Balance Sheet Synthetic CDOs

Balance sheet synthetic collateralized debt obligations are often used by Japanese financial institutions to mitigate credit risk. However, this structure involves significant legal issues in Japan that must be considered before commencing such transactions.

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In securitization transactions, some originators use structures that do not involve actual assignments of their assets to a special purpose vehicle (SPV) and instead only transfer the credit risk of their asset portfolios using such financial tools as credit default swaps or guarantees, while having similar characteristics as asset-transferring securitizations for the benefit of investors. Structures that transfer the credit risks of loans or bonds are known as synthetic collateralized debt obligations (synthetic CDOs). Those backed by loan receivables are known as synthetic collateralized loan obligations (synthetic CLOs) and those backed by bonds are called synthetic collateralized bond obligations (synthetic CBOs).

A synthetic CDO in which the subject assets are pre-owned by the originator (that is, are stated on the balance sheet of the originator) is generally known as a balance sheet synthetic CDO. These are predominantly utilized when the originators are financial institutions such as banks, and their primary purpose is portfolio risk management and/or regulatory capital relief (i.e., credit risk mitigation under the capital adequacy regulations).

The typical balance sheet synthetic CDO scheme

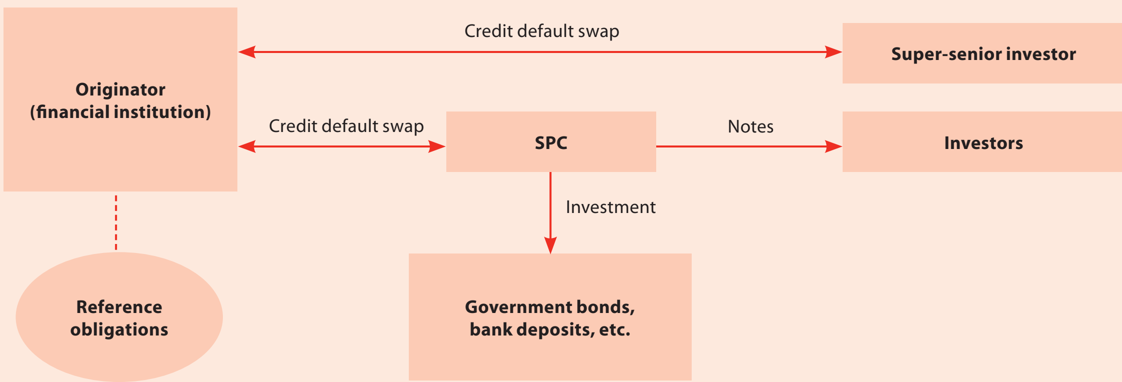
In a typical synthetic CDO in Japan, (i) a special purpose company (SPC) enters into a credit default swap or guarantee agreement with the originator and agrees to pay an indemnity to (or compensate for losses incurred by) the originator, if a credit event such as a loan default occurs in connection with the assets specified (to some extent) by a contract, thereby transferring the credit risks of such assets to the SPC in return for monetary consideration to be paid by the originator to the SPC, and (ii) the SPC will invest the proceeds of its notes or the like in government bonds or bank deposits.

In a typical balance sheet synthetic CDO structure using a credit default swap:

(i) The originator will enter into a credit default swap with the SPC in which the reference obligations are the loan receivables, etc. (subject portfolio) owned by the originator;
(ii) the SPC will be financed by investors through the issuance of notes;
(iii) the SPC will invest the note proceeds in low-risk investments such as government bonds or bank deposits (collateral);
(iv) during the term of the transaction, the originator will pay a premium, in one lump sum or in instalments, to the SPC pursuant to the credit default swap. The SPC will finance its service of interest payments on the notes to the investors using the premiums, together with payments received on the collateral;
(v) if a credit event specified under the credit default swap occurs relevant to the reference obligations during the term of the transaction, the SPC will be obliged to pay an indemnity to the originator in accordance with the credit default swap from the disposition proceeds of all or part of the collateral (such credit events generally include bankruptcy, failure to pay or restructuring);
(vi) when the notes issued by the SPC mature, the SPC will pay the principal of the notes to the investors with the disposition proceeds, or funds received, as principal repayments of the collateral then remaining; and
(vii) in deals where so-called super-senior tranches are created, the originator will separately enter into credit default swaps with other investors (super-senior investors), under which the reference obligations and other conditions such as credit events are the same as those under the credit default swap between the originator and the SPC, but the super-senior investors' obligations to indemnify the originator will arise only after the exhaustion of protections sold by the SPC to the originator.

