International
Special Report

Criteria for Rating Japanese Unsecured Consumer Loans Originated by the Banking Sector

Analysts
Tokyo
Akihiro Yamada
813 3288 2691
ayamada@fitchibca.com

New York
Masako Osako
1 212 908-0834
mosako@fitchibca.com

C. Mia Koo
1 212 908-0651
mkoo@fitchibca.com

■ Summary

Credit cards and card loans are commonly used methods of financing originated by the banking sector for the Japanese consumer and are important asset classes for this rapidly growing sector of the Japanese securitisation market. Fitch IBCA has developed rating criteria for rating securitisations backed by bank consumer assets with revolving structures.

Fitch IBCA uses a model that was developed to calculate expected losses at various rating levels for a portfolio of Japanese revolving consumer loans. The model inputs include historical data, such as portfolio yield, monthly payment rate (MPR), and writeoffs, which are collected from a "static" pool of loans provided by the lender. The model can be adjusted to account for the different revolving product types and various deal structures. This report describes Fitch IBCA's approach to analysing a consumer loan transaction's collateral, financial, and legal structure, as well as the review process performed on the lender's origination and servicing operations. *(For a discussion of criteria for rating consumer assets originated by consumer finance companies, see Fitch IBCA Research on "Criteria for Rating Japanese Unsecured Consumer and Small-Business Loans Originated by the Consumer Finance Sector," dated 10 Feb. 2000, available on Fitch IBCA's web site at www.fitchibca.com.)*

■ Credit Card and Card Loan Market

Japanese banks and their non-bank subsidiaries offer a variety of unsecured consumer loan products, ranging from conventional loans to credit card and card loans. This report focuses on the latter two product types, since despite legal and regulatory differences, they share similar characteristics that are conducive to similar types of securitisation structure. A good deal of information is available about the credit card industry in Japan. However, information on card loans is scarce since banks generally do not report on card loans as a separate category but instead classify them together with other consumer loan products in their reports.

In Japan, the history of the credit card industry started in 1960, when Nihon Diners Club, Ltd. began its operation, financed jointly by Fuji Bank, Japan Tourist Bureau, Ltd. and Diners Club International, Inc. During the 1960s, bank-affiliated credit card companies, including Diamond Credit Co., Ltd. and Sumitomo Credit Co., Ltd., began issuing credit cards. They were soon joined by retail chains and installment sales companies (Shinpan). Until the revision of the Banking Law in 1983, banks could operate credit card business only through their non-bank subsidiaries. Even after this revision, however, except for minor exceptions, Japanese banks continue to issue credit cards through their subsidiaries.

Consumer Finance Borrowing in Japan
(1997, ¥ Trillion)

Credit Sales	
Bank-Sponsored Credit Card Companies	9.1
Installment Sales Companies	9.2
Retail Chains and Others	14.7
Subtotal	33.0
Unsecured Loans to Consumers	
Banks and Other Deposit-Taking Units	5.6
Bank-Sponsored Credit Card Companies	5.4
Consumer Finance Companies	8.3
Other Entities	3.8
Subtotal	23.1
Secured Consumer Loans (By Banks, Postal Office, Etc.)	20.4
Total	76.5

Source: Japan Credit Industry Association (estimates).

Until the mid-1980s, the dominant use of credit cards was for the purchase of goods rather than cash advances. The use of credit cards for purchases increased dramatically in the 1980s from ¥2.5 trillion in 1980 to ¥11.5 trillion in 1990 and ¥18.1 trillion in 1997. The use of cash advances under credit card contracts started in 1968, but it did not become widespread until the 1980s. According to an Japan Credit Industry Association report, "card cashing" increased from ¥2.4 trillion in 1986 (the earliest year the association tracked this data) to ¥8.3 trillion in 1997.

Bank-sponsored credit card companies account for nearly one-third of credit sales and almost one quarter of unsecured consumer loan borrowing in 1997. While it is not possible to determine the portion of "unsecured loans by banks and other deposit-taking units" attributable to card loans, in total, according to the Japan Credit Industry Association's estimate, the banking sector contributes approximately 43% of total unsecured consumer borrowing in Japan.

