerned parties having a conflict of interest. R&I must be included among the parties to which the trustee sends notifications.
- (Note 2) For details, please refer to the press release “Eligible Deposit Accounts and Eligible Investment Instruments” dated December 22, 2008.
- (Note 3) Although the word “de-link” conjures the image of severing the risk entirely, no product can be insulated completely from the negative consequences from failure of a party as long as the party is related to the mechanism. For convenience, products not easily affected by the failure of one party to the scheme are referred to as “de-linked,” in contrast to products that are easily affected, which are said to be “linked.”
- (Note 4) The term “repo transaction” as used in this report refers only to securities repurchase agreements and excludes transactions of securities lending with cash collateral, which are specific to Japan’s repo market.
- (Note 5) An R&I rating does not reflect an evaluation of reinvestment risk. Therefore no problem arises in terms of ratings as long as the Credit-Linked Product principal and accrued interest (Note 6) are ensured at the time of redemption even if the Credit-Linked Product is redeemed before maturity.
- (Note 6) There are cases when a credit-linked product is redeemed before maturity, the accrued interest for the period from the immediately preceding interest payment date to the event of default date will be paid together with the principal. The subject of an R&I evaluation of a product that will be redeemed before maturity following a counterparty event, however, is the probability of redemption of the principal amount and repayment of the interest accrued until the occurrence of the counterparty event.
- (Note 7) For de-linked products assigned an AAA rating, R&I requires the pledge of additional collateral from the issue date. R&I caps the rating for products that do not meet this requirement at AA+.
- (Note 8) The eligible collateral assets that can be the subject of physical settlement as redemption are assets that R&I judges satisfy three conditions: (1) strong creditworthiness, (2) highly liquid and comparatively easy to assign or convert into cash and (3) low price volatility. The collateral assets for de-linked products satisfy this requirement.