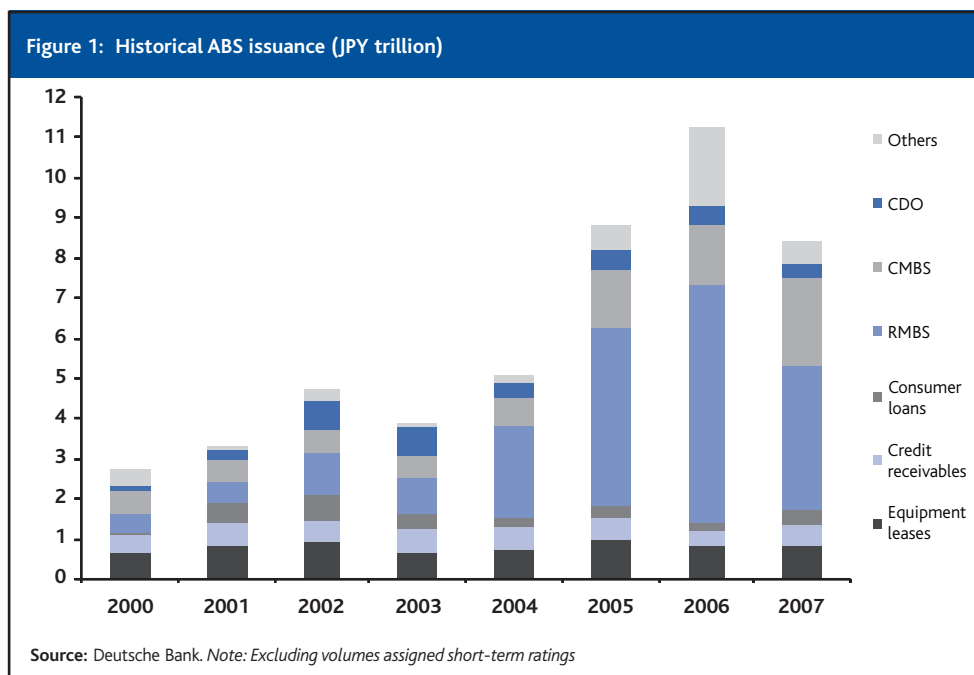


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Review and outlook of the Japanese securitisation market

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Issuance of Japanese securitised products in 2007 turned out to be ¥8.5 trillion, down 24 per cent on 2006. While such a sharp decline in issuance on an annual basis is unprecedented in the history of the Japanese securitisation market, last year's contraction in issuance is almost entirely attributable to a decline in new issue activity in the residential mortgage-backed securities (RMBS) sector, as two of the three largest originators (Bank of Tokyo-Mitsubishi UFJ and Sumitomo Mitsui Banking Corporation) substantially scaled back securitisation activity relative to 2006. The absence of mega-deals in 2007 was also evident in the supply numbers – while there was a ¥1.45 trillion (\$14 billion) whole business securitisation deal in November 2006, there were no such mega-deals in 2007. In 2007, we observed positive growth in some sub-sectors, including securitisation of consumer receivables and commercial mortgaged-backed securities (CMBS). As the investor base for Japanese securitised products is predominantly domestic real money investors such as deposit-taking institutions and insurance companies, many of whose behaviour has been little affected by the turmoil in the global financial markets, investor demand remains strong. Unlike in North America and Europe, where a substantial amount of securitised and structured products used to be absorbed by highly leveraged structured such as collateralised debt obligations (CDOs) and structured investment vehicles (SIVs), or those which are highly dependent on short-term money markets such as enhanced money market funds, in Japan holding of securitised products by such leveraged or structured entities was quite limited. For the coming year, we project a modest further decline in issuance, with annual issuance volume of between ¥7.5 trillion and ¥8 trillion.



Government enters the securitisation market

The Japanese government's first-ever asset securitisation was priced at T+37bp in February 2008. The first-ever securitisation of fiscal investment and loan programme (FILP) loan receivables by the Japanese government (specifically, the Ministry of Finance) was priced on February 22. The coupon of 1.83 per cent for the specified bonds – which have a scheduled maturity of 10 years – translates into a spread of 37bp over the comparable secondary-market Japanese government bond (JGB) yield, which appears somewhat wide when one considers that 10-year bonds issued by the Development Bank of Japan and the Japan Housing Finance Agency around the same time (FILP agency bonds that do not carry a government guarantee) were launched at spreads of around T+21bp. This relatively wide launch spread would appear to reflect both a 'novelty premium' and the fact that the final redemption date can be postponed by up to two years (which is not the case for JGBs or FILP agency bonds).

