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STANDARD & POOR'S

Global Structured Finance

ViewPoint

Going Strong And Gaining Momentum

Cover and Interior Illustrations by Sally Vitsky

Built On A Strong Foundation, Structured Finance Is Expanding Worldwide

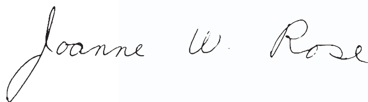
Fifteen years ago, few could have predicted the incredible growth of the structured finance market and the prestige it commands today. Much of that development is built on the strong, fundamental foundation that was created by those who invested in the market's transparency.

Indeed, structured finance has become the financing tool of choice for an ever-broadening array of global issuers. Whether in the form of securitisation, complex derivatives, or other types of financial engineering, structured finance's ability to isolate complex credit risks provides critical value to both investors and issuers. That value nurtures deeper market sophistication, which in turn leads to new types of transactions, customisation, even greater financial efficiency—and globalisation, a trend too large to ignore. Markets throughout the world are gathering momentum, and the newer markets aren't just adapting structures originated in the U.S. Investors and issuers are making their own statements, as we explain in this issue of ViewPoint, with stories on Australia, China, Germany, India, and Japan, among others.

As with any expanding industry, leadership is paramount. Our role in the structured finance market is built on two pillars—credibility and service. Credibility comes from the performance of our ratings over time—a topic we explore in this ViewPoint—and is built slowly, but could also be lost quickly. Service means delivering the most informative ratings and other credit-risk evaluation offerings at the time and in the manner that the markets need them.

I'm very excited about the long-term prospects of Standard & Poor's Ratings Services structured finance ratings. Governments, regulators, financial institutions, and corporations all over the world are seeing the benefits of structured finance. And why not? Structured finance has proven to be a reliable, highly flexible financing tool.

Sincerely,



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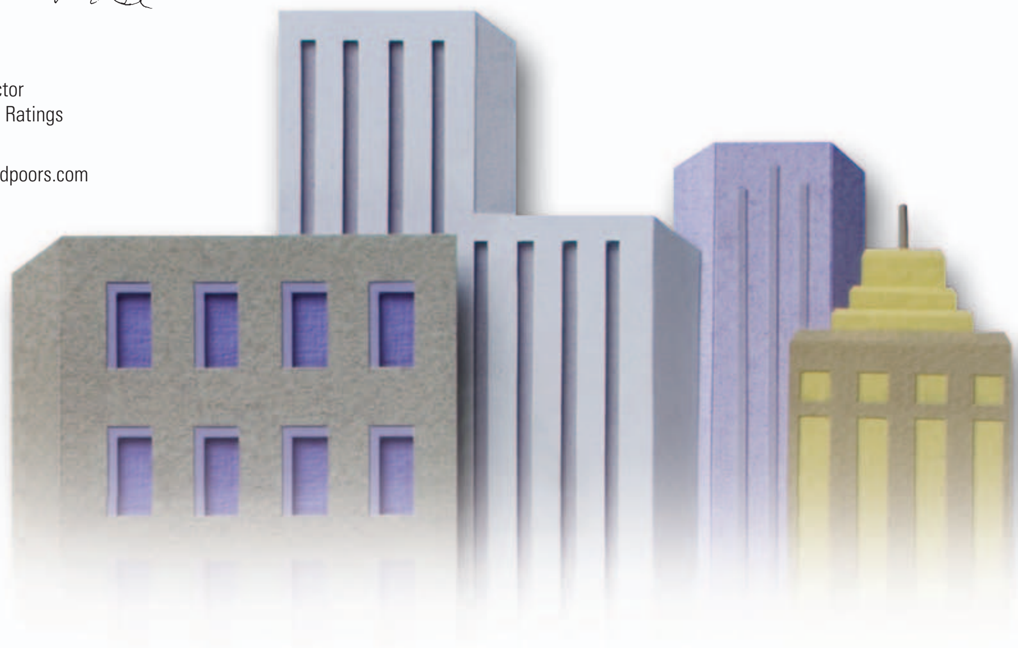

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Why Structured Finance Ratings Can Change Over Time

Some market participants perceive a paradox in the ratings assigned to structured finance securities: If the initial rating is already meant to reflect future risks over a security's lifetime, why should it ever change post-issuance? Actually, rating actions during the security's life are neither inconsistent with the philosophy of the initial rating nor an acknowledgement that the rating was "wrong."

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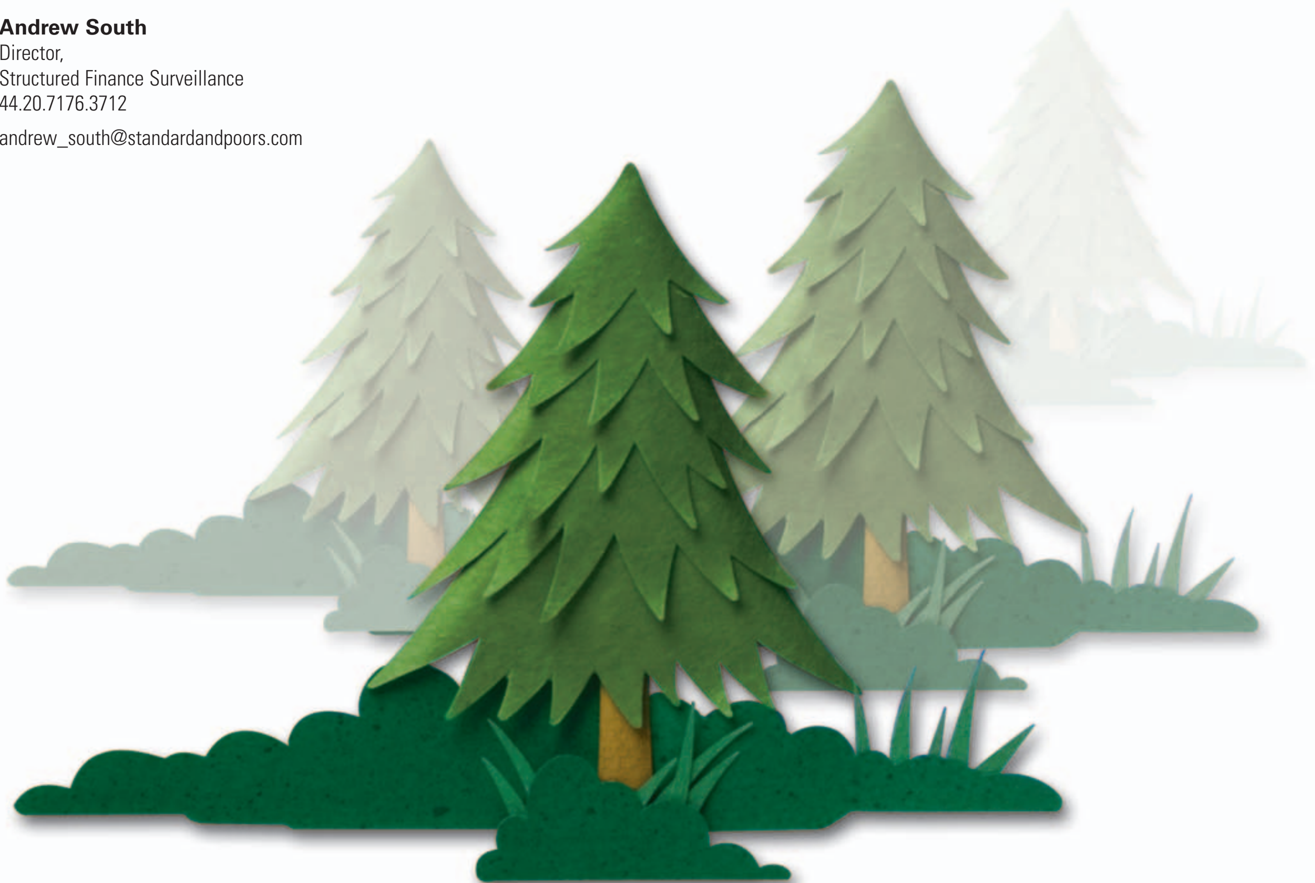
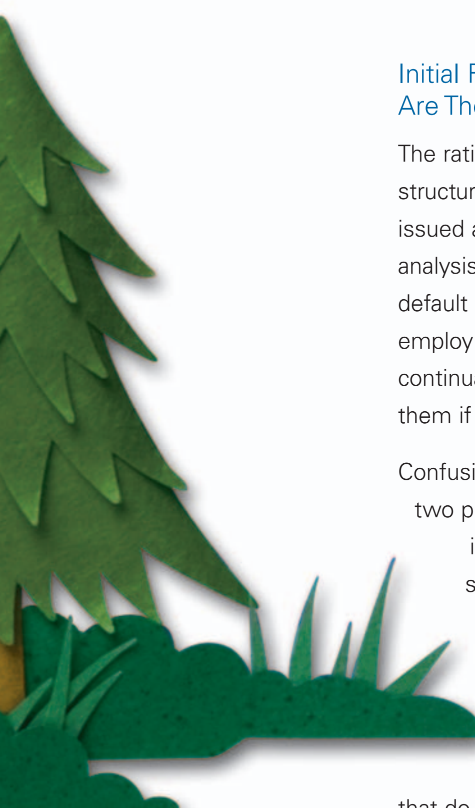




Initial Ratings Versus Surveillance: Are The Philosophies Aligned?

The ratings that Standard & Poor's assigns to structured finance tranches when they are issued are based broadly on a forward-looking analysis of the likelihood that those tranches will default over their lifetimes. However, we also employ dedicated surveillance teams, which continually review these ratings and update them if necessary.

