



Rating Methodology for ABCP/ABL Programmes

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

Rating and Investment Information, Inc. (R&I) has revised rating methodologies for ABCP and ABL programmes.

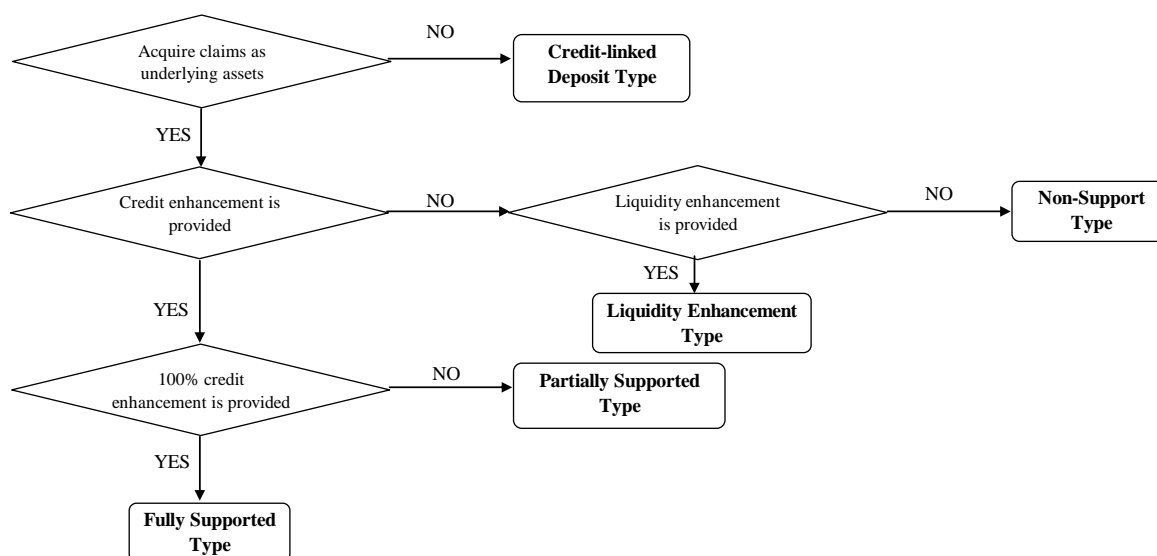
I: Types of ABCP/ABL Programmes

The programmes can be classified as indicated in Figure 1.

They can be largely divided into programmes that acquire monetary claims as underlying assets and synthetic programmes that assume the credit risks of the original obligors. The former is further divided into those with credit enhancements and those without, and credit enhancements are divided into “fully supported types” and “partially supported types” depending on the extent of the credit enhancement. Programmes without credit enhancements consist of “liquidity enhancement types” which only receive enhancement for liquidity, and “non-support types” that do not receive liquidity enhancement (Note 1).

Synthetic programmes include “credit-linked deposit types”, such as those where the fund raised by the SPC through CP issuance, etc. is managed through deposits, etc. which is in turn pledged as collateral for the loan commitment agreements held by the sponsor bank.

■ Figure 1

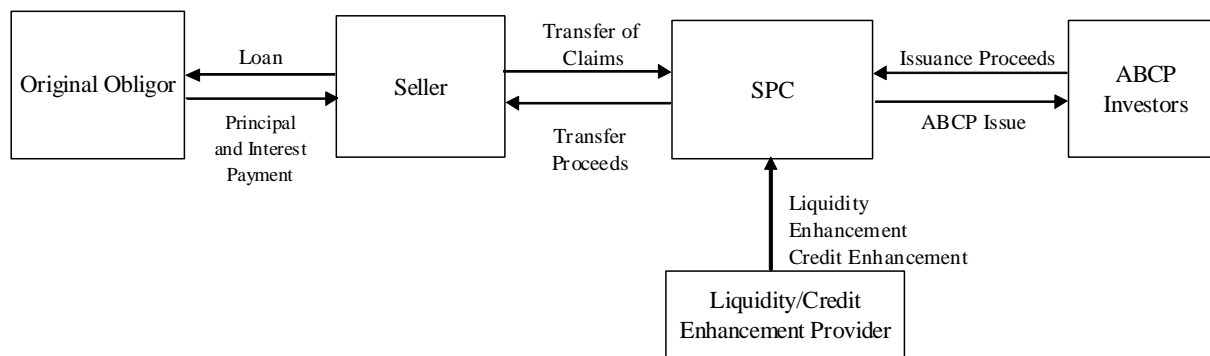


We shall explain the structure of (1) programmes that acquire monetary claims as underlying assets, and (2) synthetic programmes that assume the credit risks of the original obligor.

