

**A Proposal for  
The Japanese Non-Performing Loans Problem:  
Securitization as a Solution**

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**Introduction**

Japanese banks continue to suffer from the aggressive loans made during the “bubble” era. Despite the fact that a large proportion of these loans has turned into non-performing loans, many Japanese banks have been delaying the recognition of such non-performing loans until recently. Unlike the U.S. banks, which quickly wrote-off their non-performing loans in the early 1980s, none of the Japanese banks wrote off their non-performing loans until Sumitomo Bank took the lead in March 1995. Since then, top Japanese banks have begun to write off non-performing loans, voluntarily following Sumitomo, albeit with strong pressure from the investment community.

The main reasons for the Japanese banks’ hesitance to write-off non-performing loans can be attributed to the following:

- The Ministry of Finance’s indecisiveness in recognizing and addressing the non-performing loan problem.
- The Japanese tax system does not permit tax deductions for write-offs.
- Insufficient capital for banks to write-off the loans.

In order to address the second issue, many academics as well as industry participants have been lobbying to change the tax laws to permit tax-deductions for write-offs. The Bank of Japan addressed the third point in 1995 by increasing the nation’s money supply in order to lower interest rates, a move that increases the net interest income of Japanese banks due to larger spreads on loans (see Exhibit A – the Japanese Interest Rate Level, and Exhibit B –Net Interest Income of Japanese Banks). In this environment, many banks were able to generate sufficient profits to write off non-performing loans (Exhibit C – Provisions for Doubtful Debt, and Exhibit D – Operating Profits of Japanese banks).

Despite this favorable operating environment for the banks, the quality of Japanese banks' assets continued to deteriorate and the international capital markets started to charge a "Japan premium" on inter-bank loans. In addition, the depreciation of the Japanese yen made it increasingly difficult for Japanese banks to comply with the Bank of International Settlement's capital-adequacy ratio as the depreciation of the yen increased the value of their overseas assets and liabilities. This also increased their reluctance to provide loans to small and medium-sized companies that were fully dependent on financing from their main bank. The increasing number of bankruptcies, as well as the collapse of Hokkaido Takushoku Bank in November 1997, illustrated the seriousness of the non-performing loan problem, which is currently estimated to exceed \$1 trillion<sup>1</sup>. Over the past 12 months, the Japanese government has enacted laws to use public funds to purchase preferred stock of Japanese banks in order provide the banks with the much-needed capital to write off additional non-performing loans. The Resolution and Collection Corporation ("RCC"), an agent established to purchase loan assets and to collect the debt, has been expanded to purchase non-performing assets from Japanese banks. However, we believe that securitization is the most efficient way to ease the non-performing loan problems in Japan.

### **Benefits of Securitization**

Securitization is an attractive option for Japanese banks and non-bank finance companies. For Japanese banks plagued by non-performing loans, securitization, or specifically collateralized loan obligations (CLOs), represents an opportunity to reduce bad loans on the balance sheets, enabling them to meet the Bank of International Settlements capital-adequacy ratio. When loans are held and not securitized, Japanese banks must retain capital equal to 8% of

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<sup>1</sup> Sanger, David. "Bad Debt Held by Japan's Banks now estimated near \$1trillion" *The New York Times* , July 30, 1998.

the portfolio. However, by removing loans from the banks' balance sheets through CLOs, the capital requirement falls to the level of equity retained by the bank. For example, if the bank retains a 3% equity stake in the CLO, then the capital requirement is only 3% (100% of the 3% equity stake) instead of the 8% required by BIS standards. For non-bank finance companies, many of which have been squeezed by the banks' lowered appetite for risk, securitization offers the opportunity to obtain necessary financing. With the appropriate structure, securitized deals can obtain higher ratings than the originator's rating, resulting in lower funding costs (see Exhibit F – Japanese Bank Ratings). Furthermore, securitization transfers the risk of catastrophic loss from the originator to the investors, limiting the potential loss of the originator to the retained interest or credit enhancements. As a result, securitization of assets, from loans to credit card receivables, has been booming in Japan. A Tokyo-based lawyer recently remarked that “There are three growth industries in Japan: funerals, insolvency and securitization.”<sup>2</sup>

### **Restrictions in Japan**

Despite its attractiveness, especially for banks and non-bank finance companies, securitization remains an underutilized tool in Japan. Although foreign investment banks have established departments to promote securitization, and banks such as Fuji Bank and Sumitomo have set aggressive targets for reducing balance sheet assets through securitization, the number of deals actually completed remains relatively small. This is undoubtedly due to the significant legal, tax, and cultural restrictions and limitations existing in Japan; we discuss each of these in the following sections.

### **Legal**

Within the last year, the Japanese legal system has become increasingly encouraging for securitization. The 1998 repeal of the *Susshi-ho* law, which had prevented non-bank finance

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<sup>2</sup> Jones, Dominic. “Turning Japanese.” *Asset Finance International*. London: November 1998, page 26.

companies from securitizing loans, increased demand for securitization in Japan. The Ministry of Finance enacted the SPC Law in March 1998, which facilitated securitization by reducing the capital requirement necessary to establish a company from Y10 million to Y3 million and by waiving the 50% corporation tax. This law facilitates the formation of onshore Special Purpose Companies (“SPC”) for securitization.

The Law Relating to the Regulation of Business Concerning Specified Claims, Etc. (the MITI Law), a 1993 law issued by the Ministry of International Trade and Industry (MITI) was introduced to facilitate securitization in Japan. This law, which applies to “specified claims,” including lease receivables, credit card receivables, receivables under installment sales contracts, and auto receivables, allows the use of public notice to perfect an assignment of receivables, allowing ABS to be issued as small-lot claims to investors.<sup>3</sup>

However, such asset-backed bonds and commercial paper were not defined as securities, resulting in illiquidity. As a result, despite the legality of such transactions, little demand materialized. To resolve this, legislation in April 1996 defined asset-backed bonds and commercial paper as securities, allowing their issuance in the domestic market and facilitating the trading of these issues. The first securitization capitalizing on the law was not done until August 1997 when ING Barings brought a deal for Jumbo Asset Finance, a Cayman Islands SPC.<sup>4</sup>

Despite the legality of securitization and the steps toward creating liquidity, significant barriers remain. Due to the relatively low credit ratings of banks such as Dai-Ichi Kangyo, Fuji, Sakura, and Sumitomo, securitization without true sale is impracticable if not impossible. However, due to Japanese legal restrictions, which require the notification of obligors for loan

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<sup>3</sup> Butt, Stafford. “Securitization in Japan.” *Asiamoney*. London: December 1997/January 1998, page 33.

<sup>4</sup> Hay, Jon. “Japan’s Securitisation Age Dawns.” *Euroweek*. London: January, 1998, pages 68-70.

assignments, true sale is cumbersome, as Japanese banks hesitate to notify the debtor of the assignment due to relationship purposes.

In October 1998, the Special Assignment Law was introduced, allowing perfection without notice to or consent from borrowers. This supercedes Section 24.2 of the Money Lender's Law, which required MOF-regulated banks and entities to notify all obligors by registered letter of their intention to assign assets.

An additional complication to securitization is the Lawyer's Law. Under Section 72, non-lawyers were prevented from taking legal procedures on behalf of third parties. If the securitizing firm continues to act as servicer of the assigned loans, it may be a violation of Section 72. Under Section 73, non-lawyers were prohibited from purchasing a third party's rights with the intention of executing such rights. If the securitizing firm were to repurchase delinquent loan receivables, it may constitute a violation of Section 73. Some counsel have opined that servicing or repurchasing delinquent portions of assigned assets would not be viewed as violations, despite the fact that a strict interpretation of the law would indicate to the contrary. The government is encouraging banks to solve the non-performing asset problem using securitization; thus, additional measures to facilitate securitization are being reviewed.

Despite recent reforms that facilitate securitization, regulations effective March 31, 1998 have reduced the attractiveness of CLOs backed by domestic Japanese corporate loans. These regulations, which are similar to U.S. accounting and regulatory rules promoting transparency, require banks to reserve 8% of the face value of senior assets sold if the subordinated position exceeds 8% of that face value.<sup>5</sup> Prior to the new regulations, banks needed to retain a capital ratio of 8% of the subordinated portion of the CLO, not the face value of the senior assets. As a result, the banks must now retain less of the subordinated portion by selling more of the senior

mezzanine strips to achieve the same degree of capital relief. These strips usually have a credit rating of triple-B or lower, depending on the size of the first loss position, the quality of the underlying assets, and the originator's credit rating.<sup>6</sup> Due to the increased complexity of the structure necessary to sell a larger portion of subordinated loans, the overall cost of funds in CLOs is higher than it was prior to the March 31, 1998 regulations.