All the major Japanese banks participate in credit card business through equity participation in the credit card company. Seven major credit card companies are listed below with their major equity holders and revenues. Many of these companies operate a nationwide network of franchisees that include subsidiaries of the equity holding banks. For instance, UC Card's franchisees include Daiichi Kangyo Card, Ltd. and Fuji Credit, Ltd.

Credit Reference System in Japan

In the consumer finance industry in Japan, four trade associations function as credit bureaus for their respective member companies. Information is provided on-line regarding the credit applicant amount and type of loan outstanding, as well as any history of default. Additionally, since 1987, the Credit Information Network (CRIN), National Consumer Credit Information Center for Banks (NCCICB, or Zenkinkyou), Credit Information Center (CIC), National Federation of Credit Information Centers (NFCIC, or Zenjouren) have shared default information among their members. Effective and comprehensive coverage of these trade reference programs is often considered an important reason for the current moderate default rate among Japanese credit consumers, especially among the top-tier consumers.

Japanese Consumers

The state of consumers and economy in Japan are important factors to consider when analysing the likelihood of default by a consumer/borrower and the resulting loss to a lender or investor. Economic indicators that affect consumer behavior include wealth, unemployment rate, divorce rate, and the incidence of consumer bankruptcies, among other things. Fitch IBCA considers each of the following factors to determine appropriate stress scenarios when analysing a portfolio of consumer loans.

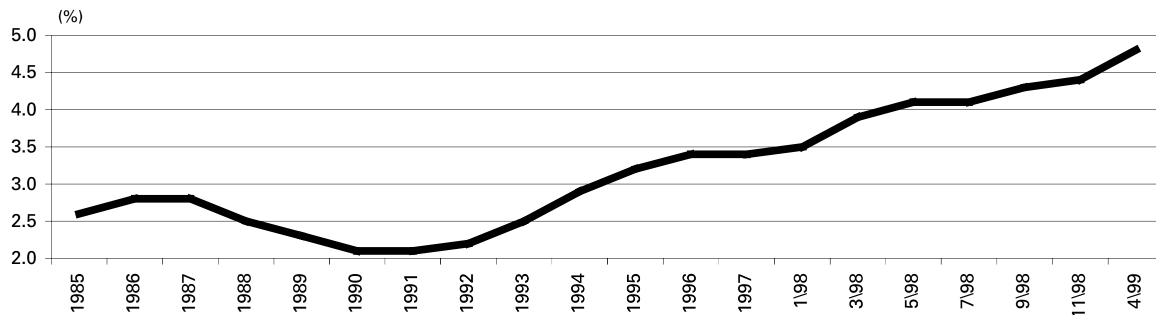
Unemployment: Japan's jobless rate hit a high of 4.8% in April 1999 due to the rise in corporate bankruptcies and plummeting earnings. Nevertheless, when compared with other major industrialised nations, including Germany, U.K., and U.S., as well as the European Union, unemployment in Japan remains

Major Bank-Sponsored Credit Card Companies in Japan

Company	Main Equity Holders	Annual Revenues (¥ Bil.)
JCB	Sanwa Bank, Sakura Bank, Daiwa Bank	2,006
Sumitomo Credit Service (VISA)	Sumitomo Bank, Nanto Bank, Sumitomo Trust, Norinchukin	1,487
UC Card	Daiichi Kangyo Bank, Fuji Bank, Asahi Bank, Sakura Bank	1,444
DC Card	Tokyo-Mitsubishi Bank, Mitsubishi Trust, Tokyo Fire and Marine Insurance	714
Million Card	Tokai Bank, Industrial Bank of Japan, Norinchukun	399
Nihon Diners Club	Fuji Bank and subsidiaries, Japan Tourists Bureau	328
American Express	N.A.	N.A.

Sources: Japan Credit Card Association and web sites of issuers (revenue figures to be updated). N.A. – Not available.

Unemployment Rate in Japan



Source: Management and Coordination Agency, Ministry of Labor, *Japan Economic Almanac, 1999.*

relatively low *(see Unemployment Rate in Japan chart above)*. Unemployment is one of the primary causes of borrower default.