Confusion sometimes arises over how these two philosophies can work together. If the initial rating analysis is forward-looking, should the range of possible future performance issues not have been foreseen and factored into the initial rating? If so, would this not negate the need for any post-issuance rating actions? Are rating actions that do occur therefore effectively a "correction" to the initial rating, or an admission that the initial rating was "wrong"?

To answer these questions and understand how rating actions arise, it's important to understand the principles of both the initial rating analysis and the approach applied by our surveillance teams when reviewing ratings after closing.

Initial Rating Analysis Doesn't Forecast Expected Performance

A common misconception is that our initial rating analysis involves forecasting an expected trend, or base case, for key performance variables, and that the surveillance analysis is then based on comparing actual performance against these forecasts. While appealing in its simplicity, this is, in fact, not the case.

Structured finance transactions contain many "moving parts" and require many variables to describe their performance. For example, the performance of an RMBS tranche might only be described by a combination of data on delinquencies, foreclosures, recoveries, prepayments, and credit enhancement.

Arriving at a forecast for each of these variables would be challenging enough. Even then, however, it would be impossible in a surveillance analysis to compare actual versus forecast performance for this multi-dimensional array of variables and consistently arrive at a "net" view of whether performance was better or worse than expected. In the RMBS example, what if delinquencies and foreclosures were higher than forecast, but recoveries and credit enhancement were higher too? Would this warrant a downgrade or an upgrade?

In fact, our initial rating analysis is generally not concerned with forecasting expected levels for any performance variables. On the contrary, the analysis models a wide *range* of possible future values for different variables in many different scenarios. The aim is to ensure that all conditions that might combine to cause stress in the transaction are covered by the analysis. We analyse how statistically extreme the economic scenario has to be before the tranche under analysis fails to pay either timely interest (if applicable) or ultimate principal: the more extreme, the less probable, and the higher the rating that can be assigned.

Rating Actions May Be Necessary To Reflect Changes In The Transaction

So, if there are no forecasts against which to benchmark actual performance as it evolves, what are the principles behind the surveillance analysis? Our surveillance approach simply reapplies the principles of the initial rating analysis, but on an ongoing basis. The initial rating analysis is in one sense dynamic, since it's forward-looking and investigates whether the tranche will default at some point in the future. In another sense, however, the analysis is static, since it's informed by a "snapshot" of the collateral pool and the liability structure at closing. In surveillance, it is this snapshot—the starting point for the analysis—that is regularly updated as the collateral pool and liability structure evolve over time.

Actual changes in the collateral pool's credit quality may alter the future likelihood of various stressful economic scenarios arising. For example, in a collateralised debt obligation (CDO) transaction, deterioration in ratings on the underlying corporate obligors means that the chance of the portfolio suffering a given level of losses has increased, potentially lowering the rating on the CDO tranche.

With regard to the liability structure, actual changes may alter a transaction's ability to survive a stressful scenario. For example, in an RMBS transaction, prepayments and note amortisation may have significantly increased the credit enhancement available to the tranche in question, making it less vulnerable to default and potentially raising its rating.

The rating level appropriate for any tranche may therefore change as the collateral pool and liability structure evolve, and this is what gives rise to rating actions.

A Rating Action Doesn't Mean The Initial Rating Was "Wrong"

As discussed above, the initial rating on a tranche is driven broadly by an assessment of future default probability: a statistical concept. The interpretation of subsequent rating actions is, therefore, also best viewed in a statistical context.

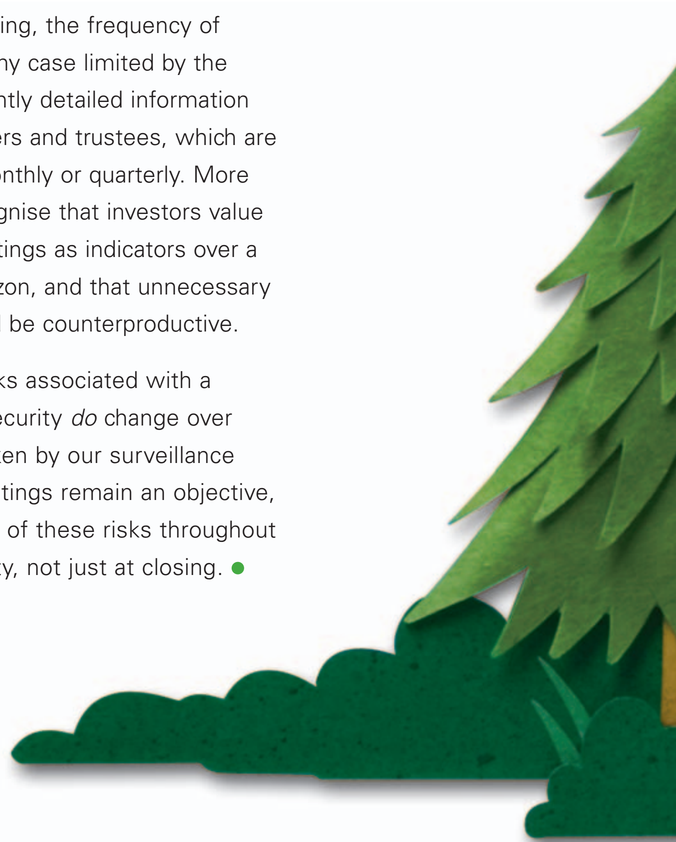
Consider 1,000 tranches from a cross-section of vintages, each with a 10-year maturity and an initial rating of 'BBB.' For each of these tranches, the 'BBB' rating implies a lifetime default probability of about 2%. Now, assume that—sure enough—20 of the tranches (or 2%) do indeed default over their lifetimes. This demonstrates that, on an averaged basis, the initial ratings were appropriate. Crucially, however, this observation applies *regardless* of how many rating actions occurred during the tranches' lives. In other words, rating actions cannot be viewed as a comment on the validity of the original rating.

The fact that our sample 1,000 tranches are assigned the same rating at closing is never intended to suggest that they will perform similarly over time. Rather, it gives an indication of how many on average are expected to default. Of the remaining tranches, some might ultimately perform strongly, others poorly, depending on transaction-specific factors and the economic circumstances at the time. This is to be expected and is entirely consistent with our initial rating analysis. Rating actions performed by our surveillance teams simply capture these performance differences as they occur.

Avoiding Unnecessary Rating Volatility

Where secondary markets are sufficiently developed, credit spreads on structured finance securities may fluctuate frequently, even on a daily basis, in part reflecting changing risk perceptions. There is no suggestion that it would be appropriate for ratings to do the same. For one thing, the frequency of rating reviews is in any case limited by the frequency of sufficiently detailed information updates from servicers and trustees, which are typically provided monthly or quarterly. More importantly, we recognise that investors value structured finance ratings as indicators over a reasonable time horizon, and that unnecessary rating volatility would be counterproductive.

All the same, the risks associated with a structured finance security *do* change over time, and actions taken by our surveillance teams ensure that ratings remain an objective, transparent measure of these risks throughout the life of the security, not just at closing. ●



Foreign Investors Are Adding Fuel To The Red-Hot U.S. RMBS Market

The meteoric rise of the U.S. residential mortgage-backed securities (RMBS) market over the past few years has been nothing if not extraordinary. With so much supply and the growing appeal of these securities, foreign investors are increasingly filling the demand, much to the benefit of U.S. mortgage issuers.

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The drivers of the U.S. RMBS market's uninterrupted growth have been no secret: low interest rates, rising home price values, innovative lenders, and an insatiable demand for mortgage credit from homebuyers and homeowners. The result has been a historic pattern of issuance from a healthy US$135.9 million in 2000 to a breathtaking US$1.1 trillion in 2005.

In addition to demographic and macroeconomic factors, a receptive securitisation market has greatly facilitated funding for mortgage issuers. Huge investor demand for RMBS and other "spread product," or financial instruments that trade based on quickly shifting spreads, has caused extremely tight spreads and reduced funding costs in spite of heightened risk factors, such as a softening real estate market, volatile interest rates, and stretched underwriting quality.

Enter the international investors. Flush with cash from improving economies and hungry for the increased yield found in U.S.-issued spread product, which has provided relative value and diversification away from their local regions, international investors are bolstering U.S. domestic demand by increasing market liquidity.

The "flattening" effect that international buying has contributed to the U.S. Treasury market's yield curve has been well documented, with some experts reporting as much as a 50-basis-point (bp) to 75-bp dampening on the long end of the curve. But what has gone underreported has been the effect of foreign buying on the tight spreads and added liquidity for U.S. RMBS issuers and other sellers of spread product.

Demand Is Ready To Meet Supply

Although U.S. home equity issuance through the second quarter of 2006 is up 29% over 2005, the boost hasn't been significant enough to satisfy investor demand. New issues have been oversubscribed and spreads are pushing tighter. Home equity spreads have steadily narrowed since the start of 2006, with 'BBB-' rated classes pricing at one-month LIBOR plus 190 bp. Some market watchers expect spreads to grind even narrower in the short term, perhaps as tight as 175 bp over LIBOR. And despite more conspicuous housing-market risks and the increasing influence of the synthetic market (which has given potential buyers alternative means to participate in the RMBS market), these spreads have remained fairly stable over time.

The scarcity of any so-called "real money" players in this market and the bid for RMBS from collateralised debt obligation (CDO) structurers have been well established, with some estimates suggesting that these vehicles are purchasing 80%-90% of home equity loan mezzanine pieces ('A' through 'BB' ratings). But the emergence of widespread demand from international investors is certainly doing its part to keep spreads tight.

As international investors have stepped up purchases of U.S. spread product, their demand for U.S. Treasuries has softened. It is estimated that international investors bought $82 billion fewer Treasuries in the first quarter of 2006 than they did in the same period of 2005. As these investors looked away from Treasuries, they've started to shift into RMBS, agency obligations, and corporate debt. International RMBS purchases in the first quarter of 2006 were $29 billion ahead of the pace set a year ago.