Cross-border transactions fall under the Foreign Exchange and Foreign Trade Law, resulting in additional complications for firms with foreign-currency denominated loans or for firms that wish to sell securitized portfolios outside of Japan.

Securitization in the real estate sector is considered an attractive option for banks seeking to reduce their exposure to distressed property. In March 1997, regulators passed twelve measures to facilitate securitization in the real estate sector. These measures included a reduction of capital requirements for SPCs, exemptions from certain corporate taxes, property acquisition and registration licenses, the ability to use a trust structure, and the classification of trust certificates as securities.<sup>7</sup>

Japan Leasing Corporation's ("JLC") recent filing for bankruptcy protection has created additional concerns about the legal issues regarding securitization. JLC represents the first test of the 1993 MITI Law, which allowed perfection of transfer. As a result of JLC's bankruptcy, creditors and claimants may argue that true sale did not exist, due to JLC's use of Cayman Islands based SPCs. If creditors successfully argue that true sale did not exist, that JLC's transaction was essentially a loan from the SPC backed by receivables, then the ABS backed by JLC's receivables will be worthless.<sup>8</sup> Additional complications to securitization include the

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<sup>5</sup> "The Hottest New Game in Town." *Euroweek*. London: August 1998, pages 25-32.

<sup>6</sup> "The Hottest New Game in Town." *Euroweek*. London: August 1998, pages 25-32.

<sup>7</sup> Butt, Stafford. "Securitization in Japan." *Asiamoney*. London: December 1997/January 1998, page 33-34.

<sup>8</sup> "JLC's Bankruptcy Affects \$1 Billion of Investments." *Airfinance Journal*. December 1998, page 6.

difficulty of foreclosing on bad loans. While troubled companies in the U.S. can seek protection under Chapter 11 of the Bankruptcy Code, an equivalent alternative is not available in Japan. Under the current Japanese bankruptcy laws, secured lenders can seize their collateral if the pre-filing management remains in place after the filing; alternatively, if an automatic stay exists, management must be replaced by a trustee.<sup>9</sup> Japan also lacks a vehicle, such as debtor-in-possession (DIP) financing, under which viable companies can obtain funds. In the U.S., through fund allocation, the market essentially determines which firms should successfully emerge from bankruptcy; Japan has no such device.

## **Tax**

Critical tax issues associated with cross-border securitizations include ensuring that securities issued in securitizations constitute bonds and not loans. Under Income Tax Law articles 161 and 212, bonds will be treated as loans if only a few investors hold them or a few investors hold a substantial amount of the principal; in this case, any interest paid to foreign investors will be subject to Japanese withholding tax.<sup>10</sup>

A critical issue for both tax and accounting purposes is ensuring that the transfer of assets from the originator to an independent third party is treated as a sale. To ensure this treatment, the following conditions must be met:

- (a) Intent, of both the originator and the SPC.
- (b) Perfection, which must comply with Japanese law.
- (c) Pricing. Consideration given to the SPC must represent fair market value of the assets transferred.

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<sup>9</sup> Whitman, Martin J. "Other Voices: Japan Should Write a New Chapter." *Barron's*. October 19, 1998, page 56.

<sup>10</sup> Yoost, Dean and Sachihiko Fujimoto. "Securing Success in Japan." *International Tax Review*. London: October 1998, pages 17-22.



(d) Repurchase. Extensive rights of repurchase may result in the classification of the transfer as a secured borrowing instead of a sale.<sup>11</sup>

The Ministry of Finance adopted favorable tax changes to the SPC Laws, effective September 1, 1998, which promoted the formation of SPCs. These included reductions of real property, registration, and acquisition taxes imposed on property transfers to SPCs, reductions in registration and license taxes for SPC establishment, and a deduction for dividends paid if at least 90% of the SPC's earnings are distributed to the SPC's shareholders.<sup>12</sup>

The creation of REITs would also improve the non-performing loan problem and create much needed liquidity in the real estate sector. However, under Japanese tax law, REITs would be subject to double taxation.

## **Cultural**

A cultural obstacle to securitization is the importance of relationships in Japan. Due to single-A and lower ratings for many Japanese banks, securitization without true sale is impracticable, if not impossible.<sup>13</sup> MOF-regulated institutions must notify the obligor to assign a loan; however, due to the importance of relationships, such notification is not an attractive option. Another cultural obstacle to securitization, or even issuing debt in general, are the low ratings of Japanese banks, as they are not accustomed to issuing securities with high risk such as non-investment grade securities. Furthermore, Japanese banks and their boards of directors are reluctant to place loans into subordinated or mezzanine tranches of CLOs, with triple-B or lower ratings, for fear of harming relationships with customers. Japanese banks are reluctant to liquidate loan assets, even for non-performing loans that have been written down, due to hope

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<sup>11</sup> Yoost, Dean and Sachihiko Fujimoto. "Securing Success in Japan." *International Tax Review*. London: October 1998, pages 17-22.

<sup>12</sup> Yoost, Dean and Sachihiko Fujimoto. "Securing Success in Japan." *International Tax Review*. London: October 1998, pages 17-22.

that either the underlying asset will increase in value or that the debtor will be able to repay an amount greater than book value in the future. A technical obstacle to the disposal of non-performing loans is the presence of multiple mortgages and other claims on underlying collateral. In Japan, different parties may own rights to the same property and land. Before securitizing, the rights to property and land must be clarified. There has been strong support from the Ministry of Justice in clarifying such rights, as well as eviction of inappropriate parties such as the Japanese yakuza. Finally, perhaps the most important issue is the Japanese investors' lack of familiarity with the ABS market, and their risk-averse attitude to securities that do not have principal guarantee.

### **Private Sector Securitizations**

Despite the myriad obstacles to achieving securitization in Japan, issuance in fiscal 1998 was expected to exceed \$20 billion.<sup>14</sup> According to another source, CLOs deals in 1997 totaled \$35 billion.<sup>15</sup> Deals such as Sumitomo Bank's Aurora CLO demonstrate not only that securitization is possible, but that it is an attractive option for Japanese firms. Under BIS standards, capital requirements are equivalent, regardless of the quality of the underlying loans. As a result, securitization is popular for investment-grade loans. To date, most Japanese deals in the banking sector have involved performing loans. Another complicating factor has been the diminished risk appetite for Asian securities in the wake of the Asian financial crisis. As a result, U.S. and European assets backed the majority of loans in CLOs brought in 1997; in its

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<sup>13</sup> Hay, Jon. "Japan's Securitisation Age Dawns." *Euroweek*. London: January, 1998, page 68-70.

<sup>14</sup> Butt, Stafford. "Securitization in Japan." *Asiamoney*. London: December 1997/January 1998, pages 33-34.

<sup>15</sup> Reinebach, Adam. "Japan's Capital-Hungry Banks Look to the Growing CLO Market." *The Investment Dealers' Digest*. New York: February 16, 1998, page 14.

January 1998 \$1.25 billion CLO deal, the Industrial Bank of Japan was forced to reduce the portion of Japanese loans from 12% to 6%.<sup>16</sup>

Two groundbreaking CLO deals in private sector securitization include Aurora and Wizard Finance. Wizard Finance, the second ever complete securitization of bank loans, was the headline securitization deal for 1997. Tokyo-Mitsubishi International, an affiliate of the Bank of Tokyo-Mitsubishi (BTM), sole managed the deal. The Wizard Finance CLO deal sold BTM's performing loans to high quality Japanese corporations. The two tranches, one dollar-denominated and one yen-denominated, were worth \$525 million and Y33 billion (\$292 million), respectively. The dollar tranche was nearly two times oversubscribed by overseas buyers, at a price of 20 basis points over LIBOR, while the yen piece was sold at 1.625%.<sup>17</sup> Due to legal restrictions on assignment, BTM employed an offshore intermediate SPC. For both the Wizard Finance deal and a subsequent Japan Loan Securitization deal, a \$1.2 billion deal in dollar, sterling, Swiss franc, and yen, BTM used a smoothed cash flow stream from investment-grade rated (by Moody's) Japanese obligors as collateral. By using an intermediate SPC with a Cayman Islands branch, BTM was able to silently assign the loans. The Cayman Islands branch of the SPC sells senior yen notes to the issuing vehicle and a 10% subordinated note to the originator.<sup>18</sup>

Sumitomo established two SPCs, L'Arc Finance Ltd. and Pegasus Funding Corporation, in the Cayman Islands to enable it to raise funds against its risk-weighted Japanese corporate loans. Through these SPCs, Sumitomo issued three Y50 billion deals of commercial paper in July and August 1997, enabling Sumitomo to improve its BIS ratio. In addition, in April 1998,

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<sup>16</sup> Reinebach, Adam. "Japan's Capital-Hungry Banks Look to the Growing CLO Market." *The Investment Dealers' Digest*. New York: February 16, 1998, page 14.