(1) Programmes that acquire monetary claims as underlying assets

For the purpose of convenience, Figure 2 describes the structure of a fully-supported ABCP programme. Although there are differences in the form of liquidity enhancements and credit enhancements, the structures are basically the same for partially supported, liquidity enhanced and non-support types. Funding structure of ABL programmes are also similar to this.

■ Figure 2



The process from issuance through redemption for ABCP programmes is as follows:

(1) Transfer of claims and issuance of the ABCP

A corporation (seller) transfers its monetary claims to an SPC. The SPC issues ABCP using the monetary claims as underlying assets, and sells the ABCP to investors.

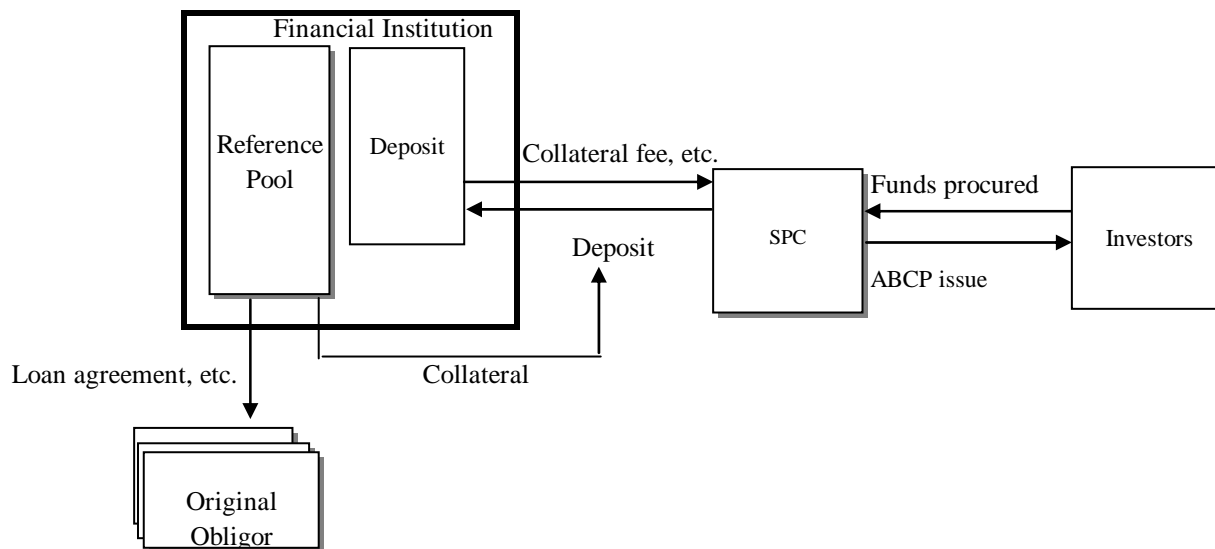
(2) Redemption of the ABCP

In general, the SPC will entrust the collection of the monetary claims that are the underlying assets to the seller, and the seller will be responsible for the collection. This is because it is deemed that the collection can be performed more efficiently by the seller than having the SPC directly involved in the collection process. The funds collected by the seller will be delivered to the SPC, and used for the redemption of the ABCP.

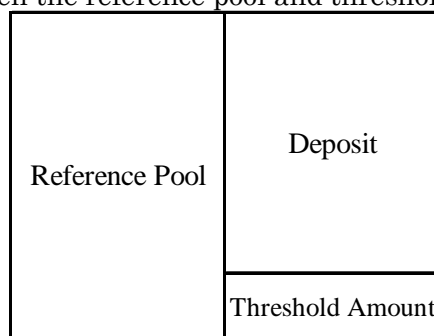
(2) Synthetic programmes that assume the credit risk

Synthetic programmes using credit-linked deposit types are ABCP programmes that manage the funds raised by the SPC through issuance of the CP in deposits, etc. The deposit is pledged as collateral for the loan commitment agreements held by the sponsor bank (Figure 3).

■ Figure 3



■ Figure 4. Relationship between the reference pool and threshold amount



In return to payment of the collateral fee, the bank that receives the collateral will have advantages such as hedging of the risk in case the loss from the loan agreement exceeds certain threshold, as well as reduction of risk weight for the loan under the capital adequacy rules set forth by the Bank of International Settlement (BIS).

Basic flow of the ABCP from the issuance to redemption is as follows:

- (1) Issuance of the ABCP
The SPC issues the ABCP, and deposits the issuance proceeds with the sponsor bank.
- (2) Between issuance and redemption of the ABCP
The SPC pledges the deposit as collateral for the loan extended by the sponsor bank to the obligor.
- (3) At time of redemption of the ABCP
Unless the total loss from the reference pool exceeds the threshold amount, the deposit will be withdrawn in full. The SPC will obtain the collateral fee in addition to the interests on the deposit, and will use the sum in addition to the principal of the deposit as the redemption fund for the ABCP.