Converging global financial markets have made it easier for investors to take advantage of differentials in relative value. Those who can buy across currencies and jurisdictions are scouring the global markets for the best opportunities. And right now, those opportunities appear to be in the U.S., even with current spreads bumping up against historically tight levels. While the relative value of these prospects may be obvious, it still takes time for investors to get comfortable with a new market. That education is taking place, and as investors' comfort levels grow, so too will their appetites, keeping spreads in line with their current levels and demand ready to meet supply.

Opening A Dialogue With Foreign Investors

Standard & Poor's, in response to the increase in global demand, hosted its Inaugural Global RMBS conference in London in May 2006. Analysts from our regional offices presented to a large gathering of European institutional investors seeking to better understand our analytical approach trends in the various housing and securitisation markets, including those of the U.S., U.K., Australia, Canada, and Latin America.

All aspects of the U.S. securitisation market were open for discussion between Standard & Poor's and European investors, including origination platforms, new issuance rating methodology, servicing, and surveillance. For instance, foreign structured investment vehicle (SIV) investors focused on the net WAC cap considerations that create embedded interest rate caps, to which the SIVs cannot be exposed when purchasing securities.

Net WAC caps restrict the amount of interest a securities holder may receive in a particular period. Many U.S. RMBS transactions contain a fundamental mismatch in assets and liabilities. Mortgage loans may be fixed rate or based on an index such as six-month LIBOR, while the securities issued may be floating rate based on an index such as one-month LIBOR. Thus, if the weighted average net mortgage rate received in a period (after swap payments and servicing, trustee, and administrative fees have been deducted) is less than the pass-through rate promised to a securities holder, the coupon payable will be capped at the net WAC cap. Standard & Poor's U.S. RMBS ratings address timely payment of interest (at the lesser of the pass-through rate and the net WAC cap) and ultimate payment of principal (by the legal final maturity date). Recent structured product innovations, including repackaging the securities and synthetically hedging interest rate exposure to the net WAC caps through swaps, have allowed SIVs to enter the U.S. RMBS market.

Investors at the conference also expressed interest in Standard & Poor's U.S. loan-level collateral analysis, which captures "credit drift" and changes to underwriting guidelines. Through an ongoing dialogue with originators and issuers, we remain apprised of new product developments and devise criteria for inclusion in rated securitisations. Moreover, when new products contain limited historical data, we perform simulation analysis during criteria development, monitor actual performance, and review our methodology on a continuing basis. Standard & Poor's explained that it models proposed structures to final maturity, not to the first optional termination date, when determining our ratings.

U.S. servicing practices, which are closely monitored by our Servicer Evaluation Group and reflected in the servicer rankings, are also a source of foreign-investor focus, according to feedback gathered during meetings with European investors after the conference. Investors were specifically interested in vintage, product, and issuer-specific performance. Standard & Poor's U.S. RMBS Surveillance Group tracks transaction performance data monthly and discusses potential concerns with our U.S. RMBS new issuance group. Through joint efforts, criteria may be implemented or modified to address current and expected market trends.

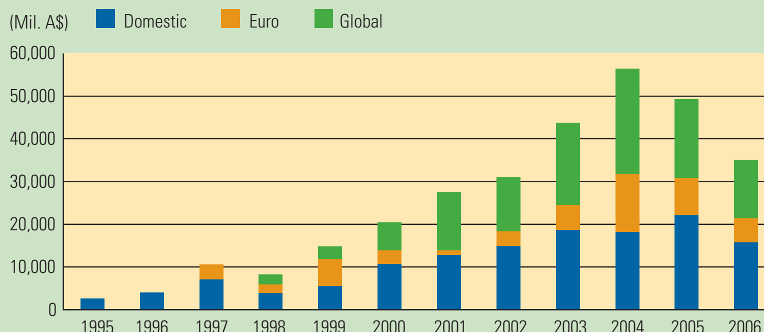
Increased Market Liquidity Is Beneficial For Many

Clearly, increased liquidity for issuers benefits consumers and housing markets across the globe. These benefits have also contributed to the rising level of worldwide home ownerships rates as increased liquidity has worked to help keep global mortgage interest rates low. Although global investors are still learning and gathering information on U.S. markets, unless there is any significant macroeconomic disruption, it appears that cross-border placement of U.S. RMBS product is here to stay.

Australian RMBS Is Finding A Home With Offshore Investors

The demand from offshore investors for highly rated Australian RMBS has increased significantly over recent years. Spreads are hovering around historic lows with most deals heavily oversubscribed. The interest is coming from U.S., European, and Asian investors. Over 60% of Australian RMBS deals, by volume, are now cross-border deals placed in the global or European markets. A further development has been the rapid increase in demand from offshore investors for the higher yielding A$ denominated tranches compared to US$ and euro tranches. Often, around two-thirds of the senior tranches of Australian domestic deals are placed with offshore investors. The chart outlines the issue volumes of Australian RMBS in each market; 2006 refers to issuance through July.

Australian RMBS Issuance Per Year



Australian RMBS only represents a small proportion of RMBS offered in offshore markets. The relative value of Australian RMBS for offshore investors is that it provides diversity and wider spreads than European and U.S. RMBS. In addition, the performance of the underlying mortgages (prime and subprime) has been exceptional. Issuers are also prepared to structure deals to recognise the specific needs of investors. For example, investors in global RMBS deals tend to prefer vanilla structures, whereas investors in other markets may have specific preferences such as super-senior structures, multiple sequential pay senior tranches to create different expected weighted lives, loan substitution periods, senior tranches denominated in different currencies, and money market tranches. Average deal sizes are also increasing, which creates more liquidity in the paper.

Australian RMBS has not tested the waters for lower rated tranches in offshore markets. Subordinated tranches are generally offered domestically. The current challenge for Australian issuers is to demonstrate relative value in lower rated tranches to create a deeper market for this paper. This could encourage more issuers to reduce their reliance on the first loss credit support of highly rated lenders and mortgage insurers in prime RMBS deals. ●

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Germany's Robust Real Estate Market Fuels CMBS Issuance

Investment in Germany's real estate market is exceeding almost all predictions. Supply of commercial properties is high, and demand for them even higher. Not only are technicals driving this growth, but the market's fundamentals are good also. The knock-on effects of this investment growth are multiple, and none more so apparent than in the related CMBS market.

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An interdependence between demand and supply of real estate is now apparent in the German property investment market. Because fundamentals are considered strong, global investors are eager to move in. Equally, this interest—and the market's high liquidity—has enabled property owners to sell at relatively high prices, thereby creating a robust supply of real estate.

The area seeing the bulk of this investment growth is portfolios of properties used for multifamily housing. Furthermore, since an increasing number of banks are using securitisation techniques to finance such investments, Standard & Poor's has seen an increase in true sale CMBS transactions collateralised by German properties.

An important trend to emerge from this rapid expansion is that the securitised loans are backed by German real estate assets, whereas previously the market was characterised by German lenders securitising loans backed by foreign properties. Furthermore, foreign lenders have originated most of the loans now being securitised, while German lenders have in fact been less active in this market. A direct outcome of these trends is a monumental rise in the number of German CMBS transactions, resulting from the foreign lenders, mostly in the U.K., adopting the securitisation structure with which they are familiar.

Technicals Help Drive The German Property Market

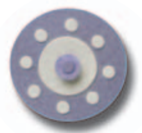
With growth in such cash flow transactions doubling between 2004 and 2005 and likely to be higher still in 2006, one might ask, "Why Germany?" "Why is the growth so fast?" And most important, "Is this trend sustainable?"

The answer to these questions lies in the underlying real estate market. Until the mid-1990s it was mainly a domestic market dominated by German investors, such as property funds, private individuals, and institutional investors. Additionally, tax credits granted for property investments after the reunification stimulated a boom. Investments were funded mainly by the German banks holding loans on their own balance sheets. Very few international investors were active at this time.

Since then, the market has undergone major changes. Nowadays, international investors are the most active group in real estate, with an estimated total investment of about €51.4 billion in 2005. This strong demand for property investments is met by German institutional property owners, municipalities, and domestic companies selling their properties into the capital markets.

These sellers are motivated by different factors:

- In a competitive corporate international environment, companies are focusing on their core businesses, including selling nonbusiness-related assets, such as the properties they own (e.g., Thyssen Krupp). They're also using sale and leaseback mechanisms to release equity, but continuing to use the properties for bank branches, offices, or retail space (e.g., Deutsche Bank AG and Dresdner Bank AG).
- Until mid-2002, German open-ended funds—an important investor in the real estate market—could not invest abroad without restrictions. Once these restrictions were abolished, they refocused their investment strategy on foreign property markets, such as the U.K., France, and The Netherlands. They also reduced their exposure to the German market through sales of properties in Germany.
- Public entities and municipalities decided to sell their real estate portfolios, or portions of them, in the course of financial restructuring (e.g., the cities of Berlin, Bremen, or Dresden).
- Driven by strong competition and the implementation of the Basel II framework, German banks have needed to restructure their loan portfolios. In the course of this, NPL portfolios—built up from a too aggressive lending strategy in the early 1990s—have been sold to investors.



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Investors Are Drawn To Multifamily Housing Portfolios

The supply of German real estate has been met by strong demand, particularly for portfolios of properties used for multifamily housing. The portion of invested funds that has been allocated to multifamily housing portfolios is significant, with acquisitions of about €15.8 billion between 1998 and 2006. The multifamily housing portfolios acquired have been concentrated geographically in North Rhine Westphalia/Rhine–Ruhr and Berlin, where corporations have large stock available or where city governments have been in need of cash.