<sup>17</sup> Hay, Jon. "Japan's Securitisation Age Dawns." *Euroweek*. London: January, 1998, page 68-70.

<sup>18</sup> Hay, Jon. "Japan's Securitisation Age Dawns." *Euroweek*. London: January, 1998, pages 68-70.

Sumitomo issued a Y1.4 billion floating rate note through Aurora Funding (see Exhibit G for details of Aurora Funding Corporation).

### **Investors in Securitized Loans**

Recent articles in the popular press indicate that demand for Japanese distressed loans exists. U.S. finance companies such as Goldman, Sachs & Co., Morgan Stanley Dean Witter & Co, and GE Capital Corp. have been purchasing distressed loans for the past few years. More recently, however, hedge funds have entered the market. Cerberus Capital Management, with approximately \$4 billion under management, is attempting to raise \$1 billion for funds that will target distressed loans in Japan. According to a recent *Wall Street Journal* article, Cerberus is buying commercial and industrial loans at 5 to 10 cents on the dollar.<sup>19</sup>

Despite articles depicting interest in acquiring loans, Fuji Bank encountered difficulties in selling its securitized loans. In a March 1997 deal, Fuji, through its conduit Prestar Funding Corp., securitized loans with maturities less than six months. A Fuji Bank official commented, "The problem with this program is that we have to retain a large subordinated interest... We tried to sell it but the market wouldn't buy it."<sup>20</sup> In a September 1997 deal, Fuji sold discounted loan participations, with an average maturity of two weeks, to Japanese regional banks and branches of foreign banks. However, a Fuji Bank official remarked that "Selling loans to relationship banks is extremely time consuming and there is a limited appetite."<sup>21</sup>

### **The Potential for Government Securitizations**

Despite the spate of successful securitizations in the private sector, the size and scope of the Japanese non-performing loan problem may warrant a government program. Advantages to

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<sup>19</sup> Pacelle, Mitchell. "Hedge-Fund Firm Likes Look of Soured Japanese Loans." *The Wall Street Journal*. February 8, 1999, page C2.

<sup>20</sup> "Fuji Bank Confirms Plans for Jumbo Securitization of Loans by March 1998." *Euroweek*. December 19, 1997, page 10.

such a program would include the ability to circumvent existing legal and tax obstacles, and the possibility of lowering the cost of resolving the problem. Critics of the U.S. bailout of the S&Ls complained of the excess costs incurred due to the use of FICO and REFCORP, which were not backed by the “full faith and credit” of the U.S. government. A Japanese government vehicle may minimize the cost of the bailout. Another problem with the private sector securitizations is that in most CLO deals, the banks retain the tranche with the most risky loans. As a result, banks increase their regulatory capital, but do not reduce their economic risk. A U.S. style RTC solution to the problem appears to be impractical due to the lack of strong financial institutions to create and distribute the securities, insufficiently developed capital markets, and a reluctance to foreign ownership. Furthermore, the lack of transparency and disclosure in Japanese financial statements will limit potential buyers. As a result, a government-led securitization may be a better solution.

### **Brady Bonds**

A potential structure on which a government-organized securitization of Japanese NPLs could be based is the Brady Bond program. Brady Bonds are named for former U.S. Treasury Secretary Nicholas Brady, who created the program that enabled banks to swap commercial bank loans into new bonds. Although there are different varieties, the principal and two or three interest payments of many Brady Bonds are collateralized by 30-year zero coupon U.S. Treasury bonds and other high quality assets. Under an exchange of bank debt for Brady Bonds, banks were offered alternatives including Par Bonds, Discount Bonds, New Money Bonds (NMBs), Debt Conversion Bonds (DCBs), Front Loaded Interest Reduction Bonds (FLIRBs), and Interest Arrears Capitalization Bonds. In a Par Bond exchange, bank debt is exchanged at 100% of face

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<sup>21</sup> Fuji Bank Confirms Plans for Jumbo Securitization of Loans by March 1998.” *Euroweek*. December 19, 1997, page 10.

value with below-market fixed interest rates; the principal is collateralized by 30-year U.S. Treasury zero-coupon bonds and a rolling guarantee on interest for the next two to three periods exists. With Discount Bonds, bank debt is exchanged at a discount to face value and the interest rate is a higher-than-market floating rate; again, principal is collateralized by 30-year U.S. Treasury bonds. New Money Bonds are not collateralized and the interest rates are usually floating, based on a spread to LIBOR. Debt Conversion Bonds usually carry identical terms as the New Money Bonds. Creditor banks were allowed to exchange existing loans for a percentage of DCBs for every dollar of new money invested in NMBs. FLIRBs allowed banks to exchange loans for medium term step-up bonds at below-market interest rates for the initial five to seven year period, and at a floating rate for the remainder of the term. Cash is collateral for partial interest payments; the collateral is rolled over upon timely interest payments. Interest Arrears Capitalization Bonds represent the capitalization of interest in arrears into short-term floating rate bonds, which are issued prior to Brady Bond rescheduling of principal.

The opportunity to reduce short-term debt service requirements through Brady Bond conversions was accompanied by mandatory IMF structural adjustment agreements, which established requirements for strict fiscal and monetary policies which must be implemented prior to the Brady exchange.

Countries involved in the Brady Bond program purchased U.S. Treasury zero-coupon bonds, which are used as collateral, in the open market and via special U.S. Treasury issues. For the collateralized interest, the government of the issuing country deposits an amount equal to twelve to eighteen months of interest payments with the New York Federal Reserve.

### **Proposed Structure for Japan**

An advantage of a Brady type structure for Japan would be a reduction in cost. Since the rating agencies rate Brady Bonds at the sovereign ceiling, the bailout of the Japanese banks would be financed at the borrowing rate for Japan, not the higher borrowing rates required in private sector securitizations. Similar to the Brady Program, the Japanese plan should include mandatory structural adjustments to the banks, such as those currently required for banks that accept public funds as capital infusions.

### **Obstacles to a Brady Bond Plan for Japan**

As of November 30, 1998, Japanese investors, including the Bank of Japan, held \$272.7 billion of U.S. Treasury bonds, approximately 7.2% of outstanding Treasuries.<sup>22</sup> Given recent estimates that the Japanese bad loan problem exceeds \$500 billion and may top \$1 trillion, the U.S. government bond holdings of Japanese will not be sufficient for full indemnification. An alternative would be to collateralize the pool of loans, using Japanese Government Bonds. The Japanese Trust Fund Bureau owns approximately 34% of the Japanese government bond market.<sup>23</sup> However, the Ministry of Finance will lose control over the Trust Fund Bureau within the next year. As a result, it may be difficult to appropriate these bonds.

### **Other Proposed Plans**

Although the Japanese government has been criticized for not adequately addressing the banking crisis, recent initiatives have been more encouraging. In October 1998, the government formed the Financial Reconstruction Commission to allocate public funds and to dictate necessary restructuring and reorganizations. On March 8, 1999, the government distributed

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<sup>22</sup> Zuckerman, Gregory. "Contrary to Common Belief, Japanese Don't Pull Strings." *The Wall Street Journal*. February 26, 1999.

<sup>23</sup> Spindle, Bill. "As Tokyo Changes Focus to Selling Debt, Japan Could Face Its Own Year 2000 Test." *The Wall Street Journal*. February 18, 1999.

Y7.45 trillion (\$61 billion) of public funds to fifteen major Japanese banks. Additional funds of approximately \$200 billion will be made available to the banks in the future. The banks will use the funds, in addition to approximately Y2.5 trillion raised from private investors, to write down bad debts in the fiscal year ended March 31, 1999. In exchange for the infusion of public funds, the banks have agreed to reduce jobs, rationalize branches, and withdraw from overseas operations. By some estimates, 450 bank branches and 20,000 jobs will disappear by 2003.<sup>24</sup> While this will undoubtedly lower banks' costs, little progress has been made on methods to improve the banks' revenues or to restructure the lending methods of the banks.

