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Rating Methodology for Small-Number Cash CDOs

(This report is an English translation of the original report in Japanese.)

Rating and Investment Information, Inc. (R&I) has revised its rating methodology for small-number cash CDOs.

On January 31, 2007, R&I issued a report regarding the rating methodology for CDOs titled "Securitization Criteria: R&I's CDO Rating Methodology." That report primarily explained R&I's rating methodology for CDOs by taking as an example synthetic CDOs that place large companies' obligations as reference entities. This report supplements the previous report particularly in regard to small-number cash CDOs that place large companies' obligations as the underlying assets. This was not explained in the report dated January 31, 2007.

1. Risk factors for cash CDOs

Risk factors that differ from those of a synthetic CDO and must be investigated for a cash CDO are described below (Note 1).

1.1. Prepayment

When prepayment of the underlying assets is not prohibited beforehand in the indenture, there is a possibility obligors will prepay the outstanding claims. If prepayments occur, and the interest until maturity cannot be received, there is a possibility of negative carry because the issuer will be unable to obtain the assumed interest income. To address this risk, R&I requires issuers to take measures such as preparation of a cash reserve. R&I confirms the affect of prepayments on an asset-backed security (ABS) by performing conservative simulations based on a prepayment penalty scenario, a cash reserve, a waterfall or other arrangement.

1.2. Offset

Failure to prohibit offset of the underlying assets beforehand in the indenture leaves open the possibility of the claims being diluted by offset. To prevent the dilution of claims as a result of offset, as a rule an issuer will be required to adopt some measure to address dilution caused by offset. When the rating of a financial institution that is an originator is comparatively high, R&I will establish a rating trigger. If the creditworthiness of the originator falls below a certain level, the issuer will be required to take actions to address offset risk, such as setting aside as a reserve an amount sufficient for the offset.

1.3. Commingling risk

Commingling risk refers to the risk that collected funds from obligors will not be transferred normally and will be intermingled with the assets of the servicer. In principle, R&I will require some measure such as credit enhancement or a cash reserve. In the case of a CLO, however, providing credit enhancement or a cash reserve against commingling risk is extremely difficult because of the possibility a large amount of funds will be repaid at a single point in time as a result of the unique characteristics of the scheme. To avoid commingling risk, R&I will establish a rating trigger for the financial institution that will act as the servicer, and the issuer will be required to take action such as prepayment of collected funds if the creditworthiness of the servicer declines below a specified level.

Furthermore, even if collected funds are being held in an account at the servicer when the servicer fails, if the servicer is a financial institution that is a member of the Deposit Insurance System there is high probability the funds basically will be recognized as a specified settlement liability under the provision of Article 69-2 of the Deposit Insurance Law, and will be eligible for payment of a deposit insurance claim under Article 54-2 of the law (for information on payment of deposit insurance claims see Note 2) and eligible for financial assistance under Article 69-3 of the law (for information on the financial assistance system see Note 3). Consequently, R&I judges commingling risk to be limited, even though collected funds from obligors would have to be accounted for as a specified deposit, suspense receipt or other category. In this case, R&I is able to assign a rating even if measures such as a rating trigger are not taken, provided the period of time the collected funds remain at the servicer is limited or preparations are taken for a temporary delay in payment of the deposit insurance and liquidity for interest payments on the ABS and the payment of various costs has been ensured (Note 4).

1.4. Interest rate risk

Interest rate risk will arise from a mismatch of the interest rate terms if the interest rate terms for the underlying assets and the ABS do not correspond. The interest rate risk can be addressed by concluding a swap agreement or other arrangement, or by establishing a cash reserve. R&I confirms the affect of interest rate risk by conservatively estimating the cash flow.

1.5 Backup Servicer

A backup servicer is required when a servicer fails and becomes unable to perform its administrative functions because it cannot reorganize. R&I fundamentally believes that if a backup servicer has not been designated when a CDO is initially structured, it is necessary to establish a backup servicer before the servicer experiences an event of failure. Under circumstances such as schemes in which claims are entrusted to a trust bank for a cash CDO, however, R&I believes it is not always necessary to designate a backup servicer because (1) the obligations that are the underlying assets of the CDO are products that can be administered by a trust bank and (2) the trust bank should be able to perform the collection itself because the number of claims in the pool is small and it has an obligation to perform the collection from the standpoint of its duty of care of a good manager. R&I judges whether a final backup servicer is necessary after considering factors such as the details of the servicer activities.