The FILP Master Trust issue is aimed at reducing the national government's interest rate risk and paring back

government-owned assets. The funds raised via the issue by the Ministry of Finance's Financial Bureau are to be used to buy back and retire Japanese government bonds that are currently held by the Bank of Japan, thereby reducing interest rate risk at the national level. In our view, this strategy is perhaps somewhat questionable from the perspective of economic rationality, as the funds that will be used to retire JGBs were raised at a considerably higher cost than typically applies to government-owned corporations when raising funds via their own bond issues. However, the issue also aims to slim down Japan's balance sheet. Consider an analogy with consolidated corporate accounting. Securitising loans to special government-affiliated corporations, independent administrative agencies and other 100 per cent government-owned entities clearly does nothing to reduce assets at the consolidated level; but because the funds raised via the FILP Master Trust transaction will be used to purchase and retire bonds held by the Bank of Japan, the deal does in fact (albeit perhaps unintentionally) serve to

slim down the central bank's balance sheet. The relatively wide launch spread would appear to reflect both a novelty premium and the fact that the final redemption date can be postponed by up to two years (which is not the case for JGBs or FILP agency bonds).

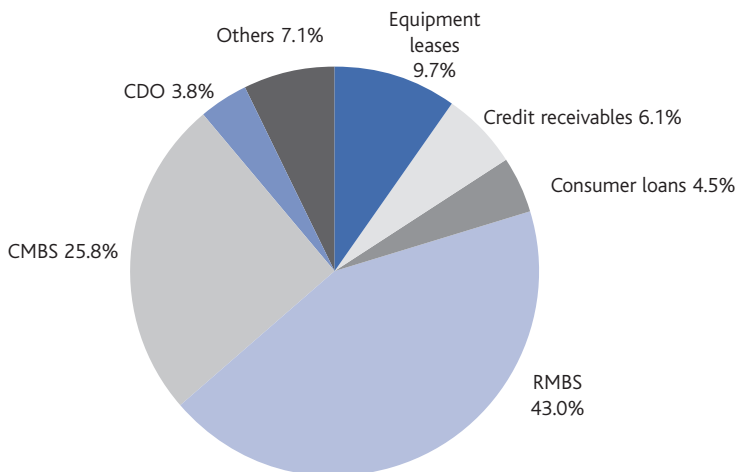
Reconsidering Japanese SME securitisations

In the SME space, the Tokyo metropolitan government announced on March 26 2008 an additional equity injection of ¥40 billion to ShinGinko Tokyo, a now-struggling bank established by the metropolitan government in April 2005 to provide operating funds to small and medium-sized enterprises (SMEs). There have been some indications that investors may be steering clear of securitised products backed by SME loan receivables, but it is unclear whether this is attributable to ShinGinko Tokyo's non-performing loan problems or general credit concerns. Indeed, according to a monthly survey by Japan Finance Corporation for Small and Medium Enterprises (JASME), the ease of borrowing diffusion index – which was at elevated levels from

2005 through 2006, indicating that financial institutions were particularly keen to lend to SMEs – has declined slightly, revealing a growing reluctance to lend to SMEs. A number of major banks launched score-based SME lending programmes in 2001 and 2002.

While competition was fierce in 2005 and 2006, since mid-2006 these programmes have not been as available, making it more difficult for smaller businesses to raise funds. This has contributed to an increase in corporate bankruptcies. There is a possibility, in our view, that default rates on SME pools may rise in the near term. That said, typical products backed by SME loan receivables have a senior/subordinate structure or some other credit enhancement mechanism that shelters securitised product investors from losses even if underlying pool losses are seven or even 10 times higher than anticipated. As such, a default rate that is two or three times higher than originally expected should not be of particular concern to investors unless there has been a major misjudgement on the part of a product's designer or the rating agency that assigned its credit