In exchange for the infusion of public funds, the Japanese government will receive preferred shares in the banks or subordinated loans, in proportion to the amount of public funds received. The preferred shares can be converted into common stock after a period of three months to 7½ years, depending on the bank.<sup>25</sup> For example, the government can convert its preferred to common as early as July for Mitsui Trust & Banking Co., Chuo Trust & Banking Co., Toyo Trust and Banking Co., and Daiwa Bank.<sup>26</sup> If the government were to exercise its conversion option, it would own in excess of 50% of the common shares of Daiwa Bank, Mitsui Trust, and Chuo Trust. Exhibit E depicts the total capital infusion by bank and type.

The Financial Reconstruction Commission, run by Hukuo Yanagisawa, is responsible for the oversight of the Japanese banking system clean up. Effective April 1, 1999, the Housing Loan Administration Corporation (HLAC) and the Resolution Collection Bank were merged to form the Resolution and Collection Corporation (RCC), the Japanese equivalent of the Resolution Trust Corporation. The RCC will be responsible for disposing of assets acquired

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<sup>24</sup> "Finance and Economics: Money for Nothing." *The Economist*. March 13, 1999, pages 87-88.

<sup>25</sup> "Finance and Economics: Money for Nothing." *The Economist*. March 13, 1999, pages 87-88.

<sup>26</sup> Otake, Tomoko. "Experts Disagree on Bank Recapitalization Impact." *The Japan Times*. March 12, 1999. <http://www.japantimes.co.jp/news/news3-99/news3-12.html>.



from Hokkaido Takushoku Bank, and the nationalization of Nippon Credit Bank and Long Term Credit Bank.

### **The Optimal Plan**

Despite the restrictions imposed on the banks that accept funds, the infusion of public funds is essentially a direct subsidy to the banks. The decision to use public funds to purchase the preferred stocks of Japanese banks faced strong opposition among politicians, leaders of various economic organizations, and the Japanese people as it was the second time in a short period of time that public funds were used to “bail out” Japanese banks. In 1995, *jusen* (the Housing Loan Corporation, a non-government entity) was liquidated using public funds. Despite the government’s reluctance to use public funds to rescue banks again, the *Kinyu Kino Soki-kenzenka-Ho* law was passed in October 1998 to encourage bank lending to small and medium-size companies to prevent the Japanese economy from sinking further into a recession.

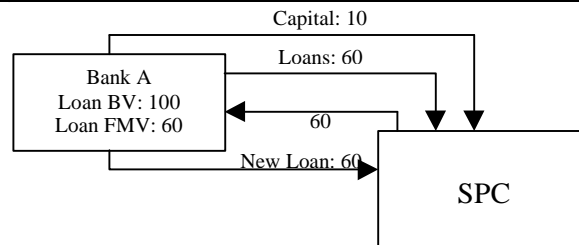
The infusion of public funds provides the banks with the necessary capital needed to write-off the non-performing loans on an accounting basis; however, the non-performing loans, as well as the collateral, remain with the banks. Therefore, the banks need to dispose of these “assets” to truly solve the non-performing loan problem.

We propose a scheme in which the Japanese banks sell their non-performing loans to a jointly established SPC; the SPC would then pool the loans and issue asset-backed securities (“ABS”). Although our proposal results in banks’ recognizing a loss when they sell the loans that are backed by collateral (“Loans”), the loss would create a tax-shield. Under our proposed scheme, banks could mix any proportion of performing and non-performing loans, depending on market demand. We realize that the banks may have some reluctance to sell performing loans to the SPC due to cultural, relationship, and economic reasons. Therefore, our scheme would allow

the banks to determine the proportion of performing and non-performing loans sold to the SPC. The benefits of this scheme are that it:

- Enables banks to remove the Loans from their balance sheet;
- Provides banks a tax benefit (simply writing off the Loans does not provide a tax benefit);
- Relieves the government from using public funds to subsidize the banks, and thus avoids the accusation that the government is giving too much preferential treatment to banks.

**Figure 1. Bank A establishes and sells Loans to SPC**



In our proposed scheme, a group of banks will first establish a SPC by investing a small amount of capital, then sell their Loans to the SPC. For example, as illustrated in Figure 1, the book value of Bank A's loans is 100; however, the probability of recovering the loans is very low. Suppose the loan has collateral with an estimated fair market value of 60. After establishing the SPC, Bank A makes a loan to the SPC in the amount of 60 ("New Loan"), the fair market value of the Loans, and simultaneously sells the Loans to the SPC at 60 (the SPC uses the new loan to purchase the Loans). Bank A will recognize a tax-deductible loss of 40 at the time of the sale. The Loans (100) will be removed from Bank A's balance sheet and will be replaced by the New Loan to the SPC (60). The benefits of these scheme are

- Bank A removes the Loans (100) from its balance sheet and adds New Loan (60)
- The loss of 40 creates a tax benefit immediately.

**Figure 2. Banks establish a SPC**

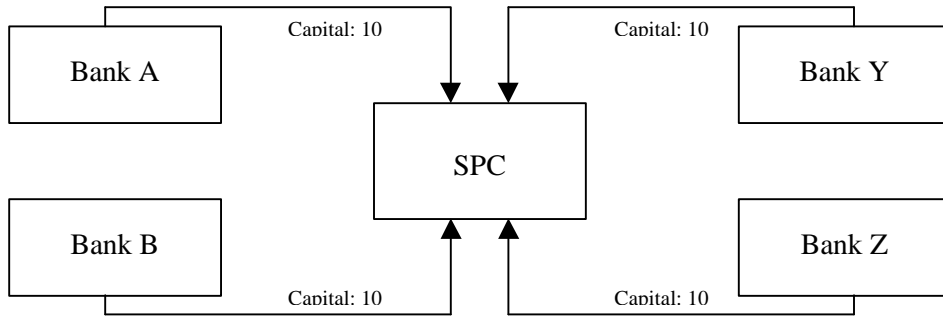
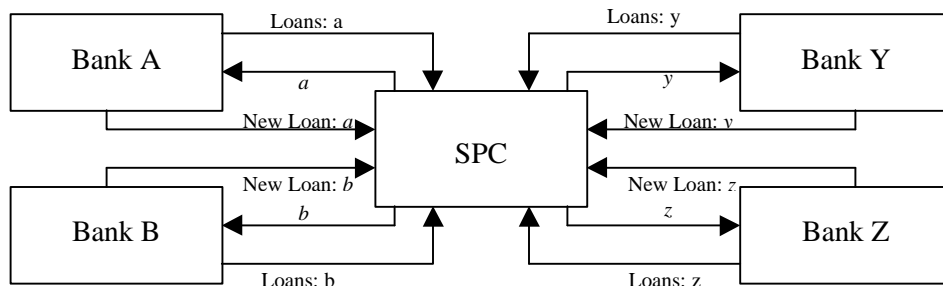


Figure 2 illustrates the process of multiple banks establishing a SPC, and Figure 3 illustrates the process of these banks making loans to the SPC and purchasing the Loans.

**Figure 3. Banks provide New Loans to the SPC and sell Loans to SPC**



The above process enables Bank A to remove the Loans from its balance sheet; however, it also creates a New Loan asset with the SPC as its debtor. Although this creates a new obligation for the SPC, the benefit of this is that it enables Bank A to recognize a tax loss immediately, as opposed to waiting for the SPC to issue the ABS, which will also be affected by the other banks. On the other hand, the SPC can purchase the Loans from Bank A using the proceeds from issuing the ABS described later. The economic effect is the same, whichever method is used to pay Bank A; the only difference is the timing of the tax loss recognition.

The next step is for the SPC to sell the collateral underlying the Loans. If the SPC tries to sell all of the collateral real estate properties (“Properties”) in the market at once, it is likely that the weak Japanese real estate market would deteriorate further. The SPC should avoid an immediate sale of the Properties that may damage the real estate market. Such action may not

only push the Japanese economy further into recession, but also decrease the proceeds from the sale of the Properties, and thus, making it difficult to repay the New Loan to the banks. Therefore, we propose that the SPC pool the Loans and issue ABS, using the proceeds from the sale of the Properties as collateral or as cash flow.

The sale of Loans to the SPC de-links the Loans from the banks, and the rating of the ABS will be based solely on that of the SPC, whose only assets are the pool of Properties. The pooling of the Properties diversifies the risk characteristics of individual Properties and decreases the portfolio's overall risk profile.