Divorce Rate: The divorce rate in Japan is also at a record high. As of 1996, the divorce rate was 1.66 per 1,000 people. Although this is higher than some other countries in the region, such as Singapore and Hong Kong, Japan's divorce rate remains significantly lower than that of the U.S. and U.K. *(see Divorce Rate in Japan chart, page 4)*. Divorce is another major cause of borrower default.

Consumer Bankruptcies: Also rising are consumer bankruptcies in Japan. As of year-end 1998, consumer bankruptcies were approximately 800 per one million people (the population in Japan is about 126 million). This 1998 figure is up from less than 200 per one million in 1991. Compared with the U.S., where consumer bankruptcies are roughly 4,700 per one million people (U.S. population is approximately 263 million), the rate of individuals filing for bankruptcy in Japan is relatively small *(see Bankruptcies Per Million of Population chart, page 4)*. One could conclude from these figures that consumer defaults in Japan, due to borrower bankruptcy, would be much lower than those in other countries, particularly the U.S.

■ Product Characteristics

Revolving Consumer Loans: The banking sector in Japan offers several types of unsecured consumer loan products with revolving structures, including card loans, credit cards, and standard consumer loans. Credit cards and consumer loans are commonly used and are a well known means of consumer finance in many countries. A card loan, on the other hand, is a product not widely used outside Japan. It is an unsecured revolving consumer loan facility issued by banks and consumer finance companies. Banks with card and other consumer loan programs benefit from cross-selling, as they generally offer loans to customers holding deposit accounts. Card and consumer loans are used primarily to finance downpayments for consumer goods or for ceremonial occasions.

A card loan and credit card are similar in concept but used differently. Both have credit limits established after conducting their respective credit evaluations, generally require monthly payments, and assess interest charges when the cardholder decides to finance the balance. In the case of the card loan, the cardholder withdraws cash from automatic teller machines or cash dispensers. Unlike credit cards, the card loan program does not have a relationship with merchants and is not used directly to finance a specific purchase. In some cases, card loans have a pre-established minimum payment due each month.

Guarantors: The use of a financial guarantor is commonplace for banks in Japanese financial markets. A guarantor guarantees, to the originating institution, repayment of all debts in exchange for a fee. However, guarantors are not required for all consumer finance companies. In the case of consumer receivables deals in Japan, if a guarantor is present, Fitch IBCA will not rely on such guarantor unless the rating of the securities is the same as the rating (or the implied rating) of the guarantor. In most cases, Fitch IBCA will not give credit to recoveries due to guarantor payments and will consider the writeoff or loss rate of the portfolio of consumer loans to exclude the guarantor's payments.

■ Information Needs

To analyse a pool of credit card or card loan receivables, Fitch IBCA will review approximately three to five years of financial performance history from an originator. The data should be presented on a

Consumer Finance Product Characteristics

	Credit Cards	Bank Card Loans
Issuers/Lenders	Banks' credit card subsidiaries, shinpan, retail stores, credit card issuers	Banks
Revolving Feature	Nonrevolving/revolving	Revolving
Collateral	Unsecured	Unsecured
Eligibility Requirement	Age, income, employment, or equivalent source of income	Age, income, employment, or equivalent source of income; deposit account with the bank
Maximum Borrowing	Varies (generally ¥2 million)	Varies (generally ¥2 million)
Purpose of Loan	Open	Open but not for loan repayment, purchase of real estate, or securities
Maximum Term	Initially 12 months, with an extension feature; automatic extension for good credit	Initially 12 months, with an extension feature; automatic extension for good credit
Repayment Mechanism	Varies	By debiting the borrower's bank deposit account
Minimum Monthly Repayment Amount (% of Balance)	Nonrevolving (100% of outstanding balance due monthly); revolving (generally 3%–5%)	¥10,000 for each ¥500,000 balance
Repayment Frequency	On monthly repayment date	On monthly repayment date
Finance Charge	Commonly ≤ 8%–≥ 20%	Commonly 6.5% to 14%
Chargeoff Rate	N.A.	Varies
Credit Bureau Reference	NCCICB (banks), CIC (shinpan, retail), and, for default information, CRIN	NCCICB and, for default information, CRIN
Credit Approval Time	A few weeks–one month	A few weeks — one month

N.A. – Not available. NCCICB – National Consumer Credit Information Center for Banks. CIC – Credit Information Center. CRIN – Credit Information Network. Notes: A considerable diversity exists within this product category. This table shows only commonly observed characteristics.

