



Effect of Securitization and Liquidation on Creditworthiness

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

- What effect do a securitization and liquidation completed by an ordinary company have on that company's creditworthiness? As a rule R&I considers the effect to be neutral, with specific effects seen case by case.
- As an oversimplification, securitization is nothing more than segregating assets originated by an entity and converting them into cash. Compared with borrowing a straightforward bank loan, securitization and liquidation certainly require greater time and expense because a larger number of parties is involved in creating the mechanism. R&I regards securitization as one financing alternative.

Effects of securitization

If securitizations were implemented in a completely efficient market, the act of securitization itself would neither raise nor lower corporate value. If an originator sold or assigned fixed assets it held having an original value of 100 to a SPV (Special Purpose Vehicle, or trust) and received value of 100 in cash, for example, the value of the originator before and after the securitization would be fundamentally unchanged. Real markets, however, cannot be said to operate under perfect conditions. Sometimes there are advantages to converting real assets with limited liquidity such as property into highly liquid financial assets. If the assets are assets such as monetary claims, or property for which a price is not established easily, the result could be that the assets ultimately are sold and purchased at a comparative discount. Moreover, when assets are securitized, payments (that is, costs) to the arranger (financial institution or securities company) and other parties involved (including a rating agency) are inevitably incurred. In the following section, R&I examines the benefits and costs of securitization and the matters to note from an originator's point of view.

Benefits of securitization and matters to note (originator's point of view)

The following points are frequently cited as reasons for securitization from an originator's point of view.

(1) Diversification of fund procurement channels

For originators that traditionally had no alternatives and had to depend on bank borrowing, securitization ensures a new means of procuring funds. Originators must be careful, however, to not violate the conditions of collateral they have pledged for bank loans or similar financing.

(2) Improved fund procurement efficiency (improved liquidity)

If the assets are accounts receivable and the funds collected from customers are incorporated into an ABCP or similar security, efficient procurement of funds becomes possible because the claims can be realized as cash immediately when assigned. Originators can also utilize their assets with greater efficiency, by selling or assigning illiquid assets such as property.

(3) Lower funding costs

In some instances Originators are able to achieve lower fund procurement costs than when using conventional fund raising mechanisms, because of the emergence of new financing entities.

(4) Movement of assets off balance sheet

Originators can improve financial indicators such as ROA and ROE by moving assets off their balance sheet.

(5) Asset liability management (ALM)

Securitization enables originators to manage customer credit risk control and adjust the mismatch between funds procurement and investment.

While these points offer obvious and significant advantageous for originator's management, originators at the same time must not overlook the time and various costs they will incur. For example, in many cases overcollateralization is set for credit enhancement when a securitized product is organized. If the overcollateralization ratio will be larger than that used for conventional fund raising, in some situations originators might not be able to achieve an overall cost reduction, even if the stated interest rate is reduced. Moreover, with regard to moving assets off balance sheet, even if a originator can remove assets from its financial statements, it may in fact not be able to substantively move the assets off its books when the securitization details are reviewed (or at least, outside observers will evaluate the assets as remaining on the balance sheet).

When all of the above are taken together, the advantages of securitization certainly exist in a realistic (imperfect) market. A firm that is thinking of being an originator, however, should of course prudently investigate what it is actually trying to achieve through securitization, including its own financial position. R&I hopes that when firms are deciding the details of a securitization, they will also give their attention to the external evaluation perspective described in the following section.

Examining securitizations in detail from an external point of view (credit risk evaluation perspective)

The previous section highlighted matters to note from originator's point of view when completing a securitization, and looked briefly at the influences securitization exerts on an

originator. This section presents somewhat more detailed points for research and investigation, given an awareness of the issue of how investors (including creditors) evaluate firms that utilize securitization.

Of course, if the consistency of the balance sheets (B/S), profit and loss statements (P/L) and cash flow (CF) statements can be fleshed out, R&I considers it possible to surmise whether a firm will utilize securitization even if complete information is not openly available. One idea is to see if the firm's IR (investor relations) manager will confirm the details.

Furthermore, various complex mechanisms must be incorporated when executing a securitization. In order to know what effect these mechanisms will have on the originator, it is critical for investors and analysts who will evaluate the firm to also have knowledge of securitized products.