This provides only a basic outline of a typical Japanese synthetic CDO and omits the details characteristic of these structures. In actual synthetic CDO transactions, various structures have been adopted depending on the needs of the relevant parties under each separate transaction.

Typical Synthetic CDO Structure



Synthetic CDOs and relief of regulatory capital

Under a synthetic CDO, because the originator does not actually assign any assets, off-balance treatment for accounting purposes with respect to the subject assets may not be granted to the originator. However, when the originator is a financial institution such as a bank subject to capital adequacy regulations, the originator may enjoy relief of the regulatory capital required with respect to its ownership of assets through mitigating the credit risk of such assets, in accordance with capital adequacy regulations, by utilizing a synthetic CDO. As described above, a balance sheet synthetic CDO is often adopted by a financial institution such as a bank, partly in order to achieve regulatory capital relief. Compared with a securitization in an assignment of assets, there are merits to a synthetic CDO such as the fact that, because the bank (as originator) need not actually assign its subject portfolio to any third party, (i) it will be possible to securitize even if the assignment of an asset or assets comprising the subject portfolio is contractually prohibited or restricted, and (ii) as the bank retains the capacity, as creditor, with respect to the assets comprising the subject portfolio even after the conclusion of the transaction, relations with obligors (i.e., bank's customers) will not be affected.

Recently, several balance sheet synthetic CDOs aiming to mitigate credit risk under the new capital adequacy rules known as the Basel II accord, which will apply to Japanese financial institutions from the end of March 2007 (for certain banks, from the end of March 2008), have been launched; in Japan, the rules of Basel II will be introduced, for banks, as part of the *Banking Code* and the Financial Services Agency Notification No. 19 of 2006 promulgated thereunder. Roughly speaking, in order to mitigate credit risk under the Japanese version of Basel II, it is necessary to satisfy the following requirements:

(i) The credit default swap between the originator and the SPC must satisfy certain requirements set out in the Notification, such as the requirement that credit events must include failure to pay, bankruptcy and restructuring (note that the definitions of these events under the Notification do not exactly match the definitions of the ISDA);

(ii) the collateral must be assets that qualify as "eligible financial instruments collateral" under the Notification;

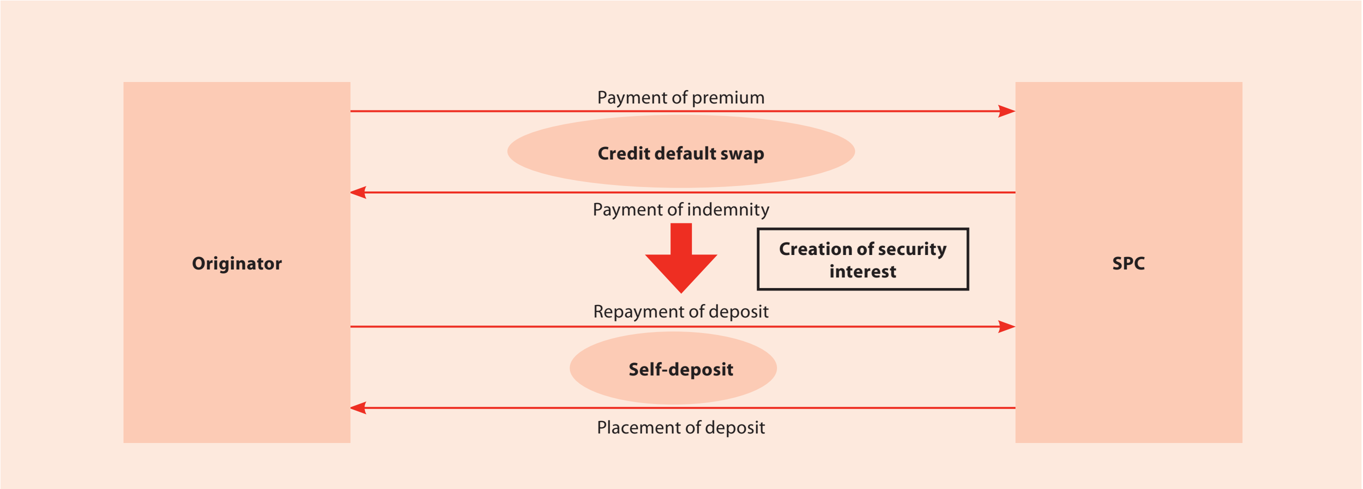
(ii) in order to secure payment obligations with respect to indemnity payments by the SPC to the originator, security interests that satisfy the requirements provided in the Notification need to be created for the benefit of the originator over the collateral; and

(iv) the overall structure of the synthetic CDO transaction needs to satisfy the requirements provided (although only implicitly) under the Notification.