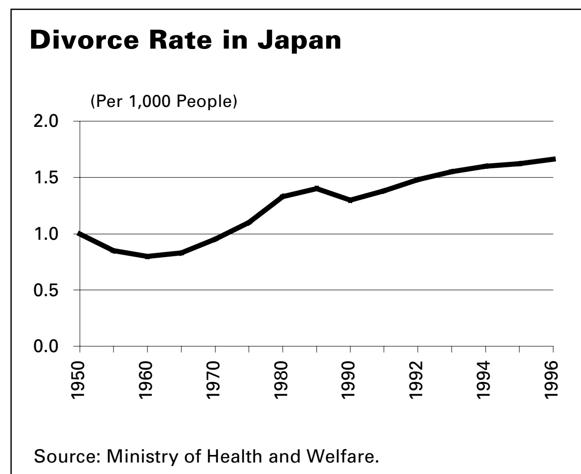
static pool basis by month of origination and include all accounts in the originator's current portfolio. The data requirements are as follows:

- Total number of accounts/loans.
- Outstanding balance.
- Collections.
- Delinquencies (including a breakdown).
- Writeoffs (including amounts put to guarantor).
- Recoveries (excluding amounts put to guarantor).
- Total finance charges.
- Interest income.
- Fee income.
- Portfolio yield.
- Writeoff payment rate.
- Setoff amounts.

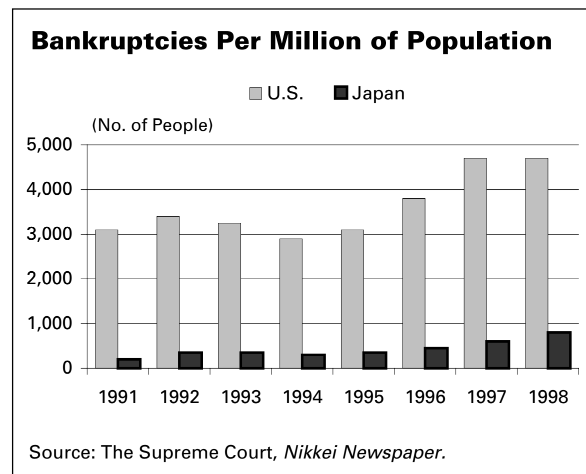
Stress Scenarios

Fitch IBCA uses a similar approach and model for rating unsecured credit cards, card loans, and consumer loans if they have a revolving structure and other similar characteristics. However, variables change depending on the individual pool characteristics. Stresses may also change depending on the type of receivables being analysed.

The performance of a pool of consumer receivables is influenced by many factors, which may have positive



Source: Ministry of Health and Welfare.



Source: The Supreme Court, *Nikkei Newspaper*.

or negative effects on the performance of a securitisation. Fitch IBCA considers current and historical performance, or a conservative projection of performance if the portfolio is unseasoned, as a benchmark by which to assess future performance. The stress scenarios applied to a transaction are determined on a case-by-case basis. The main variables used in the stress scenarios that influence credit enhancement levels are writeoffs, portfolio yield, MPR, investor coupon, and purchase/draw rate.

Writeoffs

Consumer loans are unique in that the credit quality of each borrower is reflected in the credit limit and interest rate of the facility, which are based on the borrower's ability to meet debt payments (i.e. the higher the risk, the lower the credit limit and higher the interest rate). Many issuers use credit-scoring models or well trained credit analysts to determine the borrower's probability of default. This probability dictates the credit limit level that should be granted and the interest rate.

However, examining the credit limits and interest rates of a portfolio does not always give a true picture of the issuer's total risk. Some issuers might be more aggressive in assigning higher limits to lower credit quality borrowers. Others may not have well developed scoring models. Finally, some may try to gain market share by offering very low interest rates, possibly at the expense of credit quality. All these factors must be analysed and are usually reflected in the delinquency and writeoff rates of a portfolio.