II: Points to note for rating evaluation

II-1: Programmes that acquire monetary claims as underlying assets

The issuer of ABCP/ABL programmes basically procures funds using the cash flows generated by the underlying assets. In case the ABCP/ABL cannot be rolled over, or where there is a gap in the timing of collection of the funds and the redemption of the ABCP/ABL, temporary shortfalls in redemption funds may occur; therefore, generally, a liquidity enhancement will be provided. In addition, a credit enhancement will be established in order to compensate for the shortfall in redemption funds for the ABCP/ABL in case the collection from the underlying assets becomes impossible due to a default by the original obligor. As described above, there are different types of ABCP/ABL programmes depending on the form of enhancements, such as whether or not there are liquidity and/or credit enhancements, and whether or not coverage provided by such enhancements are full or partial.

R&I confirms the safeness of the programme structure, focusing on the below items.

Figure 5 summarizes the main check points for each type of programme.

(1) Bankruptcy remoteness of the SPC

In most cases, the issuer will be an SPC established in Cayman Islands, or its Tokyo branch. Basically, the issuer must be severed from the bankruptcy risks of the seller and sponsor bank, etc. Therefore, whether or not bankruptcy remoteness of the SPC has been secured with respect to matters such as the composition of the directors, capital relationships, restrictions on business, and covenants against filing for bankruptcy by related parties, must be confirmed.

In addition, as the SPC does not have employees, administration of payment of funds and settlement procedures must be entrusted to a third party. Whether or not the company or the person thus commissioned has the appropriate administrative capacities will also be a point to consider in the ratings evaluation.

(2) Liquidity enhancement agreements and credit enhancement agreements

(i) Loan refusal events

As stated above, credit enhancements are implemented for the purpose of avoiding the effect of a default of the original obligor to impact the redemption of the ABCP/ABL. Therefore, the provider of the credit enhancement can not refuse supplying the backup loan other than in the event of bankruptcy of the SPC. On the other hand, liquidation enhancements are aimed at covering for temporary shortfall in funds; therefore, there is no requirement to extend this line of credit in case of default by the original obligor, unlike credit enhancements. Hence, liquidation enhancement contracts set forth the rights to refuse provision of a backup loan in the event of bankruptcy of the original obligor, in addition to events such as bankruptcy of the SPC.

In the past, most contracts incorporated both liquidity and credit enhancements. However, when fully supported ABCPs were recognized as eligible collaterals by the Bank of Japan in December 2002, separation of contracts for liquidity enhancements and credit enhancements were prescribed as prerequisites for eligibility. Since then, liquidity enhancements and credit enhancements are set forth in separate contracts in most cases.

■ Sample Agreement

■ Event for refusal of loan (example)
Liquidity enhancement agreement Notwithstanding an application for a loan from the SPC, ABC Bank (provider of liquidity enhancement) may refuse to provide a loan where an event for termination of liquidity enhancement agreement occurs or where the original obligor defaults.
Credit enhancement agreement Notwithstanding an application for a loan from the SPC, ABC Bank (provider of credit enhancement) may refuse to provide a loan where an event for termination of the credit enhancement agreement occurs.

■ Events for termination of the liquidity/credit enhancement agreement
In the event of petition or decision for suspension of payment, suspension of transaction from the clearing house, commencement of bankruptcy procedures, corporate rehabilitation procedures, civil rehabilitation procedures, corporate liquidation or special liquidation, or petition or decision for other similar procedures based on applicable overseas laws against the SPC, ABC Bank may terminate the agreement without requesting any actions from the SPC, subject to notice to the SPC.

(ii) Priority of redemption pertaining to liquidity enhancements and credit enhancements

In general, the programme structures require that the liquidity and credit enhancement agreements providing backup lines to such programme to remain in place so long as there are unredeemed ABCP/ABLs. In case the redemption date of the ABCP/ABL is the same as the repayment date for the loans obtained as liquidity and/or credit enhancement, in principle, the repayment of the funds borrowed as liquidity and/or credit enhancements must be subordinated to the redemption of the ABCP/ABL. This is aimed to prevent a shortfall in redemption funds for ABCP/ABL to be caused by the prioritized allocation of funds collected from underlying assets to repayment of liquidity and credit enhancements.

(iii) Prohibition of transfer of notes where the liquidity and/or credit enhancement is made in the form of loan on notes

In case liquidity or credit enhancement is provided using loan on notes, transfer of the note must be generally prohibited. This is necessary because the SPC may not be able to maintain its claims under covenants, etc. executed with the parties related to the scheme against the transferee of the note under the Bills of Exchange and Promissory Notes Act (severance of claims).