The nature of the assets (real estate) and the lack of liquidity in the Japanese real estate market are obstacles to creating high demand from investors for ABS. The risk of selling the Properties persists, as does the risk of default on interest payments by the SPC due to insufficient cash flow generated by the Properties. In order to address this issue, the SPC could have monoline insurers such as CapMac insure the interest payment. However, given the estimated amount of Loans to be sold to the SPC and the size of the ABS program, it may not be economical to have monoline insurers insure the interest payments. Thus, the ABS issued by the SPC may be zero-coupon bonds, or the government could support the ABS program by providing a contingent credit enhancement. The use of zero-coupon bonds would compensate for the questionable timing of cash flow obtained from the sale of the Properties.

Unlike a direct subsidy such as purchasing banks' preferred shares, the government could provide insurance to the ABS program in the form of a contingent credit enhancement. The U.S. Treasury bonds as well as the Japanese Government Bonds (JGB) held by the Bank of Japan or the Japanese Trust Fund Bureau, will be used to enhance the credit of the ABS program. If the SPC fails to generate sufficient cash flow from the sale of the Properties or from the Properties'

cash flow, the government will liquidate part of the US Treasuries or JGBs to make the payment. We believe that the \$272.7 billion of US Treasury bonds combined with the Y92,279 billion (\$769 billion) long-term Japanese Government Bonds held by the Ministry of Finance should be sufficient to guarantee the interest and principal payments of the ABS.<sup>27</sup>

The ABS will be issued in senior, junior and subordinate portions varying by the amount of the government's guarantee. For example, [80-100%] of the senior notes may be guaranteed, whereas only [50]% of the junior portion may be guaranteed. These percentages would vary based upon the quality of the pool, the proportion of performing loans versus non-performing loans, the government's level of participation in the scheme, and the demands of the market. The SPC will enter into a swap agreement with a counterparty to hedge against currency and/or interest-related risk.

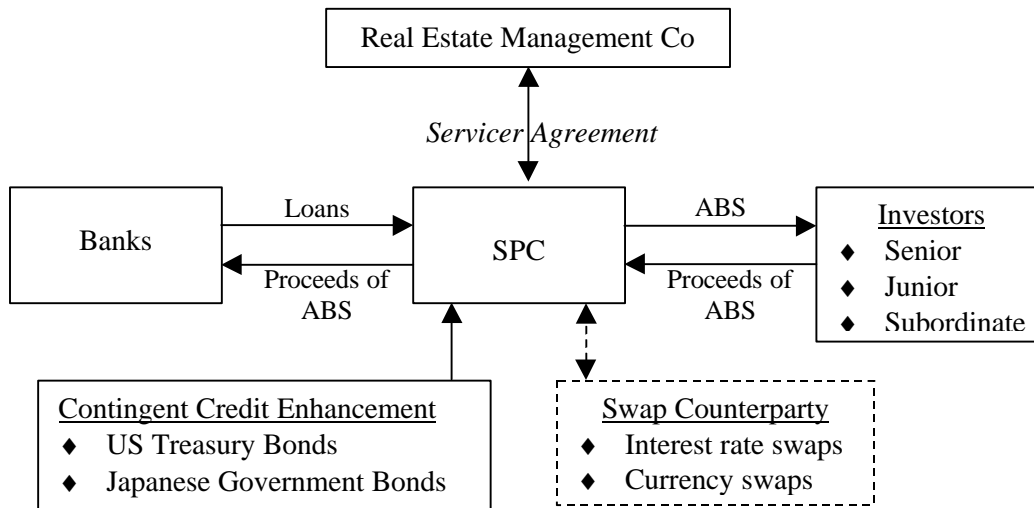
An alternative issuer of the ABS would be the Resolution and Collection Corporation. However, we recommend that banks establish a SPC and issue the ABS. The reason for this is that Kohei Nakabo, the president of the RCC, is opposed to any additional funding. He does not want the government to spend any more public funds for bailing out banks, as it has spent enough public funds for the *jusen*. Therefore, he is likely to oppose the government providing any contingent credit enhancement. For this reason, using the RCC may create unnecessary coordination problems that would delay solving Japan's non-performing loan problem. Furthermore, despite having the government guarantee as a contingent credit enhancement, we recommend using the SPC as it will limit the involvement of unnecessary parties from the ABS program, thus, decreasing the need for coordination. We also recommend limiting the government's involvement to avoid creating the impression that this structure is another scheme

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<sup>27</sup> Ministry of Finance, Statistical Summary, Investment Summary, February 1999. <http://www.mof.go.jp/mr-tfb/lc014ad.htm>

to subsidize the banks using public funds. Thus, using a SPC established by the banks, as opposed to using a semi-government vehicle such as the RCC would better.

**Figure 4. Sample CLO Transaction**



**The benefits of this scheme:**

- Increases liquidity in the real estate market
- Increases the potential investor base. For example, many life insurance companies are restricted from investing in real estate properties. However, they may be able to invest in ABS.
- If the Properties generate sufficient cash flow to pay the interest, the SPC could seek an optimal time to sell the Properties, thereby decreasing the risk of having to sell at the bottom while avoiding depressing the real estate market.

**Potential Participants**

As stated earlier, there have been several private sector securitizations such as Sumitomo Bank's Aurora CLO and the Bank of Tokyo-Mitsubishi's Wizard Finance CLO. However, there are many Japanese banks that have non-performing loans, but have not sold the Loans.

Therefore, we expect many of these city banks that have not sold their Loans, the trust banks, and selected regional banks to utilize our scheme.

### **Potential Investors**

*Senior portion* – For most of the Japanese ABS issues, the Euromarket has been a favorable market due to its sophisticated investor base. Perhaps a new group of investors will be the Japanese domestic investors who may be attracted to the ABS due to i) the higher yield compared to the low-yield Japanese Government Bonds, and ii) the contingent guarantee from the Japanese government.

*Junior portion* – Japanese investor may not be interested in this portion of the ABS due to the larger risks. However, if the issue is priced appropriately, we expect the Euromarket to have a sufficient number of interested investors. In addition, U.S. financial institutions have been aggressively buying non-performing assets from Japanese banks. Given that the increase in competition to buy such assets has decreased the number of “bargains” available, another way to earn a good return in Japan may be to invest in the ABS issued by the SPC.

*Subordinate portion* – According to David Atkinson, Goldman Sachs’ well-known equity analyst in Japan, there will be many U.S. investors interested in purchasing the subordinate portion, at the right price. He states that the price will be at such a discount that it would decrease the economic benefits; therefore, he recommends that the banks (originators) retain the subordinate portion. As stated earlier, the regulation change requires banks to reserve 8% of the face value of senior assets sold if the subordinated position exceeds 8% of that face value. This increases the cost of the ABS program, but it may be inevitable.