To size credit enhancement to absorb defaults, Fitch IBCA analyses the lender's portfolio to determine a steady state default rate. Most lenders' written off loans are considered unlikely to be recovered. Different lenders also have customised writeoff policies. Therefore, to evaluate each consistently and comparatively when determining a steady state default rate for a portfolio, Fitch IBCA usually considers any loan delinquent more than six months to be defaulted regardless of the lender's policy. However, this may be adjusted on a case-by-case basis. Once a steady state default rate is determined, stresses can be applied to calculate expected loss or credit enhancement for the desired rating categories.

Portfolio Yield

The portfolio yield is made up of periodic interest rate charges, as well as annual, late payment, and overlimit fees. Most of these components are relatively stable and only constitute a small percentage of the yield. On the other hand, interest income accounts for a large majority of the yield and is the most vulnerable.

In stressing a portfolio's yield, competitive position is a critical factor, since a highly priced portfolio will be under pressure to reduce rates to maintain market share. Another important factor to consider is the likelihood of a government imposed interest rate on consumer loans.

Monthly Payment Rate

The MPR includes monthly collections of principal, finance charges, and fees paid by the borrower and is stated as a percentage of the outstanding balance as of the beginning of the month. The MPR will fluctuate depending on borrower payment behavior. During months where borrowers increase payments or pay off entire loan balances (e.g. upon receipt of salary bonus), the MPR may increase. In Japan, MPRs tend to be lower than those in the U.S. For this reason, in certain instances, Fitch IBCA may use the minimum MPR for cash flow modeling.

Purchase or Draw Rate

An additional variable that must be examined for revolving loans is the pool's receivables balance. If the portfolio's outstanding principal receivables amount declines, especially during early amortisation *(see Early Amortisation, page 7)*, the result is a longer payout period and increased investor exposure to a deteriorating pool.

The primary concern from an analytical perspective is how loanholders will behave with regard to the solvency of the seller. Fitch IBCA's purchase or draw rate stress scenario will vary depending on whether or not the consumer loan, card loan, or credit card is from an institution with high credit or support ratings or, in the case of retail credit cards, if the store has a particular importance or strength in the Japanese retail sector, such that it has a low likelihood of insolvency or liquidation.

Because most consumer loan receivables are issuer-specific, Fitch IBCA believes that, in the event of issuer bankruptcy, the borrower would no longer be able to draw on the facility. This results in a finite set of receivables. Therefore, for certain credit card issuers (e.g. a small regional store in Japan) or a regional issuer of card loans, Fitch IBCA may assume a 0% purchase/draw rate, which presumes that there are no additional purchases/draws and the receivables balance of the trust will decline in lockstep with the amortisation of the securitisation.

For well underwritten, geographically diverse general-purpose portfolios or when certain market conditions are present, insolvency of the seller may not have such a dramatic effect. In the case of all revolving consumer loan products, Fitch IBCA will consider the profitability of the businesses, the market conditions for the sale and purchase of pools of accounts or loans, and the level of competition for market share among lenders, as well as the credit and/or support ratings of the financial institution.

If, after considering all these factors, it is determined that a strong and competitive loan or card market exists or that the lending institution is highly unlikely to become insolvent, these portfolios should remain active, with consumers continuing to charge and the portfolio continuing to be serviced, even if not by the original servicer. For example, for bank transactions involving a pool of MasterCard or Visa credit card receivables, if the originator/seller were to become bankrupt, the MasterCard or Visa operations could very likely be easily be transferred to another bank, thereby ensuring a receivables regeneration. In this case, the risk of receivables decline is mitigated and the purchase rate assumption will be 100%.

Support Ratings

Fitch IBCA assigns individual and support ratings, in addition to credit ratings, to more than 35 Japanese financial institutions. A support rating of 1 or 2 implies that the bank is of such importance to the economy internationally or domestically that support from the government would be forthcoming, if necessary. A support rating of 3 indicates that the bank has institutional owners of sufficient reputation and resources that support would be forthcoming. If it believes that an institution will have a high degree of support when required, the purchase rate stress tends to be lower, as the borrowers are allowed to continue making purchases/draws.