2. Method for deciding the credit enhancement level

R&I decides the credit enhancement level based upon a loss analysis and cash flow simulation. R&I will set the final credit enhancement level after comprehensively investigating quantitative and qualitative risk factors, including the characteristics of the individual obligors and the risk of collective failure among the obligors of the claims that are the underlying assets, based on a loss analysis and cash flow simulation.

2.1. Loss analysis

For its loss analysis R&I utilizes “R&I Tranche Pad (Note 5).” When using R&I Tranche Pad, information such as the ratings of individual obligors of the underlying assets, industry classifications, national registrations, recovery rates, claim amounts and claim amortization schedules must be input.

(1) R&I Rating

If it has assigned a publicly disclosed rating to the underlying assets, R&I will basically use that credit rating. For underlying assets that do not have a publicly disclosed R&I rating, R&I will decide the input values using methodologies such as (1) a credit evaluation (Note 6), (2) mapping R&I’s rating and the internal ratings of a financial institution, (3) mapping R&I’s rating and the Probability of Default (PD) estimated using data from leading research institutions or historical data from various models, (4) mapping R&I’s rating and the rating of another rating company and (5) estimates made from financial data using a rating estimation model (Note 7).

(2) Industry

R&I inputs the industries (Note 8) corresponding to the underlying assets.

(3)Other input items

R&I inputs information corresponding to the underlying assets.

2.2. Cash flow simulation

Because the individual obligor exposures that generally become the underlying assets for a cash CDO are not uniform like those of a synthetic CDO, the cash flow analysis takes on greater importance. Moreover, because interest rates on the obligations that are the underlying assets tend generally to be higher as the creditworthiness of the obligors weakens, R&I will investigate the impact a default by the relevant obligors will have on the cash flow. Finally, unlike the case of a diversified scheme, it is difficult to assume defaults will occur at a constant rate, and R&I will also study default occurrence scenarios regarding which obligors will experience defaults.

In its cash flow simulation, R&I will first assume the required credit enhancement amount determined using R&I Tranche Pad for the target rating to be the total amount of principal defaults. R&I will then study of default occurrence scenarios, performing a check that includes not only the possibility of redemption of the principal but also the probability of payment of various amounts such as expenses and interest. If the cash flow is insufficient, R&I will require additional credit enhancement.

Furthermore, if there is a problem in the cash flow simulation such as a mismatch of the interest rates on the underlying assets and the ABS, R&I will confirm this by taking into consideration the interest rate scenarios and other data.

(Note 1) For debentures the points of contention are limited compared with loans because obligors generally cannot prepay or offset the claims. Therefore we have described the main points by assuming a loan.

(Note 2), (Note 3) As deposit protection mechanisms when a financial institution fails, the Deposit Insurance Corporation can use a method to pay deposit insurance claims directly to depositors (deposit insurance claim payment system), or a method to provide financial assistance such as moving insured deposits to other financial institutions (financial assistance system).

(Note 4) For details, please refer to the press release "R&I View on Commingling Risk of a Servicer that is a Financial Institution covered by the Deposit Insurance System (DIS)" dated March 3, 2005.

(Note 5) A new application for calculation of credit enhancement amounts that R&I introduced in April 2007. For details refer to the "Tranche Pad Version 1.0 Technical Document" dated April 2007.

(Note 6) A credit evaluation that is not based on request by the company evaluated and that R&I does not disclose publicly.

(Note 7) For methods (1) through (5), when deciding the rating R&I will prudently decide the level to adopt after obtaining the necessary data, and implementing other steps such as due diligence meetings if necessary. Moreover, in some cases R&I might use an estimated Probability of Default (PD) for the individual obligors directly when inputting the model, rather than the rating.

(Note 8) R&I has established a total of 41 industry classifications for R&I Tranche Pad. In some cases R&I will utilize industry classifications for the data received.

Rating and Investment Information, Inc. Nihonbashi 1-chome Bldg., 1-4-1, Nihonbashi, Chuo-ku, Tokyo 103-0027, Japan
Investors Service Division TEL.03-3276-3511 FAX.03-3276-3413 http://www.r-i.co.jp
TEL.03-3276-3511 FAX.03-3276-3413 http://www.r-i.co.jp E-mail infodept@r-i.co.jp