(1) Evaluation of the securitization structure itself

To clarify the relationship between a securitization and the creditworthiness of the originator, it is necessary to separate and consider the effect on corporate value from the act of implementing a securitization itself, and from the risk factors that derive from securitization, which may arise later. The implementation of a securitization begins with the originator selling or assigning assets to an SPV. When making an evaluation of the securitization, it is necessary to first confirm a) what assets, b) at what price and c) in what form the assets will be securitized.

a) To understand the quality of the assets, investors will confirm the type of assets - accounts receivable, loans or property - and their size. Many financial statements, unfortunately, do not thoroughly disclose securitization information. Active information disclosure by the originator must be requested. Another critical investigation point is how the assets to be securitized are positioned when considered from the standpoint of the quality of all of the originator's assets. When an originator will securitize accounts receivable, for example, the originator will be left holding the remaining assets of low creditworthiness if the creditworthiness of the accounts receivable it assigns (that is, the creditworthiness of the parties owing on the accounts receivable) is higher than the creditworthiness of the remaining accounts receivable (the same holds true if the originator holds subordinated bonds* that are structured as credit enhancement for the securitized product..)

* On the other hand, holding subordinated bonds also has the advantage of setting a cap on the risk held by the firm.

Therefore even if the equity ratio improves because the originated assets (accounts receivable) have been moved off balance sheet on the surface, investors cannot simply evaluate that the originator's creditworthiness has improved.

Investors also will want to confirm, particularly for property-related assets, whether there is

an arrangement for repurchases. The reason is that investors will not judge the subject assets have really been moved off the originator's balance sheet when such an arrangement exists.

b) An assessment of the value of the assets being securitized is based on the assumption that a proper value has been set. When the transfer price is too low compared with the actual market value, this will create doubts concerning the assignment (and depending on the circumstances, the assignment could be negated). Conversely, if the price is too high, the investors in the securitized product will suffer a loss (therefore when assigning ratings to securitized products, R&I calculates asset value conservatively). Investors are likely to consider a transaction that has not been priced properly to probably have some problems that are not restricted to the securitization itself.

c) The form of the securitization is a checkpoint. Specifically, investors will distinguish between when an ABS is used as a means of long-term funds procurement and when an instrument such as ABCP is used to obtain short-term funds. While such forms are prescribed to some extent by the character of the assets to be securitized, the point is that investors want to ascertain whether the originator has used a form that is suited for the purpose of the securitization.

d) The most important point investors will want to grasp and understand after these factual elements have been confirmed is the reason that management is using securitization. As mentioned earlier, the act of securitization itself places an extra burden on the originator. The only reason firms implement securitizations in spite of this fact is that they can gain the advantages described above, even if time and effort are required.

(2) Risk factors that can result from securitization

The fact that securitization's effects do not stop at the time of implementation must be carefully considered as well. Because the points that should be investigated vary widely, depending on the securitization scheme, here we will note just one typical example.

The first point that must always be confirmed is how the issuer will use the procured funds. Assuming the funds obtained through the securitization are used to reduce existing debt, then as a rule the effect on the originator's creditworthiness can be considered to be neutral if the time and cost burden mentioned earlier are ignored. If the originator will use the funds to start a new business, however, the risks from the new business must be added to the evaluation of the originator.

When business management advantages such as competitive dominance can ultimately be anticipated from pulling the receipt of future cash flows in advance and undertaking business reorganization, on the other hand, the securitization can be evaluated as a positive factor. The same also holds true when the originator will use the funds as working capital for an existing business with healthy, growing operations. Understanding the use of the funds can be said to be a

critical point to examine when investigating the creditworthiness of the originator.

Investors will next study whether an originator will be able to securitize its assets on a continual basis. Even if an originator decides to pursue securitization with the objective of “diversification of fund procurement channels,” the originator will be unable to achieve this goal if it cannot steadily continue to offer new issues in the market. In order to investigate whether steady issuance is possible, it is crucial for investors to first understand the stability of the entire market and details of the originator's agreements.

Even within the securitization market, for example, the market for securities backed by lease claims can be deemed a stable source of funds because the market is considerably mature, whereas property-related securitizations demand close, prudent investigation of each project because variations can be substantial. The financial covenants incorporated into the agreement when securitizing assets are another aspect that must be understood if possible.

Finally, one point investors might want to note for a firm that traditionally has raised funds using unsecured bank loans or new bond issues is the fact that if the firm's creditworthiness deteriorates, the assets the firm can provide as collateral to creditors will decrease as well.

R&I's rating point of view (summary)

As we've seen through this discussion, it is extremely difficult to make generalizations regarding the effects of securitization on an originator's credit risk. This is because the “mechanisms” are too varied. Consequently R&I concludes that as a rule the effects are neutral, with the effects to be verified case by case.

Among the ratings it has assigned in the past, there are cases involving certain non-bank financial institutions in which R&I made a positive assessment of a securitization as part of its overall judgment. For ordinary firms, however, R&I has never revised a rating simply because of the fact the issuer had implemented a securitization.

As rated firms increase the percentage to which they rely on funds raised through securitization in the future, the factors requiring detailed investigation described in this report will undoubtedly take on greater importance. If securitization is neither a “magic wand” nor “horn of plenty,” it also is not a “destructive instrument.” In the end, what is important is how securitization is used.

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