This asset appears attractive to property investors for a variety of reasons:

- The residential market comprises approximately 40 million units and has performed steadily in the past. The rental income is considered less volatile due to the granularity of the tenancy structure and the protection given by the legal rent regulation. In turn, this stable cash flow enables investors to materially leverage their investment, benefiting also from the current low interest rate environment.
- In contrast to other European residential markets, Germany has not seen significant value increases in the past, thus limiting the risk of unexpected value declines.
- The property investors have a variety of available exit strategies designed to enhance the value of their portfolios. These include selling subportfolios, selling blocks of flats, and privatising single units. The exit strategies seen in the market have been different, ranging from buy and hold to an aggressive sell-down of the portfolio, where it is intended to sell all assets within the term of the loan (i.e., five to seven years). Another strategy could be the floatation of the property company.

The business plans of the property investors usually comprise rent increases, sell-down strategies (such as tenant privatisations), modernisation, redevelopment of properties, and the reduction of management expenses, i.e., restructuring of property management.

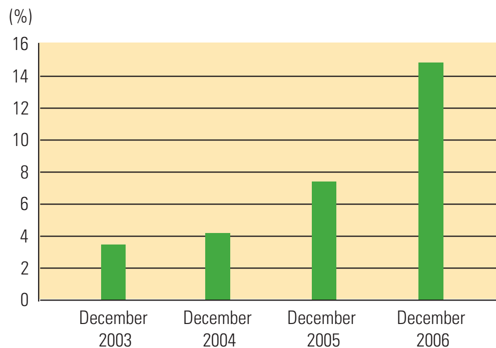
Charting The Rise Of German True Sale CMBS

Before 2003, CMBS issuance in Germany was done mainly using synthetic transaction structures. Owing to Germany's unique legal environment, German banks transferred substantial amounts of credit risk to the capital markets using credit derivatives rather than selling the loans to the note-issuing SPE—as in true sale or cash transactions. Interestingly, though, properties located outside of Germany collateralised the majority of these transactions.

The first cash transactions securitising loans backed by German commercial real estate closed in 2003. In the following year the issuance amount stayed at a similar level. The first groundbreaking year was 2005

Chart 1 **German CMBS Collateral As Share Of European Total**

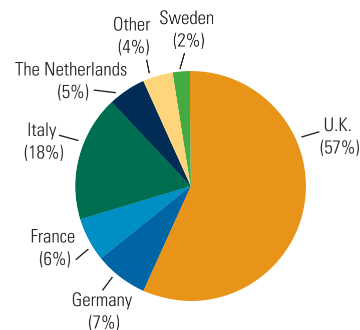
December 2003-December 2006*



*Projected figure

Chart 2 **Distribution Of European CMBS Collateral**

December 2005



when the amount of issued notes increased strongly. Based on the issuance to date and the current pipeline, we expect a new record year for 2006, with an increase of more than 100% possible. The expansion of the new cash transaction is being made possible by the increased collateral available (see chart 1). The German market's share of Europe's commercial real estate has risen correspondingly, from 3% only three years ago to today's level of 7% (see chart 2).

The high demand for real estate has had a direct knock-on effect in the CMBS market, helping fuel these significant growth figures. Competitive margins in the asset-backed market have also had an effect, as lenders have increasingly turned to securitisation to fund loans for property investment rather than syndicating the loan or holding it on their balance sheets.

German NPL Securitisations Could Feature In The CMBS Market's Outlook

In looking at the outlook for German CMBS, the most obvious question is whether this phenomenal growth is sustainable. The answer again depends on the underlying real estate market. While such growth is likely to slow in the medium term as the base on which it is calculated rises, several factors will determine how quickly this growth normalises:

- *Interest rates:* The current low interest rate level stimulates the demand for property investment by investors funded by debt. It also has a significant impact on exit strategies at a loan's maturity, when a refinancing or a sale of the property is required.
- *German economy:* Real estate market fundamentals are closely linked to Germany's general economic and demographic conditions. Thus, property investors need to consider these factors for the different German regions.
- *Liquidity:* The current investment market is characterised by the ample availability of funds, thus increasing property prices.
- *Investment opportunities:* The availability of further portfolios for sale is a precondition for continuing investments. That clearly depends on the price level achievable.
- *New assets:* Following the continuing restructuring process of the German banking industry, we also expect to see the first CMBS transactions backed by NPL portfolios.

As both technicals and fundamentals drive German commercial real estate, and the market opens up its borders, the corresponding CMBS market looks set for a robust few years ahead.

Hybrid CDOs Keep Evolving To Meet Market Demands

The first hybrid collateralised debt obligations (CDOs), which fuse different structural elements of cash flow and synthetic CDOs, surfaced about six or seven years ago in Europe and haven't stopped evolving and expanding into new territories.

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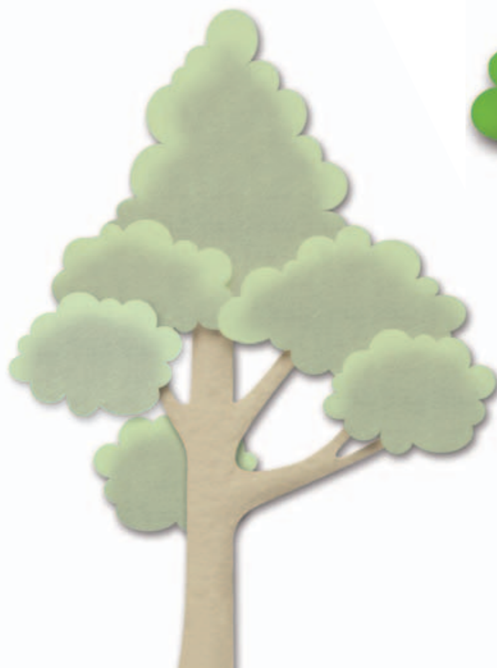


These structures were born of the increased demand for—and the market's relative scarcity of—loans or bonds that could be bought in the open market and the challenges associated with transferring assets to create a cash flow CDO. The market responded by tailoring the transactions to synthetically reference the credits. Fundamentally, hybrid CDOs are cash flow CDOs whose collateral is entirely or in part credit default swaps or credit-linked notes.

By today's standards, the first hybrid transactions were relatively simple. They were static or lightly managed transactions that referenced corporate credits. Since about 2000, the hybrid structure has quickly evolved.

Here's a simple example of a hybrid CDO: A special-purpose vehicle (SPV) issues a series of tranches to investors. The money from the investors is then invested in eligible assets held by the SPV, and the assets are referenced through a number of credit default swaps. The swap counterparty pays a periodic premium for the credit protection it receives on the referenced names. The SPV uses the premium and interest earned on the eligible investments to pay interest to the note and equity holders.

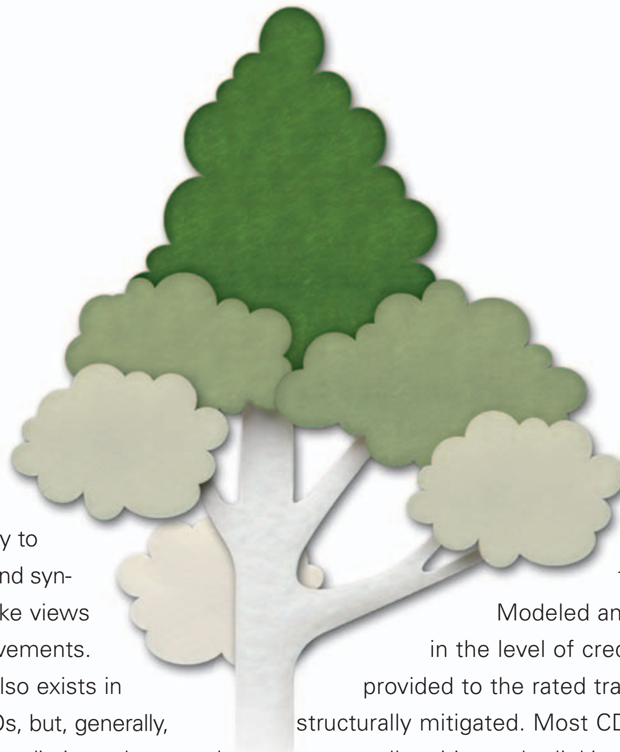
The hybrid CDO has a payment waterfall similar to any cash CDO. If any of the reference credits default, a settlement is made, and the SPV pays the counterparty with money from the eligible investments.

When the transaction reaches the end of its reinvestment period, the SPV pays noteholders back their principal from eligible investments as the credit default swaps mature.

By today's standards, the first hybrid transactions were relatively simple. They were static or lightly managed transactions that referenced corporate credits. Since about 2000, the hybrid structure has quickly evolved. By 2003, some transactions allowed for a combination of synthetic and cash assets, and the ability to include shorting (buying credit protection on specific credits). The introduction of pay-as-you-go (paygo) swaps referencing cash flow structured finance securities has also dramatically increased the popularity of the hybrid CDO. Under a paygo swap, payments between the SPV and the counterparty are based on actual cash flows of the reference security, with the SPV paying if the security is written down or defaults. Since the end of 2005, the vast majority of U.S. hybrid transactions use paygo swaps referencing structured finance assets.

Hybrid CDOs Give Managers More Flexibility

Today's hybrid transactions provide a great deal of flexibility. They can include physical loan and/or bond assets, long synthetics, long and short synthetics based on the same asset, and naked synthetic shorts (buying credit protection on names the SPV does not have). This gives the CDO manager a tremendous amount of flexibility in taking credit positions and shifting to the markets where the best relative value can be found. For example, a CDO manager might like a credit but not its relative value in the cash market. Under the hybrid CDO structure, the manager may purchase that credit in the synthetic market if it deems that the relative value is better.



Therefore, a hybrid CDO gives managers the ability to shift between the cash and synthetic markets and to take views on directional credit movements. Some of this flexibility also exists in traditional cash flow CDOs, but, generally, cash flow CDOs have some limits on how much synthetic collateral the manager can purchase.