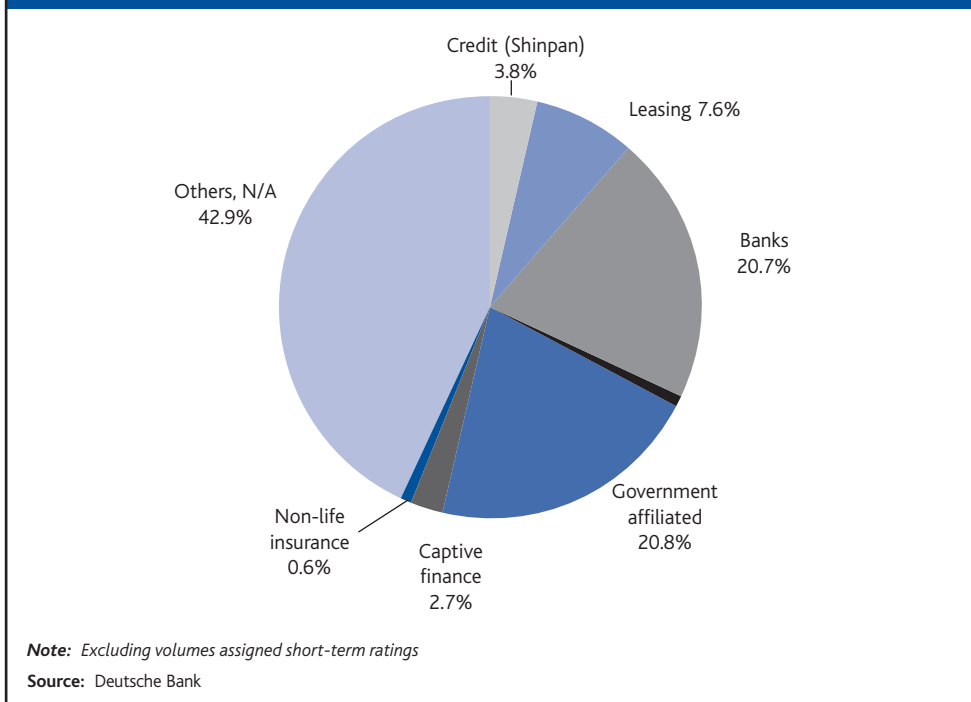
Figure 2: Breakdown by asset type (2007)



Note: Excluding volumes assigned short-term ratings

Source: Deutsche Bank.

Figure 3: Breakdown by seller industry (2007)



rating. Such is the case of CBO All Japan (Bloomberg ticker CBOALL Corp), a securitisation issued in March 2006 of bonds issued by Japanese SMEs. The default rate of the underlying pool has consistently been more than 10 times higher than the rating agency’s initial expectation (base default rate). In this case:

- the rating agency was highly inaccurate in its default forecast; and
- the product was designed with an extremely and unusually aggressive level of credit enhancement (whereby the rating agency conferred a triple-A rating on a tranche with a subordination ratio of less than 5 per cent).

Prospective investors in SME loan securitisations obviously need to consider a variety of factors, including the potential for losses on underlying assets and aspects

of product design that may help to mitigate the impact of such losses (including senior-subordinate structures, provisions for the use of excess spreads, and the existence and scope of third-party guarantees from credit guarantee associations or similar entities). Additionally, investors should evaluate the effective level of credit enhancement and the likelihood of actual losses exceeding this effective level of credit enhancement. We feel that there is no need to shun all securitised products backed by SME receivables due to concerns over headline risk.

Why has the performance of Japanese residential mortgages not deteriorated?

High debt-to-income (DTI) housing loans to individuals with relatively poor creditworthiness are very rare in Japan. The distinction between prime and sub-prime is not typically used in the context of the Japanese