With respect to a synthetic CDO transaction by depositary financial institutions such as banks, bank deposits to accounts opened with the originator (under the Notification, "self-deposits") are often selected as collateral because the deposits will result in the originator raising funds as part of the transaction. When the collateral are self-deposits, the form of security interest that satisfies the requirements of mitigating credit risk under the Notification is usually organized as follows (note that under Japanese law, security interest cannot be created over a bank account but rather over the SPC's contractual right to reclaim the amount deposited from the bank).

Main legal issues in mitigating credit risk under the Notification

A description of the main legal issues of the requirements under the Japanese version of the Basel II accord (specifically, the requirements provided in the Notification) when mitigating credit risk through a synthetic CDO transaction follows.



(i) No interruption of credit risk mitigation effect

Item 3 of Article 118 of the Notification provides that, in order to use credit derivatives as a technique for mitigating credit risk, except for a termination or suspension due to a failure of premium payments or where the treatment pursuant to sub-item (i) of Item 2 of Article 130 of the Notification is applied (see (iv) below), the effect of a credit risk transfer by a credit default swap cannot be interrupted or suspended. Therefore, in concluding a synthetic CDO transaction, if the credit default swap will or can be terminated due to an event other than a failure of premium payments, it should be carefully analyzed and determined whether the effects of the credit risk mitigation will still apply under the requirement listed in Item 3 of Article 118 of the Notification.

(ii) Scope of indemnity under credit default swap

Item 2 of paragraph 1 of Article 119 of the Notification provides that, when a guarantee is used as a technique for mitigating credit risk, the payment obligations of the relevant obligor (with respect to amounts other than the principal, such as interest and fees) must also be covered by such guarantee. However, the scope or range of the payment obligations that a credit derivative, as a technique for mitigating credit risk, should cover to indemnify is unclear under the Notification. In this regard, the Financial Services Agency of Japan once publicly stated its opinion that, when a credit derivative is used as a technique for mitigating credit risk, such credit derivative need cover the interest as well as the principal of a reference obligation. While there have been criticisms from among Japanese market participants, the scope of indemnification to be provided under a credit default swap needs to be carefully determined with this background in mind.

(iii) Definitions of credit events

Item 1 of Article 120 of the Notification provides that, in order to use credit derivatives as a technique for mitigating credit risk, payments of indemnity must be made in any of the following circumstances:

(a) A failure to pay an obligation with respect to the subject receivable (however, it is permissible to provide that the indemnity becomes payable only when the failure to pay invloves a payment exceeding a certain threshold);

(b) a decision to commence bankruptcy proceedings, rehabilitation proceedings, reorganization proceedings, an order to commence special liquidation or insolvency with respect to the obligor relevant to the subject receivable, or the existence of a document that certifies an extremely high possibility of default when the subject receivable becomes due, or other similar events; or

(c) in the case of a reduction or exemption, or payment deferral with respect to the payment of the principal of, interest on, or fees from the subject receivable, or that made for the purpose of a business turnaround or management assistance to the obligor relevant to the subject receivable.

In this regard, in order to mitigate credit risk by concluding a synthetic CDO transaction, the credit default swap between the originator and the SPC needs to provide for credit events the definitions of which satisfy these requirements. Therefore, if the credit events are required to be modified from the terms provided in Item 1 of Article 120 of the Notification for any business reason, it is necessary to consider whether modification would have any effect of mitigating credit risk under the Notification.

(iv) Matching the terms of maturity

Article 132 of the Notification provides that, if the remaining term of the adopted technique for mitigating credit risk is shorter than that of the exposure that is the subject of the credit risk mitigation, the effects of mitigating the credit risk will be adjusted and reduced in accordance with the calculation method prescribed in the

Notification. Therefore, in order to ensure that the full effects of mitigating the credit risk are felt, the maturity of the credit default swap (and the duration of the security interests over the collateral) is required to be equal to or longer than the remaining term of the assets comprising the subject portfolio.

On this point, sub-item (i) of Item 2, Article 130 provides that, if the protection provider holds the right to terminate or cancel the technique for mitigating the credit risk (e.g., a right to terminate a credit default swap before the maturity thereof), the maturity of the technique will be deemed to be only until the first day on which such right will become exercisable. Therefore, if the credit default swap provides the right of termination on the part of the SPC, it is necessary to consider carefully whether or not there could be a maturity mismatch between the terms of the credit default swap and the remaining terms of the reference obligations, which could result in limiting the credit risk mitigation effect recognized under the Notification.