Hybrid CDOs also offer flexibility on the liability side of the structure. They can be structured with both funded and unfunded tranches. The unfunded tranches generally take the form of super-senior tranches that are sold to highly rated investors. The super-senior investor must make payments to the SPV if the losses exceed the funded tranches below the super-senior tranches.

Rating Hybrid CDOs Is Similar To Rating Traditional CDOs

Standard & Poor's applies the same fundamental credit approach to hybrid CDOs as it does to traditional cash flow and synthetic CDOs. We first analyse the structure, then the credits, and then model the cash flows. As with cash flow CDOs, hybrid transactions must be structured to ensure that the SPV is bankruptcy remote, and that the SPV owns and has a right to all the assets. This requires the risk from the different counterparties to be controlled. Counterparty risk is a critical consideration in hybrid CDOs, since the synthetic assets are generally entered into (purchased) from one or more counterparties. The level of counterparty risk may affect and/or constrain the rating on a hybrid transaction.

Most hybrid CDO ratings are not, however, linked to the rating on the counterparty. To achieve this rating separation, counterparty risk may be addressed in two ways: Modeled and reflected in the level of credit support provided to the rated tranches; or structurally mitigated. Most CDO transactions structurally mitigate the linking of their ratings to the rating on the counterparty by including replacement requirements upon a downgrade of the counterparty, or by terminating the transaction at no cost to investors.

The second part of the rating process is the credit analysis. The aim is to establish the expected level of defaults that the asset portfolio will experience under every rating scenario. To establish this, we use our CDO Evaluator™ model to estimate the level of expected gross defaults. We use CDO Evaluator for all cash flow, synthetic, and hybrid CDOs.

The last, but equally critical, part of the analysis is to determine that each rated liability can withstand the expected level of asset default, at the commensurate rating level, and still pay back the investor in full. To achieve this, each hybrid transaction must be modeled using a representative cash flow model and then stressed according to the required cash flow stresses at each rating level. In general, the same cash flow stresses are used as for traditional cash flow CDOs. But, depending on the specifics of the hybrid CDO, there may be some additional or modified stresses.

Standard & Poor's expects that hybrid CDOs will continue to expand and evolve over time, as investors and arrangers seek out new opportunities. The pace of evolution will depend on the balance of investor appetite for such structures and the willingness and ability of the various counterparties to enter into such swaps. ●

A New Era For India's Securitisation Market

Strong economic growth coupled with relatively low interest rates in India have helped raise incomes—and the aspirations of consumers. That's making Indians today far more receptive to credit as a financing tool. Thus, consumer finance in the form of housing, auto, and personal loans has edged deeper into India's mainstream, and by extension, the market for securitised transactions has expanded.

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Moreover, a new regulatory regime, which caused a sharp, temporary drop in issuances from 2005 to early 2006, is expected to further aid in the market's development as regulators work to provide clarity on the treatment of securitised transactions. The continued need for funds to sustain the rapid growth of retail lending also promises to foster growth.

The Three Stages Of Indian Securitisation

Securitisation in India has passed through two stages (the early years and the growth phase) and is now on the threshold of a new era (see chart 1). Securitisation began with the sale of consumer loan pools, where originators directly sold loans to buyers. The originators acted as servicers and thereafter collected the installments due on those loans. The first securitised transaction, in 1992, pooled auto loans originated by Citibank. In the late 1990s, the creation of transferable securities backed by pool receivables became common. Known as "pass-through certificates" (PTCs), these securities represented the proportional interest of each investor in the pool receivables. At that time, there were only six or seven issuances per year, with each issuance averaging about US$10 million.

In the next phase, beginning in 2000, the volume of issuances grew exponentially, fuelled by the rapid growth of consumer finance, the realisation of how important securitisation is as a financing method, and investors' increasing acceptance of securitised instruments. During this phase, which saw the issuances of both the first mortgage-backed securities (MBS) transaction and the first offshore transaction backed by aircraft purchase receivables, volumes nearly doubled annually, with approximately 75 issuances each year at an average issue size of US$43 million.

The continued growth in consumer credit created pressure on the resources of large originators. As a result, securitisation emerged as an effective way for institutions to raise funds. From 2004 to 2005, 40% of vehicle finance was funded through ABS backed by vehicle loans. This period also included the first multiasset CDO in India. Originators were able to book large profits arising from the sale of assets and achieve significant capital relief in the absence of stringent capital requirements for credit enhancements. At the same time, the strong performance and higher yields of securitised transactions attracted investors. The significant growth of debt mutual funds, one of India's largest investor classes in securitised paper, also supported the expansion of the market.

Chart 1 **Securitisation In India: Landmarks**

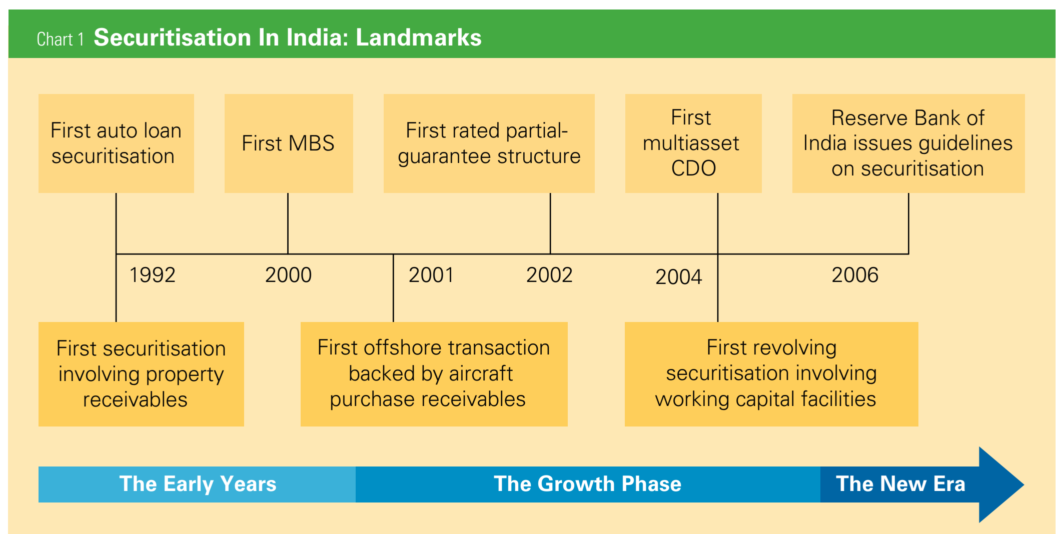
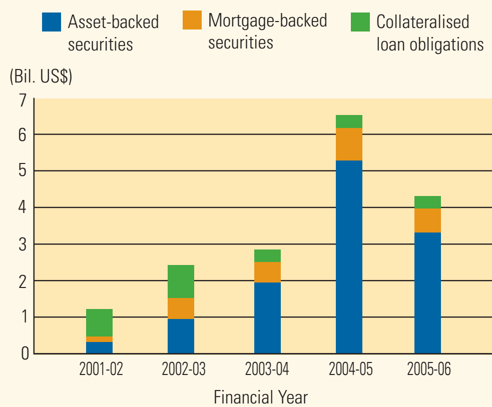


Chart 2 **Securitisation Market Volumes**

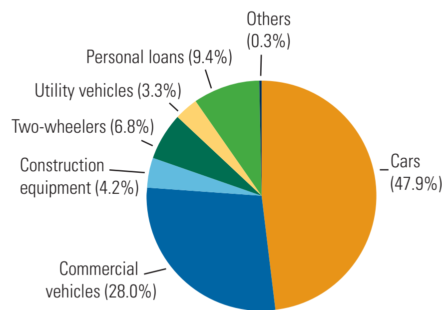


- The above figures represent CRISIL estimates of market volumes.
- Only rated issuances are included. Private bilateral deals are excluded.
- Indian financial year runs from April 1st to March 31st.
- CLOs refer to securities backed by single corporate loans. FY 2001-02 and 2002-03 saw an unusual spike in volumes as a result of offloading of large corporate exposures by a financial institution, which was being merged into a commercial bank.
- Volumes declined sharply in FY 2005-06 as the market adjusted to a new regulatory regime compounded with rising interest rates and a liquidity crunch.

Several key characteristics have emerged in India's securitisation market. These include:

- *Domination of ABS.* With a compounded annual growth rate of more than 100%, ABS dominates the securitisation market in India, accounting for over two-thirds of issuances (see charts 2 and 3). A low investor appetite for longer tenor assets has hindered the growth of MBS. (Insurance companies and pension funds, institutions that traditionally invest in longer tenor instruments internationally, are not active in the securitisation market.) In addition, multiasset CDOs also have yet to take off in a big way, due to the high level of credit enhancements needed, making them unattractive for originators.
- *High concentration of originators.* Although the number of originators increased from under five

Chart 3 **ABS Distribution By Asset Class**



in 2000 to more than 20 in 2005, the top five originators account for more than 90% of issuance volume. Even though state-owned banks account for almost three-quarters of the banking sector assets in India, they have yet to adopt securitisation on a significant scale because they have access to lower cost resources and because clear regulations were lacking until recently. Going forward, with increasing pressure on resources, these entities are also expected to become active securitisers.

- *Preference for the highest-rated tranches.* In addition to a focus on the short end of the yield curve, investor appetite has been restricted to senior tranches that carry the highest ratings ('AAA' or 'P1+'). Originators retain the junior tranches as unrated pieces.
- *Bond-like characteristics of PTCs.* Given the early stage of the market, PTCs are structured to have a predetermined schedule of monthly interest and principal payments to be paid on a timely basis, regardless of collections from underlying assets. This is in contrast to structures prevailing in international markets where interest is paid on a timely basis and principal is repaid by instrument maturity.
- *High level of enhancements compared to international norms.* Enhancements, typically in the form of overcollateral, subordinated excess spread, or reserve accounts, cover

not only credit losses but also timing mismatches due to delayed collections. Bond-like outflows, coupled with volatile inflows, result in relatively high enhancement levels.