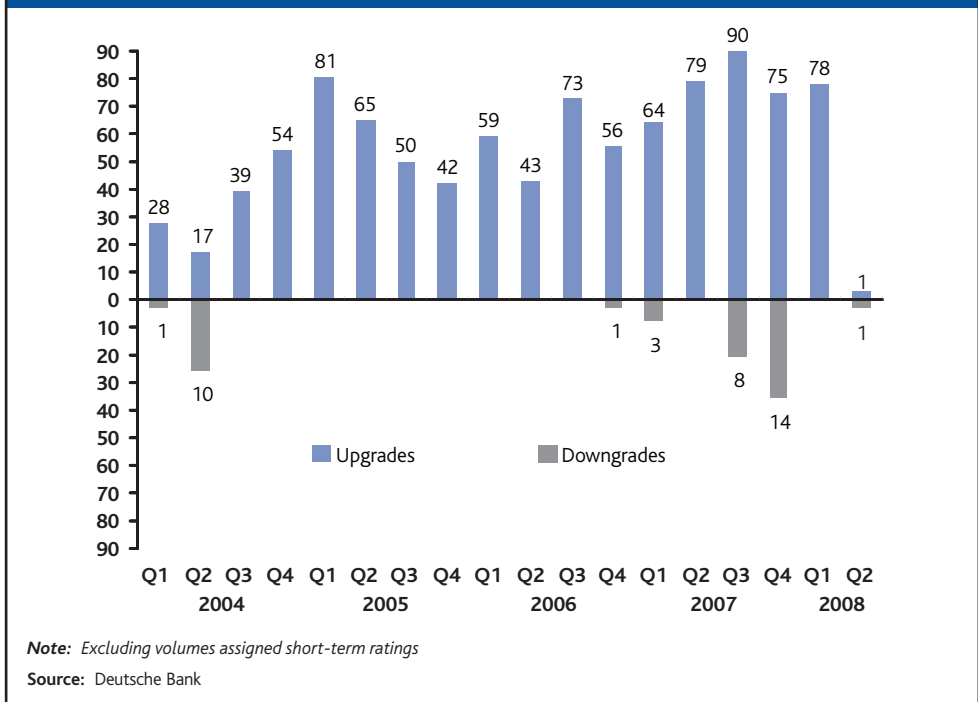
housing loan market, but the vast majority of Japanese loans would perhaps be considered prime in the United States and in fact have probably been outperforming their US counterparts in recent months.

Japan experienced a prolonged decline in residential land prices during the 1990s. Moreover, the market for previously occupied housing is less developed in Japan than in the United States or many European countries, with newly built properties typically depreciating in value over time. For these reasons, mortgage lenders tend to emphasise debt repayment capacity over collateral value when screening prospective borrowers. Most lenders set a 25 per cent upper limit on DTI ratios. Cash out refinancing is not generally available in Japan, which means that most borrowers tend to use loans to purchase properties or to refinance existing loans without increasing the loan balance.

In the United States, we understand that the practice of not requiring documentary evidence of an applicant’s income in loan underwriting (‘stated income’ or ‘no doc’, or more commonly referred to as ‘liar loans’) was widespread. Japanese mortgage lenders almost always require documentary evidence of income. Some US states such as California have a *de facto* non-recourse system (due to the so-called ‘one form of action’ rule), whereby debts are waived in full following disposal of collateral property; but Japan has no such system or practice. Borrowers will be legally and practically liable for any deficiency even after their properties are foreclosed – which probably means that Japanese borrowers have a strong incentive to repay their loans even if housing prices fall sharply.

Downgrades of US securitised products during 2007 amounted to approximately \$300 billion, well above the

Figure 4: Upgrades / Downgrades of Japanese ABS (number of tranches)



previous all-time high of \$142 billion in 2003. Sub-prime RMBS and CDOs backed entirely or partially by sub-prime RMBS (ABS CDOs) accounted for some 95 per cent of last year's downgrades. By way of contrast, no Japanese RMBS product has been downgraded since 2002 and only two RMBS issues have been downgraded in the entire history of the Japanese securitisation market.

Investors now back in the driver's seat

The typical Japanese investor in securitised products is a financial institution investing on its own account and following a buy-and-hold strategy focused on medium to long-term income gains rather than attempting to profit from short-term price fluctuations. The investor base has expanded somewhat since the so-called 'value at risk' shock of late 2003 – when a sharp rise in secondary-market JGB yields saw financial institutions with large investments in longer-term JGBs facing sharply higher value at risk levels and large unrealised losses – to encompass regional lenders as well as the big city banks, which in our understanding is attributable to domestic financial institutions shifting into credit products (eg, corporate bonds and securitised products) offering higher yields than JGBs with shorter durations. Over the past

few years we have frequently heard dissatisfied mutterings from domestic institutional investors frustrated by unattractively tight credit spreads, and the period from 2003 through early 2007 was indeed characterised by a trend towards tighter spreads throughout credit markets both at home and abroad. This seller's market finally appears to be coming to an end, however, with credit spreads having widened sharply in overseas markets and some of the world's largest financial institutions facing higher fundraising costs and a reduced capacity to take on risk. With investors likely to remain in the driver's seat for some time to come, we believe that this may be an ideal opportunity for buyers (risk-takers) to push for greater transparency and fuller post-issuance information disclosure from securitised product originators, arrangers and marketers. Indeed, given that domestic financial institutions are still awash with surplus funds (by virtue of deposits continuing to exceed outstanding loan balances), investors should take this opportunity to make their voices heard by issuers/originators and underwriters.

This chapter is taken from previously published Deutsche Bank research.