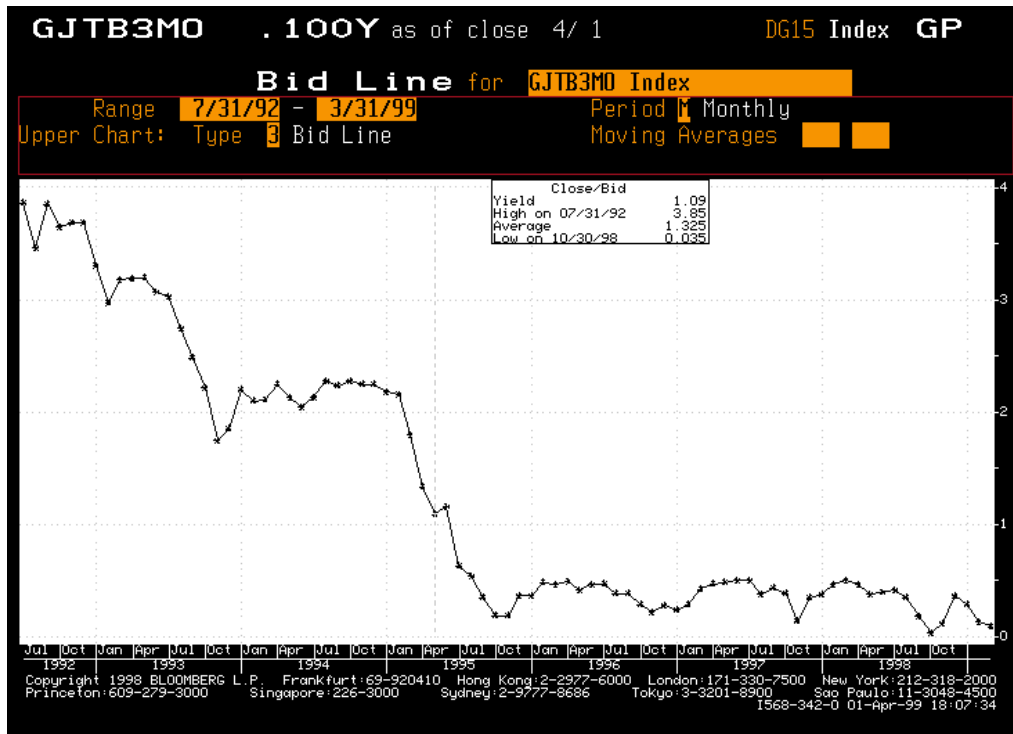
## **Conclusion**

Our scheme is certainly feasible. The largest benefit is that it enables the banks to remove the non-performing loans from their balance sheet. The removal will relieve the capital used as reserve for the potential loss of the non-performing loans. The next benefit is the tax-benefits for the banks, which are not available by simply writing off the loans. Our scheme does not require additional capital to be raised from the government through the issuance of preferred stocks; thus, the banks will be less restricted by the guidelines imposed by the Financial Supervisory Authority. Finally, it avoids an immediate sale of real estate properties, thus, it would minimize the downward pressure on the Japanese real estate market.

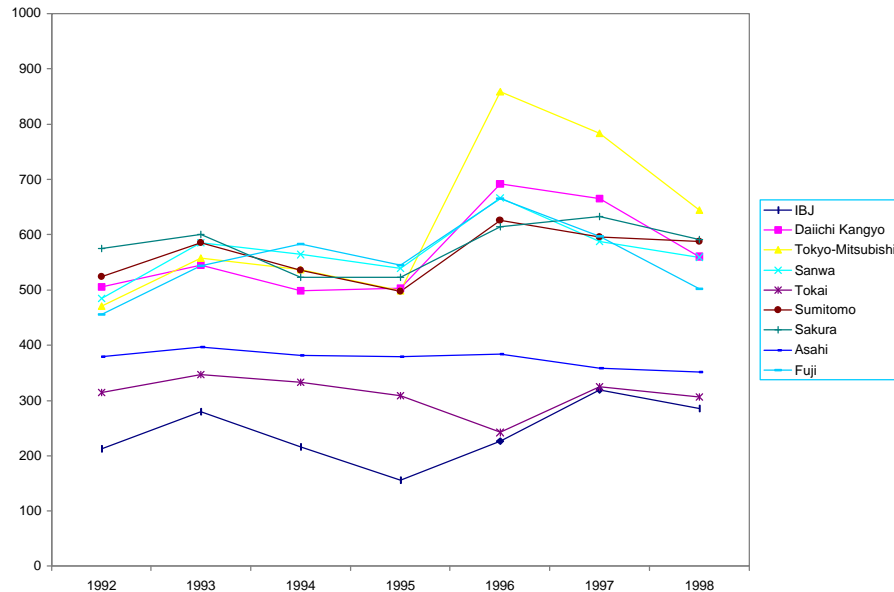
Private sector securitizations such as Sumitomo Bank's Aurora Funding have been completed, despite the obstacles. We expect banks that can securitize their assets on their own to continue to do so. Our scheme, on the other hand, is targeted more towards those banks that have not yet securitized their assets – either by choice or due to lack of ability, and select regional banks that are in need of such program. We propose pooling the Loans in order to diversify the risk and thus, decrease the cost of such a transaction. The main obstacle to our scheme is leadership. It is unlikely that any major bank will lead such a scheme beyond their corporate group (*Keiretsu*). On the other hand, it is unlikely that the Ministry of Finance will initiate such coordinated efforts for fear of appearing to be giving preferential treatment to banks. Therefore, we suggest involving politicians who can influence both individual banks as well as the bureaucrats at the Ministry of Finance to consider our scheme.



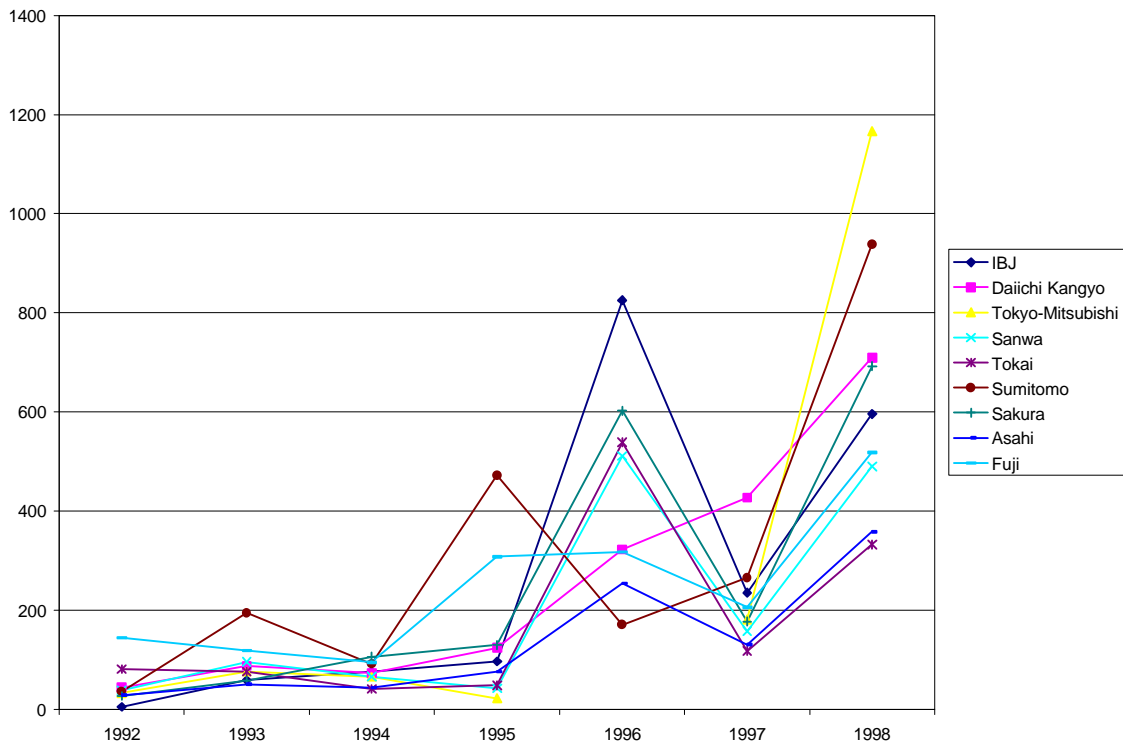
**Exhibit A. Japanese Interest Rate Level**



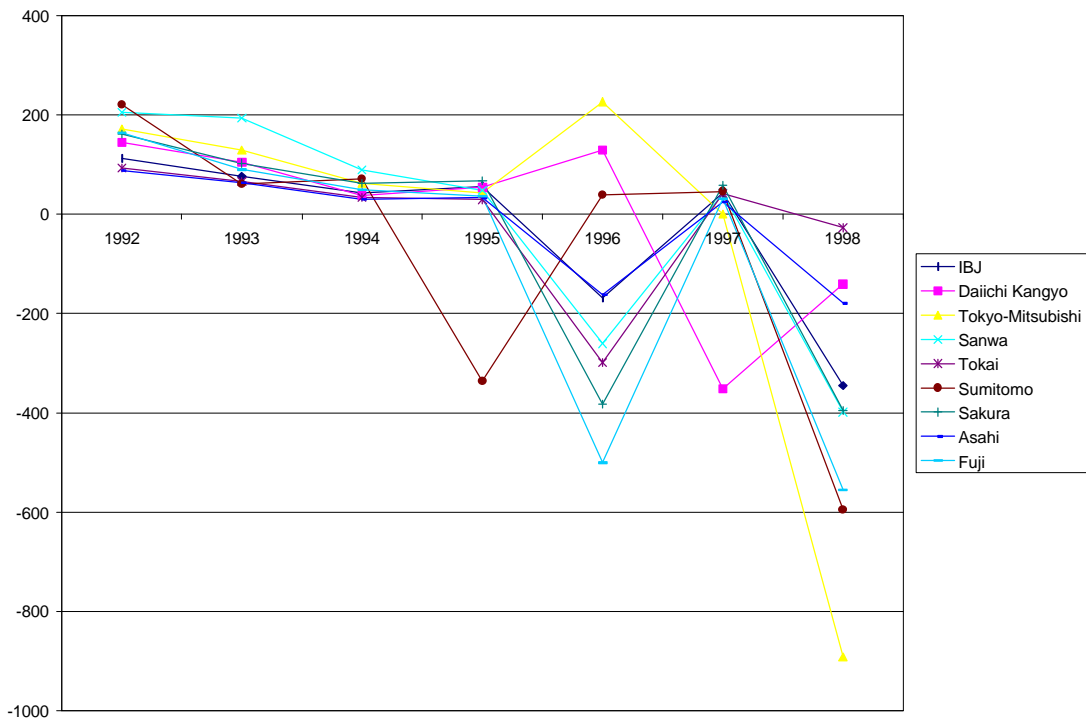
**Exhibit B. Net Interest Income of Japanese Banks**