The Regulatory Environment Is Likely To Steer Securitisation Into The Future

In our view at CRISIL *(Standard & Poor's India-based subsidiary)*, the new regulatory framework announced by the Reserve Bank of India (RBI) in February 2006 is likely to facilitate the securitisation market's development in India, ushering in a new era. We believe that the new regulations will lead to more efficient and evolved structures and help widen and deepen the market over the long term.

The new regulatory framework announced by the Reserve Bank of India in February 2006 is likely to facilitate the securitisation market's development in India, ushering in a new era.

Under the new regulations, both true sale requirements and capital requirements for credit enhancement have become more stringent. In addition, the new regulations encourage third parties to participate in transactions. (To facilitate this, third-party enhancement providers now receive preferential capital treatment over originators providing the same service.)

A key impact of regulation is that profit arising from the sale of assets is to be amortised over the life of the instrument. This provision dilutes a key incentive for originators, as up-front profit booking was, in the past, an important driver of securitisation activity.

The recognition of PTCs as securities will also provide a significant boost to securitisation. Currently, without this recognition, PTCs cannot be listed, which hinders market development. A long-awaited amendment to the Securities Contracts Regulations Act (SCRA), likely to be enacted soon, will pave the way for listing PTCs and bring them into the mainstream of the Indian capital markets.

More Efficient Structures Mean Global Alignment And Continued Growth

With the continued growth of India's economy and the support of regulatory agencies, we expect to see many exciting developments in the securitisation market in India. As the markets move toward more efficient structures that are in line with the international markets, the appetite for non-'AAA'-rated tranches will grow, and specialised third-party service providers will emerge, making the securitisation market in India more vibrant. ●

Editor's note: The article is authored by Prasad Koparkar and Aparna Karnik of India's CRISIL Ltd., Standard & Poor's India-based subsidiary. The thoughts expressed in this article are those of CRISIL and do not necessarily reflect Standard & Poor's view.

Securitising Small-Business Loans:

Applying The U.S. Approach To China

All businesses begin small and dream big, and the fulfillment of that dream is often tied to their ability to finance expansion plans inexpensively. But avenues for cheap financing aren't always open to everyone, and that's where the securitisation market has begun to play a wider role by giving small businesses from the U.S. to China greater access to that cheaper financing.

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Small businesses employ the majority of workers and generate the greatest share of GDP in major economies throughout the world. Moreover, some small businesses go on to become major market participants in the constant and ever-faster cycle of "creative destruction," a poignant term coined in 1942 by economist Joseph Schumpeter in his work, *Capitalism, Socialism, and Democracy*, which describes the process by which innovation and enterpreneurialship destroy old and established companies by creating new ones in their wake. Think Microsoft being challenged by Google, and how Microsoft (along with Intel), in turn, only recently toppled IBM and the mainframe establishment.

Financing small business is challenging in all economies. In every creative-destruction cycle, the Goliath enjoys a vast public equity market, a ready public debt market, eager banks, and a fast-growing securitisation market, particularly collateralised debt obligations. Small businesses, in contrast, have paltry private savings, limited private equity, and cautious banks to contend with. This is where securitisation can make the greatest contribution by opening capital markets to small businesses throughout the world. In fact, the capital market innovations that are gathering momentum in the U.S.'s nascent small-business securitisation market can be applied to China to create sustained economic growth.

Active Government Support Has Been Key In The U.S.

With approximately 25 million small businesses, the U.S. is arguably the most entrepreneurial and capitalist economy in the world, and it has the most developed small-business sector. Recognising the important role of small business in driving economic growth and evolution, the U.S. government has long played an active role in its financing.

The Small Business Administration (SBA) began providing loan guarantees in 1953 through its 7(a) program. With the guarantee, small commercial borrowers with insufficient experience and/or weak collateral can obtain loans from lenders that otherwise would have rejected the loan. Many businesses that benefited from SBA support in its infancy have grown to be today's industry leaders. SBA counts Intel, Ben & Jerry's, Apple Computer, AOL, Nike, and Staples among its success stories. To demonstrate the impact of such successes, the SBA notes that the income tax now paid by Intel alone, in a single year, amounts to several hundred million U.S. dollars more than the SBA's entire annual budget.

Another example of active government support was the passing of the Riegle Act in 1994, which reduced regulatory barriers to securitisation for originators of loans to small-business owners and commercial real estate investors. The act was intended to aid "the development of a secondary market for small-business loans–where loans would be pooled together, packaged as securities, and purchased and traded by investors—[such development] has the potential to improve the flow of capital to entrepreneurs, bringing economywide benefits in terms of increased output, innovation, and employment."

However, securitisation of small-business loans hasn't yet developed to the same extent as the securitisation of commercial real estate loans. By the end of 2005, Standard & Poor's rated over 40 small-business loan transactions, amounting to $12 billion, a fraction of the estimated $1 trillion small-business loans held by commercial banks and specialty finance companies. In contrast, an estimated 20% of commercial real estate loans have been securitised, translating into hundreds of billions of dollars in commercial mortgage-backed securities. A key reason for this disparity lies in the challenge of assessing the credit quality of small businesses.

To address this problem head-on, Standard & Poor's developed an analytical model called SELECT (Small Enterprise Loan Evaluation and Criteria Tool). The model uses a Monte Carlo simulation to determine the default distribution for geographically correlated loan pools. With SELECT's introduction, Standard & Poor's took an

important first step in building a "one-size-fits-all" model to tackle the diverse business risks found in such loan portfolios. We conducted more than 20 demonstrations of the model to capital market participants, who have been receptive to the model's added flexibility, speed, and transparency.

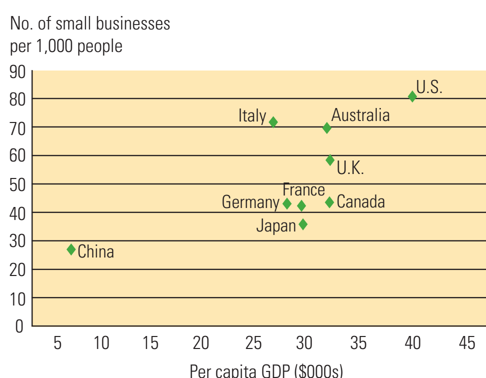
Small Business Is Taking On A Vital Role In China

Compared to the U.S., the challenges in financing a newborn small-business sector in China are simply daunting. Small business in China essentially didn't exist before the 1980s. Before then, the economy was dominated by large state-owned enterprises on one extreme, and farmer collectives or communes on the other. The central government planned everything based on established production goals.

In the 1980s, China embarked on a reform course by gradually introducing a market economy. Small businesses began to emerge, playing two key roles in this reform. They absorbed large numbers of migrant farmers (an estimated 200 million between 1978 and 1996) as the society transformed from agrarian to industrial. Additionally, when state-owned enterprises began paring down or being eliminated, small businesses took in many of the workers who were laid off. Today, China has more than 35 million small businesses, or one for every 350 people. But still, this level is far lower than the one business per 12 residents in the U.S., orone for every 25 people in Japan (see chart).

A key contributing factor to the underdevelopment of China's small-business sector is the severe lack of financing: Chinese banks are ill-suited to lend to small businesses. The four large "megabanks" that dominated the banking sector, with 55% of all assets, were government-policy banks until the mid-1990s. As such, their mandate was to lend to state-owned enterprises. Since then, these and other banks gingerly entered the small-business sector. But primarily, financing is limited to the short term (three to five years) and, in most cases, requires loan guarantees.

Small Business Population Of Major World Economies, 2004

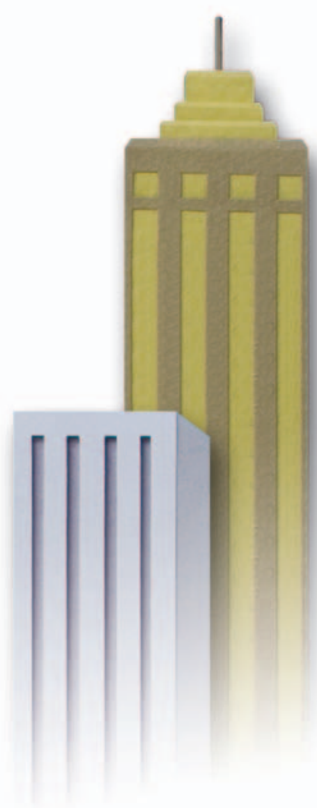


It's no wonder that an entirely underground lending-collectives network developed in coastal provinces. These collectives pool savings from villagers and lend the money to local small businesses. Some government estimates put the size of this lending market at RMB800 billion (US$100 billion), ranking it as the sixth-largest "bank" in China.

Future Uncertain For Chinese Securitisation

If China is to sustain its economic growth, new business opportunities need to be created as the state-owned enterprises continue to decline. It also needs the next generation of Intels and Apple Computers to compete in the global market. In fact, creative destruction takes on added historical significance, and securitisation can emerge as a logical, though untested, solution. With the support of the Chinese government and banking regulators, a number of banks now place small-business loan securitisation as a high priority, as we found during a trip to China in early 2006.

One example under consideration is the "bundling" of small-business loans to issue debt, i.e., securitisation. However, this may be viewed as a high-risk, high-return approach to the capital market, albeit a creative solution to the financing challenge facing Chinese small businesses. Although the future of securitisation in China is uncertain, we believe the area represents a unique opportunity for our credit models and securitisation know-how alike. ●



Clearing A Legal Path For Europe’s Securitisation Market

Just a decade ago, securitisation in Western Europe was confined to a handful of countries and viewed largely as an emerging asset class where only the most basic assets were being securitised, such as residential mortgage and trade receivables. Securitisation has come a long way since then, aided by the passage and development of favorable laws and legal regimes, which have made it among the financing tools of choice in almost every country in the region.