In addition, sub-item (ro) of Item 2, Article 130 provides that, if a bank holds the right to terminate or cancel the contract on the technique for mitigating credit risk, and if the bank has appropriate motivation to terminate or cancel the contract prior to its maturity, the remaining term of the credit risk mitigation technique will be deemed to be until the first day on which such right will become exercisable. Therefore, in cases where the originator bank holds the right to terminate or cancel the credit default swap, it is necessary to consider whether the governmental agency would or could deem that the originator had the appropriate motivation to terminate or cancel it prior to maturity.

It should be noted that if the collateral has limited terms, like time deposits or government bonds, and if such terms are shorter than those of the subject portfolio, the maturity of the collateral might be deemed as setting the end of the term of the credit risk mitigation effect even in cases where security interests would somehow be recreated over alternative assets that are to become part of the collateral upon the maturity of the original collateral.

(v) Hierarchy of credit risk

Item 2 of Article 1 of the Notification defines a securitization transaction as "a transaction with at least two different ranked exposures that reflect different degrees of credit risk where part or all thereof is transferred to a third party". Therefore, if the credit default swap does not provide the first loss portion remaining for the originator and the notes issued by the SPC constitute only a single tranche, then there is the possibility that the credit risk of the subject portfolio would not be deemed to be multilayered and such scheme would not fall under the definition of a "securitization transaction", in which case regulatory capital relief might not be available.

(vi) Transfer of a significant part of the credit risk

Item 1 of paragraph 2 of Article 248 of the Notification provides that, in order for a synthetic securitization transaction's effect on mitigating credit risk to be recognized, "the significant part of the credit risk relevant to the subject assets needs to be transferred to a third party". As to the interpretation of "significant part", no concrete guidance has yet been publicized. Therefore, it should be noted that if, after the transfer of a portion of the credit risk relevant to the subject portfolio from the originator to the investors through a synthetic CDO structure, the government authority might determine that the significant part of the credit risk relevant to the subject portfolio remains with the originator, in which case no capital relief may be recognized.

Other significant legal issues for a synthetic CDO

Brief explanations of other significial legal issues with respect to synthetic CDOs besides those related to regulatory capital relief under the Japanese version of the Basel II accord are as follows.

(i) Applying regulations under the *Insurance Business Law*

A credit default swap between an originator and an SPC used in a synthetic CDO structure is considered similar to an insurance agreement in light of the fact that the originator could be indemnified for the loss of the subject portfolio it owns. Therefore, especially in a scheme that includes an SPC repeatedly and continuously entering into credit default swaps, the legal question arises of whether or not the SPC is subject to the regulations under the *Insurance Business Law*.

In such cases, it is necessary to conclude that the credit default swap agreements entered into by the SPC were not insurance policies. The rationale for this might include such factors as (i) the parties did not intend to conduct an insurance transaction but a financial one, and (ii) in the case of a credit default swap, a protection buyer could be paid the indemnity in accordance with the credit default swap even if the protection buyer does not actually hold the reference obligations and, therefore, the indemnity could be paid without any actual loss accruing to the originator, which contradicts the basic principle of insurance regulation.

(ii) Gambling

The issue has been raised of whether the conclusion of a credit default swap by an originator and an SPC as part of a synthetic CDO transaction falls under the definition of "gambling", as provided in Article 185 of the *Penal Code*. It could be argued that such transactions do not fall under the gambling definition because (i) the purpose of the transaction is appropriate, (ii) the originator, as one of the parties thereto, is permitted to conduct credit derivative transactions under business regulations in accordance with the *Banking Code* and the like.

(iii) Regulations under the *Financial Instruments and Exchange Law*

Under the *Securities and Exchange Law* currently being applied, the conclusion of credit derivative swaps and the intermediation of such transactions are not regulated by law or any regulations promulgated thereunder. However, under the *Financial Instruments and Exchange Law* that was passed on June 7 2006, the definition of "market derivative transactions" includes transactions for which it is agreed that one party shall pay money and, in compensation, the other party shall pay a certain amount of money if any event occurs that was provided for by the parties in advance and which is categorized as an event relevant to the credit conditions of legal entities, as well as events stipulated as being similar by cabinet order. Therefore, it should be noted that, when the *Financial Instruments and Exchange Law* becomes effective, both the conclusion and intermediation of a credit default swap will be subject to new regulations.

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