(iv) Restriction on application for bankruptcy

As the providers of the liquidity and credit enhancements may become creditors of the SPC, “non-application for bankruptcy” must be expressly stated. This is necessary as such covenant lowers the possibility of falling under “events such as the bankruptcy of the SPC” which is a refusal event for extension of credit enhancement loans.

(v) Restriction on off-setting

In the event of bankruptcy of the SPC, providers of the liquidity and credit enhancements may off-set their claims against the deposit by the SPC. As such off-setting may dilute the redemption funds for the ABCP/ABL, in general, a covenant prohibiting off-setting must be executed beforehand.

(3) Underlying assets

(i) Requirements for perfection and risk of dilution

At the time of transfer of claims, the SPC must satisfy the requirements for perfection of transfer in order to assert its rights with respect to the assets against third parties. This can be achieved by either (i) providing the obligor with a notice bearing a certified date or obtaining consent by the obligor in accordance with Article 467 of the Civil Code, or (ii) registering in accordance with the Act on Special Provisions of the Civil Code in Relation to Requirements for Perfection of Transfer of Movable and for Assertion of Assignment of Claims (Saikenjoto no taikoyoken ni kansuru Minpo no Tokurei ni kansuru Horitsu).

In the case of the latter, although the registration in accordance with the Act will satisfy the requirements for perfection against third parties, it will not satisfy the requirements for perfection against the obligor. In order to satisfy the requirements for perfection against the obligor, the SPC must notify the obligor of the assignment of the claims through delivery of the certificate of registration, or obtain its consent.

If only requirements for perfection against third parties have been met (Note 2), the rights and obligations between the seller and the original obligor may be extinguished through off-setting in case of bankruptcy of the seller, and there is a risk that the value of underlying assets transferred to the SPC may be reduced. Therefore, depending on the type of the programme, the method for perfection must be sufficiently confirmed.

(ii) Risk of default

For programmes with liquidity and credit enhancements such as the fully supported programmes, the content of the enhancement agreements are more important for rating evaluation purposes than the analysis of the eligibility requirements and contents of the claims.

For other types of programmes, the analysis of the eligibility requirements and contents of the claims are important because the risk of bankruptcy etc. of the original obligor affects the redemption of the ABCP/ABL.

(iii) Timing of the cash flow

For programmes without liquidity enhancement, there is a possibility that the ABCP/ABL cannot be redeemed due to a temporary shortfall in the cash flow. Therefore, timing of the cash inflow (timing of the collection of the underlying claims and the redemption of the ABCP/ABL) must be confirmed, in addition to the performance of the claims.

(iv) Interest rate risk

Depending on the content of the underlying assets, interest rate risk may exist between the underlying assets and the ABCP/ABL. In such a case, implementation of separate measures will be necessary.

(v) Commingling risk

There is a risk that the funds collected from the original obligor is not delivered in the normal manner, and becomes mixed with the assets of the servicer (commingling risk). It would not be an issue in fully supported type programmes, however, if a commingling risk exists for other types of programmes, separate consideration will be necessary.

■ Figure 5

	Fully supported	Partially supported	Liquidity Enhanced	Non-support
(1) Bankruptcy remoteness of SPC	○	○	○	○
(2) Enhancement agreements				
Credit enhancement agreement	○	○		
Liquidity enhancement agreement	○	○	○	
(3) Underlying assets				
(i) Perfection		△	○	○
(ii) Default risk		○	○	○
(iii) Cash flow timing				○
(iv) Interest rate risk		△	△	○
(v) Commingling risk		○	○	○

○: matters that basically require confirmation

△: matters that require confirmation depending on the features of the programme

II-2: Synthetic types that assume the credit risk

As with programmes that acquire claims, securing bankruptcy remoteness of the SPC is important for synthetic type programmes. Basically, the rating will be the lower of either (i) the creditworthiness of the reference pool with the credit enhancement, or (ii) the creditworthiness of the weak link of the creditworthiness of the deposit bank. Analysis of the creditworthiness of the reference pool mainly involves confirmation of the structure of the contractual loss with respect to (3)(ii) above.

(Note 1)

- i) Fully supported type: The bank sponsoring the programme, etc. provides liquidity enhancement and 100% credit enhancement.
- ii) Partially supported type: Liquidity enhancement is provided, but credit enhancement is only provided partially.
- iii) Liquidity enhancement type: Sponsor bank, etc. only provides liquidity enhancement (no credit enhancement is provided).
- iv) Non-support type: Liquidity and credit enhancements are not provided, by fully linking the creditworthiness and the term of the CP, etc. to be issued with those of the underlying claims.

(Note 2)

Even if a notice to satisfy requirements for perfection against obligors is provided, claims that existed in sufficient conditions for off-setting prior to the arrival of the notice may be off-set.

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