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The legal aspect, most certainly, hasn't been the sole contributor to the development of Europe's securitisation market: Investors have driven demand as they became more knowledgeable about the structures and risks, and as they search for fixed-income alternatives and diversified yield opportunities. Europe has sought to mirror the growth of the U.S. structured finance market by importing U.S.-developed structures, asset classes, and techniques. However, legal challenges unique to Europe have made this progression difficult.

Navigating A Sea Of Laws

A patchwork of numerous legal jurisdictions with diverse transaction structures has posed a key challenge for the European securitisation market. In particular:

- European countries are generally divided between two systems of law: common law and civil law.
- Each country in Europe has its own unique legal system(s).
- Europe doesn't have a common bankruptcy law.
- Tax laws are different in each country.
- There is an absence of specific laws or legal precedents that apply to the cornerstones of securitisation, such as true sale and security interests.

Although not exhaustive, this list is illustrative of the legal challenges Europe faces in seeking to replicate securitisation structures first used in the U.S. and to initiate unique European securitisation structures.

As governments in Europe have come to appreciate the benefits to their economies of securitisation as a financing tool for both commercial enterprises and governments, they've made a concerted effort over the past 10 years to adopt laws supporting securitisation. The focus of legislative activity in Europe on this front in the past decade has been to attempt to provide discrete legal answers, often where none previously existed, to the four legal principles key to facilitating securitisation:

- Identification of the legal asset,
- Isolation from an originator's bankruptcy,
- Creation of a safe harbor, and
- Avoidance of negative fiscal impact.

Identification of the legal asset

What's important here is ensuring that the law helps define and protect the assets and any associated contractual rights originated by an originator. In particular, the law should mitigate against risks to the assets' existence.

Isolation from an originator's bankruptcy

The next point is that the law define a clear and efficient mechanism for the assignment of assets to a securitisation structure and provide comfort that such assignment will be recognised and protected in any subsequent bankruptcy of the originator. In securitisation parlance, this is referred to as a "true sale."

Creation of a safe harbor

Having defined the assets and isolated them from the originator's insolvency risk through their assignment through a true sale mechanism, the law should recognise and support the use of vehicles or entities, often referred to as special-purpose entities (SPEs), to hold such assets and secure them and their cash flows for the benefit of noteholders who finance the purchase of such assets.

Avoidance of negative fiscal impact

The law should also support a benign tax impact on securitisation structures, including taxes on cash flows and/or SPEs.

Here's a snapshot of laws that support securitisation in Western Europe, which have been adopted or refined during the past decade:

Italy
- Italian securitisation law provides a framework for true sale opinions.
- Statutory segregation of securitised assets.
- Favorable (off-balance sheet) tax treatment of Italian securitisation SPEs.

France
- French securitisation law provides a framework for true sale.
- Securitisation fund ("Fonds commun de créances" or "FCC") concept created by French securitisation law as SPEs.
- Statutory segregation of securitised assets.
- Favorable (tax-exempt) tax treatment of French securitisation funds.

Spain
- Spanish securitisation law provides a framework for true sale.
- Spanish securitisation funds ("Fondo de titulizacion de activos" and "Fondo de titulizacion hipotecaria") concept created by Spanish securitisation law as SPEs.
- Spanish securitisation law supports statutory segregation of securitised assets.
- Tax neutrality possible for Spanish securitisation funds.

Portugal
- Portuguese securitisation law provides a framework for true sale.
- Portuguese securitisation funds ("Fundo de titularisacao de creditos" and "Sociedades de titularisacao de creditos") concept created by Portuguese securitisation law as SPEs.
- Portuguese securitisation law supports statutory segregation of securitised assets.
- Tax neutrality possible for Portuguese securitisation funds.

Luxembourg
- Luxembourg securitisation law supports the use of Luxembourg securitisation companies or securitisation funds as SPEs.
- Luxembourg securitisation law provides a framework for true sale.
- Luxembourg law supportive of Luxembourg SPE's use in pan-European securitisations.
- Advance tax rulings for SPEs available.

Germany
- Introduction of "Refinancing Register Law" to provide for a new statutory framework to facilitate the securitisation of assets in Germany.

Belgium
- Belgian securitisation law provides a framework for true sale.
- Belgian securitisation law supports statutory segregation of securitised assets.
- Securitisation fund or Securitisation Co. concept created by Belgian securitisation law as SPEs.

Ireland
- Irish law supportive of Irish SPEs used in European securitisations.
- Tax neutrality possible for Irish SPEs.

England
- Common law precedents supportive of true sale.
- Tax neutrality possible for English SPEs.

Netherlands
- Dutch law supportive of Dutch SPEs used in European securitisations.
- The availability of favourable tax rulings and the extensive double tax treaty network of the country.

European Union
- EU Winding Up Directive for Credit Institutions to provide an EU-wide framework to the laws applicable in the bankruptcy of credit institutions.
- Adoption of EU Insolvency Regulation to provide an EU-wide framework to the laws applicable in the bankruptcy of nonbank entities.
- Adoption of EU Collateral Directive to provide an EU-wide framework to the laws applicable in the exercise of collateral arrangements.

As governments in Europe have come to appreciate the benefits to their economies of securitisation as a financing tool for both commercial enterprises and governments, they've made a concerted effort over the past 10 years to adopt laws supportive of securitisation.

The key to securitisation, whether in Europe or elsewhere, is having the law establish a firm foundation for such structures. It's no coincidence that those countries in Europe that have adopted laws over the past decade, which speak to the key legal principles highlighted above, have seen growth and development in their respective securitisation markets relative to those jurisdictions that have not.

Patchwork Of Legal Systems Will Continue To Present Challenges

The snapshot merely highlights those European laws that have been adopted or refined to support securitisation, and there are many more examples (e.g., laws adopted to support European covered bond markets). This makes the listed legislative developments all the more impressive considering the number of countries involved in adopting or refashioning their laws to support European securitisation. Tremendous progress has been made in the past on this issue and this is reflected in the exponential growth in the volume and number of asset-backed securitisation transactions in Europe.

Does that mean legal challenges to securitisation in Europe have been eliminated? No. The patchwork quilt of legal systems in Europe will continue to add a level of complexity to structuring and executing securitisation transactions. Securitisation has proven to be an evolving financing tool used by the capital markets in novel and unique ways, often probing areas for which, in Europe, no legal guidance or certainty is available. Responding to this evolution will no doubt involve further changes in laws to help expand and support securitisation markets in Europe. The multitude of lessons learned as the market continues to overcome the legal challenges in various countries throughout Western Europe will be the linchpin to the market's further progression. ●

The Varied Paths To Global Servicing Standards

Given the increasing focus on global servicing practices, especially in light of the SEC's Regulation AB in the U.S., it's no surprise that the subject of standardisation has become a hot discussion topic. As the SEC attempts to establish minimum standards for prudent asset servicing in the U.S., global markets are beginning to realise the importance of having universally accepted servicing standards to enhance liquidity.

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But as ideal as the concept of global best practices sounds, the roads to achieving this have a long way to go before they merge, simply because different jurisdictions have evolved at different paces. In the U.S., separate standards are well established for residential and commercial mortgages, leaving little room for backtracking. In markets where third-party servicing is relatively young, such as Europe, Australia, and Japan, practices within each region are well focused but are relatively unique to their own regions.

In Europe, where third-party servicing is still in its infancy, signs of standardisation are beginning to materialise but may never yield practices that are as uniform as those on the other side of the Atlantic. Comparatively, servicing practices for the residential and small-balance commercial mortgage markets in Australia are relatively solidified, yet they each rely on widely varying servicing platforms. In Japan, as in the U.S., there is a significant focus on servicing, and practices have been formed independently for both commercial and residential mortgages.

One Industry, Diverse Paths, One Goal

While the standard practices for commercial and residential servicing practices in the U.S. evolved independently, they have each become unwritten guidelines that all participants now abide by. In the residential arena, the foundation for standardisation grew out of the long-established dominance of the government-sponsored entities, namely Freddie Mac and Fannie Mae. The evolution of standardised commercial servicing occurred independently. After the savings and loan trust collapse of the late 1980s, which led to the creation of the Resolution Trust Corp. (RTC), standardised commercial servicing began to take form. Then, in the late 1990s, a group of industry professionals formed the Commercial Mortgage Securities Association (CMSA), an industry trade organisation that built the framework for true servicing and reporting standards for the CMBS market.

In regions where structured finance is newer, third-party servicing is still a rather novel concept, and best practices have yet to propagate significant roots. Unlike in the U.S., where servicing platforms have become highly specialised to handle either residential or commercial mortgages, asset-specific servicing practices are not the norm in the European marketplace and are not likely to develop as the market matures. This is primarily because most servicers in Europe handle both residential and commercial originations due to their close affiliations with their corporate parents.

In markets where third-party servicing is relatively young, such as Europe, Australia, and Japan, practices within each region are well focused but are relatively unique to their own regions.

Best practices are, however, beginning to germinate in Europe, which may in and of itself create an environment that's somewhat standardised. Specifically, independent third-party servicing, once atypical, has become more common recently. And as the secondary servicing market matures, it's likely that future efforts will follow the paths already in place today. Even with some progress underway, many challenges remain before third-party servicing goes mainstream.

Still, certain market trends should accelerate the standardisation of loan documents and servicing agreements. For example, the presence of conduits, which are essentially originating platforms that tend to outsource servicing duties to third parties, is expanding.