**Exhibit C. Provisions for Doubtful Debt**



**Exhibit D. Operating Profits of Japanese Banks**



**Exhibit E. Capital Infusions to Banks and Trusts (in billions of Yen)<sup>28</sup>**

<b>Institution</b>	<b>Preferred Stock</b>	<b>Subordinated Debt/Loans</b>	<b>Total Capital</b>
Industrial Bank of Japan	350	250	600
Dai-Ichi Kangyo Bank	700	200	900
Sakura Bank	800	0	800
Fuji Bank	800	200	1,000
Sumitomo Bank	501	0	501
Daiwa Bank	408	0	408
Sanwa Bank	600	100	700
Tokai Bank	600	0	600
Asahi Bank	400	100	500
Bank of Yokohama	100	100	200
Mitsui Trust	250	150	400
Mitsubishi Trust	200	100	300
Sumitomo Trust	100	100	200
Toyo Trust	200	0	200
Chuo Trust	150	0	150
<b>Total</b>	<b>6,159</b>	<b>1,300</b>	<b>7,459</b>

Source: FSA Web Site

<sup>28</sup> <http://www.fsa.go.jp/letter/7/17/008.html>.

**Exhibit F. Japanese Bank Ratings & Non-Performing Loans<sup>29</sup>**

<b>Institution</b>	<b>Moody's</b>	<b>R&amp;I</b>	<b>JCR</b>	<b>Non-Performing Loans (Y billion)</b>
Industrial Bank of Japan	Baa2	A+	NR	1,980
Dai-Ichi Kangyo Bank	Baa2	A	NR	2,100
Sakura Bank	Baa2	A-	NR	2,030
Fuji Bank	Baa2	BBB+	NR	1,400
Sumitomo Bank	A3	AA-	NR	2,000
Daiwa Bank	NR	NR	A-	1,140
Sanwa Bank	A2	AA-	NR	1,820
Tokai Bank	Baa2	A	NR	960
Asahi Bank	Baa2	A-	NR	965
Bank of Tokyo-Mitsubishi	A2	AA-	AA+	NA
Mitsui Trust	Baa3	NR	A-	702
Mitsubishi Trust	Baa2	NR	A+	1,235
Sumitomo Trust	Baa3	A-	A	1,380
Toyo Trust	NR	NR	A	580
Yasuda Trust	Baa3	NR	BBB+	NA
Chuo Trust	NR	NR	NR	175

<sup>29</sup> "Non-Performing Assets of banks which received capital injection exceed Y19trillion" *Nikkei Shimbun*. Tokyo: March 16, 1999

**Exhibit G. Cutting edge close-up: Sumitomo's Aurora CLO****International Financial Law Review; London; Jul 1998; Marke Raines**

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                               3400: Investment analysis

Geographic Names:     US  
                               US

Companies:             Sumitomo Bank Capital Markets Inc  
                               Sumitomo Bank Capital Markets Inc

**Abstract:**

*New benchmarks in corporate loan securitization technology were set when the Structured Finance Group at the London bank of the Sumitomo Bank completed their Aurora CLO on April 1998. Aurora Funding was supported by a structure which: 1. de-links the loan assets from Sumitomo's credit risk, 2. provides for a fully funded CLO, 3. hedges currency exchange and interest rate exposures on the multi-currency loan portfolio, 4. Enables borrowers set-off risk to be contained, and 5. supports regulatory capital relief for drawn loans and undrawn commitments.*

**Full Text:**

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New benchmarks in corporate loan securitization (collateralized loan obligations, or CLO) technology were set when the Structured Finance Group at the London branch of The Sumitomo Bank completed their Aurora CLO on April 8 1998. The 1.395 billion (US\$ 23 billion) issue of floating rate notes by Aurora Funding was supported by a structure which:

- 'de-links' the loan assets from Sumitomo's credit risk, enabling Aurora's senior notes to obtain a AAA/Aaa rating, without using an assignment, novation or secured loan as a delinking device;
- provides for a fully funded CLO, ie for the funding of loans drawn at the time of closing and for the committed funding by Aurora of further loans made by Sumitomo to borrowers;
- hedges currency exchange and interest rate exposures on the multi-currency loan portfolio, including exchange rate exposures resulting from borrower defaults;
- enables borrower set-off risk to be contained; and
- supports regulatory capital relief for drawn loans and undrawn commitments.

**Simple structure**

The relatively simple structure (see diagram) entailed a single special purpose company, Aurora, which issued class A1 and A2 notes (rated AAA/Aaa by Standard & Poor's and Moody's respectively), and four subordinated classes of rated Notes. Sumitomo declared a trust in favour of Aurora and itself in respect of existing and future loans in consideration of, among other things, the payment by Aurora to Sumitomo of L331 million of note proceeds.

From the remaining proceeds of the note issue, Aurora deposited about 148 million in GIC accounts to pay (later) for its trust interest in further loans, and about 7 million in a reserve account by way of credit enhancement and applied 916 million to repurchase (but not cancel) all of the A2 notes. Aurora has the right, subject to certain conditions, to put class A2 notes to National Westminster Bank (NatWest) at par. Aurora entered into hedging agreements with SBCM Derivative Products Limited, a Sumitomo affiliate, with respect to currency exchange and interest rate risks.

Sumitomo covenanted to Aurora to administer the securitized loan portfolio on behalf of Aurora and itself. Segregated trust collection accounts were established into which the proceeds of securitized loans are deposited. Aurora charged its assets to a note trustee on trust for the noteholders and granted to the note trustee an irrevocable power of attorney to:

- secure the performance of its obligations in respect of the payment to Sumitomo of the advance further trust subscription price (see below); and
- delegate to the note trustee its powers under the originator power of attorney (see below).

#### The securitized loan portfolio

The credit facilities in the securitized loan portfolio consist of fully drawn term loan facilities under which no additional borrowings may be made and revolving credit facilities provided by Sumitomo to 60 different borrowers. Each credit facility is denominated in, or has a base commitment denominated in, one of four currencies and various facilities include commitments by Sumitomo to provide credit support to borrowers by way of advances in one or more currencies, the acceptance of eligible bills of exchange, the issue of guarantees or indemnities and the issue of letters of credit. US dollar-denominated swingline advances made by the New York branch of Sumitomo under these credit facilities were not securitized. The securitized loan portfolio consists of syndicated and bilateral credit facilities, and there are provisions in most of the credit facilities which limit or restrict the transfer or assignment of the loans.

#### The trust and irrevocable power of attorney

The restrictions on transfer and assignment contained in the credit facilities meant that the usual securitization transfer device of an equitable assignment could not be used. Nor could a novation (by way of transfer certificate) be used. The technique developed for the Aurora transaction, a first in European securitization, is to use an English law trust and an irrevocable power of attorney as a means of de-linking the securitized loans from Sumitomo's credit risk. This trust and power of attorney mechanism allowed the CLO to be completed without breaching the restrictions on equitable assignment by Sumitomo contained in the underlying loans.

Under an originator trust deed, Sumitomo declared a trust in favour of Aurora as to 99% of the trust property (see below), and to Sumitomo as to 1% of the trust property; in consideration of the payment by Aurora to Sumitomo on the closing date of an initial trust subscription price of 331 million and of Aurora's covenants to pay to Sumitomo from time to time an advance further trust subscription price and a deferred trust subscription price. The initial trust subscription price represented 99% of the difference between the amounts outstanding under the loan portfolio on closing and a discount component (overcollateralization) determined in relation to the aggregate commitments under the credit facilities. The advance further trust subscription price is, broadly, an amount equal to 99% of further advances made under the credit facilities. The deferred trust subscription price will be an amount equal to the discount component of the initial trust subscription price subject to adjustment in respect of losses on the securitized credit facilities. The trust property comprises Sumitomo's rights under the credit facilities and advances made under them at closing as well as further advances and the segregated collection accounts.