Pan-European transactions are also becoming increasingly popular, a trend that's complemented by the emergence of large back-office servicing platforms.

Australia And Japan Have Their Own Flavors

On the other hand, some markets may never truly embrace third-party servicing. Australia, for instance, isn't expected to develop a strong secondary servicing market, primarily because most lenders there opt to service the mortgages they originate. Nevertheless, servicing standards and practices for residential and small-balance commercial mortgages in Australia do exist.

Because almost all prime residential mortgage lenders insure some or all of their loans through highly rated insurance companies, industrywide practices for servicing are already well established—specifically because the regulations for servicing, arrears management, and reporting obligations imposed by the insurers form the foundation for practices used by lenders. Additionally, the core functions of many residential platforms are flexible enough to be used for commercial products as well, which promotes an environment with generally consistent processes.

In Japan, servicing practices have been closely monitored since 1999, when the country implemented its "Servicer Law" to dispose of nonperforming loans effectively, particularly those involving real estate. Given the law's focus on judicious collections, it specifically requires companies conducting special servicing, or administration of troubled loans, to obtain a license from the Ministry of Justice.

Even with the extensive regulations in Japan, third-party servicing of commercial mortgages has grown significantly since the Servicer Law was enacted. In fact, more than 100 servicers were licensed as of June 2006, up significantly from 27 back in 1999.

Along with legislation and regulation, several other factors have encouraged standardisation of servicing practices in Japan, such as the establishment in 1999 of the Resolution and Collection Corp. (similar to the RTC in the U.S.) and various efforts by the Government Housing Loan Corp. to promote the securitisation of housing loans. These advancements signify not only that progress is being made, but that the foundations for best practices are already in place as third-party servicing becomes more commonplace.

Conscious Efforts Around The World

Before servicing practices become standardised within a jurisdiction, particularly the younger ones, other aspects of the securitisation process need to be solidified. In Europe, for example, several challenges regarding data availability and reporting remain. However, CMSA-Europe, the European Securitisation Forum, and the European Commission are making progress in addressing these hurdles.

Likewise, CMSA-Japan has helped establish best practices for that region's commercial sector, although third-party servicing of residential mortgages has yet to truly take off. Farther south, regulatory requirements covering loan origination and servicing in Australia are intact and often prescriptive, inspiring many servicers to focus on creating best practices for reporting processes and customer service.

Regardless of their jurisdiction, industry participants around the globe are making conscious efforts to streamline and refine their servicing practices. While there will always be cases where standard solutions will need to be modified to meet the needs of a specific situation, the underlying theme around the globe is that everyone's eyes are similarly focused on the road ahead. ●

Japan's Real Estate Rebound Doesn't Ensure Stronger Ratings For J-REITs

After a long period of painful adjustments across sectors, the Japanese economy is finally showing signs of healthy growth. The real estate market is no exception, as reflected in the recent recovery in land prices, office rents, and occupancy rates. This rebound, however, is unlikely to simply translate into a broad improvement in the credit quality of Japanese real estate investment trusts (J-REITs). Rather, their credit quality will likely diversify, although remain solid, driven by intensified competition for properties and fresh funding.

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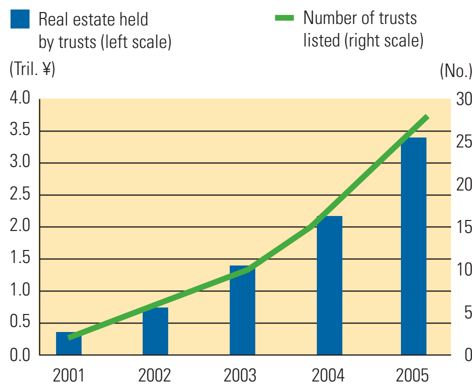
Growth Of Listed J-REITs



The Boom In J-REIT Listings Continues

The growth of the J-REIT market has accelerated in the last year-and-a-half or so, with the aggregate market capitalisation of the listed J-REITs growing to ¥3.4 trillion as of the end of March 2006, up 79% from a year earlier. The total reported size of real estate holdings by the trusts also grew to ¥3.4 trillion as of the end of December 2005, up 54% (see chart). During 2005, 13 J-REITs went public, bringing the total number of listed J-REITs to 28. The listing boom of the J-REITs continued into the second quarter of 2006, with another six funds listing, for a total of 34 as of June 19, 2006.

Despite the rapid overall growth in market capitalisation, not all J-REITs have been positioned favorably in terms of financing. In fact, the gap between the financial flexibility of J-REITs has widened, a trend that's likely to accelerate. For example, the initial trading prices for six of the 13 J-REITs fell below their initial public offerings last year. This year, initial trading prices of four out of six J-REITs fell below their IPO prices. This reflects intense competition for fresh financing among J-REITs, including both newly listed and existing players. Moreover, J-REITs have to compete against other private sector players, which are keen to expand and have become more attractive to investors, backed by a recovery in earnings and earnings prospects.

Property Market Recovery Could Pressure Near-Term Profitability

The rapid increases in property prices poses another challenge for J-REITs. Prices of prime real estate have risen sharply in the last year following a steady increase that began about five years ago. These hikes reflect the strong competition for investments among real estate market players, including real estate companies, J-REITs, and private funds. This competition has made it difficult for J-REITs to make key purchases as planned, and thus hindered their ability to maintain investment yields as in the past. In addition, because of the difficulty of purchasing superior properties, some J-REITS are entering into contracts for projects that have a certain level of development risk at an early stage, or are investing in equity interest in anonymous partnerships (tokumei kumiai equity) or real estate-related securities (i.e., preferred securities as defined under the Asset Liquidation Law).

Although rents for prime properties have already started to rise, it will take some time for J-REITs to fully benefit from the market recovery. Since rents are negotiated as existing leases or price agreements expire, potential increases can only go so far to ease pressures on investment yields in the near term.

Investment And Financial Policies To Be Tested

Given the tough environment, the trusts' investment and financial policies will become increasingly important from a credit quality perspective. J-REITs will be tested on their ability to manage the pace of asset growth in line with their investment guidelines in a heated market. The quality of assets, cost positions, and cash flow stability of newly acquired assets, and whether J-REITs set limits on investments in riskier asset types, will be key factors.

On the financial side, the main challenge will be controlling leverage in line with changes in the financial market. A conservative capital structure is important, as J-REITs typically acquire properties

Rated J-REITs In Japan

Issuer Name	Rating	Real Estate Assets (mil. JPY)	Major Sponsors	LTV* (%)	Total debt/ capital**(%)	FFO/ TD (%)
NBF Nippon Building Fund Inc.	A/Positive/A-1	539,395	Mitsui Fudosan, Sumitomo Life Insurance	52.2	48.9	8.4
JRE Japan Real Estate Investment Corp.	A+/Stable/A-1	326,561	Mitsubishi Estate, Dai-ichi Mutual Life Insurance, Tokio Marine & Nichido Life Insurance, Mitsui & Co.	41.7	37.1	12.3
JRF Japan Retail Fund Investment Corp.	A+/Stable/A-1	308,307	Mitsubishi Corp., UBS AG	44.7	40.0	17.4
JPR Japan Prime Realty Investment Corp.	A-/Stable/A-2	202,663	Tokyo Tatemono, Meiji Yasuda Life Insurance, Taisei Corp., Yasuda Real Estate, Sompo Japan Insurance	47.9	43.4	10.3
TRE TOKYU REIT, Inc.	A/Stable/A-1	157,860	Tokyu Corp., Tokyu Land Corp.	37.5	36.3	12.7
NOF Nomura Real Estate Office Fund, Inc.	A/Stable/A-1	210,120	Nomura Real Estate Holdings	46.6	42.1	10.1
FRC Fukuoka REIT Corp.	A-/Stable/A-2	85,273	Fukuoka Jisho, Kyushu EPCO	47.2	41.8	13.5

*Security deposit, hoshokin adjusted. **Hoshokin adjusted.

with debt, leading to a temporary increase in leverage toward the end of each fiscal period (most J-REITs have half-year accounting periods, not a year). This temporary rise in leverage is usually resolved within a few months by raising funds through public offerings. However, increased competition has hindered timely fundraising. Failure to raise equity in a timely fashion will most likely lead to unexpected increases in debt servicing burdens for extended periods, a negative development from a credit quality perspective.

Rated J-REITs Are Likely To Maintain Solid Credit Quality

Standard & Poor's currently rates seven of the 33 listed J-REITs (see table). Although the ratings on the J-REITs are concentrated in the 'A' rating category, this doesn't suggest that all listed J-REITs would be rated at this level. The total assets of the seven rated trusts are, in general, large compared with other listed J-REITs, with Nippon Building Fund Inc. (NBF) topping the list at ¥539 billion (as of December 2005). The investment portfolios of the rated J-REITs are all of relatively high quality, characterised by top properties in terms of location, age, and size. The trusts also maintain conservative capital structures, giving them comparatively high financial flexibility.

We expect that these rated trusts will maintain solid credit quality amid a changing environment. In fact, the outlook on the long-term issuer rating of NBF, one of the two initially listed trusts, was revised to positive from stable on May 12, 2006. Most of the rated J-REITs have already announced a shift in focus to internal growth from external growth to maintain portfolio quality. This change in investment policy is considered reasonable, as they have already achieved initial growth targets to realise diversification benefits. A slower pace of asset acquisition should also allow the J-REITs to operate on the more conservative side of their financial leverage guidelines, resulting in a cycle more supportive toward maintaining credit quality.

However, not all J-REITs are ready to shift into a more conservative gear. They don't all face the same difficulties accessing financial markets, and they have different management policies, growth stages, existing portfolio qualities, and track records in operations and financing. As the intense competition in investment and financing persists, these changes are likely to become more apparent and lead to a divergence in the credit quality of J-REITs. ●

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