Sumitomo granted to Aurora an irrevocable originator power of attorney to secure the performance by Sumitomo of its obligations under the originator trust deed, including its covenants to enforce its rights under the securitized credit facilities and to collect in amounts owing from borrowers in the ordinary course of its business. The originator power of attorney will entitle Aurora to enforce the credit facilities, acting in the name of Sumitomo, following a Sumitomo insolvency or if Sumitomo is in breach of its obligations to collect and enforce the securitized loans (provided that the note trustee is satisfied that the breach is materially detrimental to the interests of the noteholders).

The Aurora CLO marks the first time a trust and irrevocable power of attorney have been used to de-link securitized assets in Europe (although Scottish lawyers might argue that the security trust used in securitizations of Scottish assets is at least a crude precursor of the Aurora trust technology). It offers away of securitizing receivables previously thought to be unsecuritizable because of restrictions on assignment contained in documents under which the receivables were created. Accordingly, the distinction under English law between an equitable assignment and a declaration of trust is important. While both an equitable assignment and a declaration of trust result in the assignee or beneficiary holding a beneficial interest in the receivables, in the case of an assignment of rights the right to sue the debtor is transferred to the assignee, whereas in the case of a trust over the credit facilities the beneficiary ordinarily may not sue the borrower in the beneficiary's own name. The distinction between an equitable assignment and a trust was most recently recognized in the case of *Don King Publications v Frank John Warren S Others* (1998) (now being appealed). A careful analysis of the assignment and transfer restrictions in the securitized credit facilities was necessary to ensure that they would accommodate the creation by Sumitomo of the originator trust and the originator trust deed.

#### Committed funding

One of the problems in structuring the Aurora transaction was how to fund Aurora's obligation to pay the advance further trust subscription price. If the proceeds of the A2 notes were deposited in the GIC accounts, the interest earned by Aurora would be insufficient to meet its corresponding interest payment obligations under the A2 notes. Funding the advance further trust subscription price by means of a commercial paper programme was rejected on various commercial grounds. The solution adopted was the repurchase by Aurora of the A2 notes coupled with the put agreement provided by NatWest. This solved this negative carry problem related to the A2 notes and afforded a substantial degree of flexibility for Aurora and Sumitomo.

The insolvency of Aurora and the appointment of a receiver over Aurora's assets as a result of its losses under the securitized credit facilities will not, by itself, release Aurora from its commitment to perform its obligation to Sumitomo to pay the advance further trust subscription price in respect of further advances under the securitized credit facilities. The deferred trust subscription price was sized on the basis of the entire amount of the undrawn facilities.

#### Hedging

In the European CLOs completed to date, where the originator bank transfers the commercial risks associated with a multi-currency loan portfolio by way of a sub-participation or credit-linked note arrangement (and accordingly where the credit of the originator bank is not de-linked from that of the securitized loan portfolio), the hedging tends to be undertaken at the level of the originator bank rather than at the level of the issuing vehicle. Thus payment obligations from the originator bank to the issuing vehicle under the sub-participation or credit-linked note will be denominated in the same currency as that of the notes issued by the issuing vehicle. In a de-linked securitization of multi-currency loans, however, where the issuing vehicle acquires a beneficial interest in the securitized loans, that approach will not work. Thus, Aurora's currency exchange and interest rate risks needed to be hedged effectively for atop-rated transaction and, because Aurora is a UK tax resident, the hedging arrangements needed to be tax efficient.

First, it was necessary to address Aurora's exposure to currency exchange rate risks in respect of amounts drawn by borrowers from time to time in a wide variety of non-sterling currencies (without hedges, Aurora would hold a large amount of non-sterling assets against sterling liabilities). Second, because a number of the securitized credit facilities have non-sterling base currencies, currency exchange rate risk arises in relation to a possible appreciation of one or more of these non-sterling base currencies against sterling followed by a borrower default (in sterling terms, the size of the loan which subsequently defaults has been inflated). Finally, interest rate and basis mismatches can arise in relation to the credit facilities and the notes. These various risks were hedged using a combination of market risk hedges and credit derivatives.

With respect to the first risk, a drawing swap agreement was entered into between Aurora and SBCM, under which Aurora and SBCM enter into currency swaps related to non-sterling advances under the securitized credit facilities. If these had been documented as simple currency swaps (ie if they did not contain embedded credit derivatives), then Aurora would remain exposed to exchange rate risk arising in respect of borrower defaults. Such a risk would materialize if, for example, a non-sterling currency appreciated against sterling between the time an advance was

made in that currency and the time the borrower defaulted. In this event, Aurora would be obliged to purchase the non-sterling currency at the then prevailing spot rate to make its forward payment to SBCM in respect of that advance, which would cost more in sterling than Aurora initially paid to SBCM for the non-sterling currency when the advance to the borrower was made. Accordingly, the drawing swap agreement provided that under these currency swaps, in the event of a default by a borrower under a credit facility, no further amounts would be required to be paid by either Aurora or SBCM except in respect of recoveries made from the borrower within the interest period in which the default occurs.

With regard to the second risk, Aurora and SBCM entered into a contingent forward agreement under which, in the event of a borrower default under a securitized credit facility with a non-sterling base currency, Aurora would receive from, or make to, SBCM a payment which would ensure that the maximum net effect of the default to Aurora would be the sterling equivalent of the base currency equivalent of the drawn balance, calculated at the sterling/base currency spot rate in effect at the closing date.

The final risk was hedged using basis swap agreements under which Aurora pays to SBCM sterling interest received under securitized credit facilities, from the GIC accounts and under drawing swaps and receives sterling Libor note interest.

#### Set-off

In the Aurora transaction, as in many CLOs, it was necessary to address the risk of a borrower exercising rights of set-off against the originator bank. These rights can arise in respect of deposits placed by the borrower with the bank or in relation to swaps or other transactions entered into between bank and borrower, and can have the effect of reducing the amount owing by the borrower under securitized loans. In pre-Aurora non-de-linked European CLOs-- where a sub-participation or credit derivative was used to transfer the commercial risk of the securitized loan portfolio--the set-off risk effectively was absorbed by the originator banks. In other words, a bank's obligation to make payments to the issuing vehicle under the sub-participation or credit-linked note would not be reduced by borrower set-off rights. In rating these transactions, of course, reliance was placed on the creditworthiness of the originator bank.

In the Aurora transaction, however, a comprehensive asset review and set-off and insolvency analysis was necessary to achieve top ratings for the class A notes. The result was relatively straightforward. Most of the securitized credit facilities contained waivers by the borrowers of their set-off rights. As for the few credit facilities which lacked effective set-off waivers, Sumitomo's exposure to those borrowers was sized and, following closing, Sumitomo gave notice of the creation of the originator trust to all borrowers whose credit facilities had been securitized. The giving of this notice limited the accrual of future set-off rights in respect of the credit facilities which did not contain effective set-off waivers. In the case of all of these credit facilities a Sumitomo insolvency ordinarily would give rise to the statutory application of mandatory set-off rules which would override contractual waivers of set-off. The creation by Sumitomo of the originator trust, however, destroyed the mutuality between Sumitomo and the borrowers required for the application of those rules.

#### Regulatory capital

The Aurora structure should support regulatory capital relief for 100% risk-weighted drawn as well as 50% risk-weighted undrawn advances under principles applied by regulators in a number of jurisdictions. The originator trust creates in favour of the issuing vehicle a beneficial interest in the securitized assets and, accordingly, should be regarded as an effective transfer technique for drawn loans for regulatory capital purposes. With regard to undrawn loans, a simple commitment from Aurora, a 100% risk-weighted counterparty, to fund future drawings would not help achieve regulatory capital relief. On the other hand, a direct commitment from a 20% risk-weighted counterparty to fund undrawn loans would assist. The Aurora structure, by various security devices and covenants, effectively provided to Sumitomo the benefit of Nat West's committed funding obligations under the put agreement and, accordingly, supports the reduction of the risk-weighting on undrawn loans under the securitized credit facilities to 10%.

[Author note]



Marke Raines of Allen & Overy London, English legal advisers to The Sumitomo Bank, London, in connection with the Aurora CLO.