Investor Coupon

For fixed-rate asset-backed securities (ABS), Fitch IBCA uses the expected pricing level of the securities as the transaction's investor coupon expense. For floating-rate ABS, Fitch IBCA assumes that the investor coupon will increase significantly. Depending on the interest rate index used, Fitch IBCA will determine an appropriate stress scenario for each relevant rating level, looking to a historical period with high interest rate volatility to determine appropriate stress levels.

Additional credit enhancement is needed to cover the potential basis and interest rate risk between a rapidly rising investor coupon and lagging floating-rate or low fixed-rate loans or cards, where trust expenses increase faster than trust earnings. This risk is issuer- and deal-specific and is estimated based on card or loan interest rates, frequency of floating-rate resets, investor coupon index, frequency of investor coupon resets, and, to a limited extent, the issuer's ability to change interest rates.

■ Structure

One possible structure for a transaction backed by revolving consumer loans, such as credit cards and card loans, could resemble that used in U.S. credit card receivable securitisations. (Obviously, certain modifications are necessary due to Japanese laws, regulations, and market practices.) In this case, a designated pool of accounts is transferred to a trust created in Japan, including the outstanding receivables at the closing date that constitute the initial trust assets. As the obligors start to pay their balances, the collections are deemed part of the trust assets. During the revolving period, these collections are used for purchasing additional receivables created on the designated accounts.

A typical U.S. credit card deal is structured with a senior and subordinate class of certificates and a seller piece. Fitch IBCA views the seller's maintenance of an ownership in the trust favorably. The seller participation performs several critical functions. The seller piece acts as a buffer to absorb seasonal fluctuations in the receivables' balances. It is also allocated all dilutions (canceled balances due to returned goods) and any fraudulently generated receivables that have been transferred to the trust, as well as absorbing setoff risk. Additionally, it ensures that the seller will maintain the credit quality of the assets of the trust since the seller owns a portion of it. To ensure that the investor's interest remains always fully invested in receivables, the size of the seller's participation should remain at or above a minimum percentage of the trust receivables. If the seller's participation falls below the required minimum, the seller should be obligated to add additional receivables to the trust assets. If the seller cannot provide additional accounts, an amortisation event will occur.

The typical revolving card loan or credit card securitisation has three different cash flow periods — revolving, controlled amortisation (in some cases, controlled accumulation), and early amortisation. Each period performs a specific function and allocates cash flows differently. This structure is designed to mimic a traditional bond, in which interest payments are made every month and principal is paid in a single bullet payment on the maturity date.

Since the average life of a consumer loan receivable is short (depending on the MPR), an amortising structure,

typically used in automobile and mortgage deals, would cause bonds to be issued with very short maturities. Use of a revolving structure gives the issuer medium- to long-term financing and the investor a predictable schedule of principal and interest payments.

All collections on the receivables are split into finance charge income and principal payments. Each of the three periods treats finance charge income in the same manner. Monthly finance charges are used to pay the investor coupon and servicing fees, as well as cover any receivables that have been charged off in the month. Any income remaining after paying these expenses is usually called excess spread and is released to the seller. However, principal collections are allocated differently during each period.

During the revolving period, principal is allocated pro rata to the investors and seller (although the principal payments are used to purchase new receivables). During the controlled amortisation period *(see Controlled Amortisation and Controlled Accumulation charts, page 8)*, a portion of the seller's principal is reallocated to the investors. Principal payments among the senior and subordinate investors are divided sequentially. Interest and default allocations are always pro rata between the seller and investors. In transactions where credit enhancement is in the form of excess spread and subordination with respect to the investor portion losses, interest and default amount are typically allocated first to excess spread and then to the subordinate class *(see Credit Enhancement, below right)* Generally, the seller's participation does not provide credit enhancement for the investors, except for dilutions, fraud, and setoff.

Revolving Period: During the revolving period, monthly principal collections are used to purchase new receivables generated in the designated accounts or new draws on the loans to purchase a portion of the seller's participation if there are no new receivables. If there are not enough new receivables to reinvest in, an early amortisation will be triggered because the seller's participation has fallen below the required minimum. In some cases, the excess principal collections will be deposited in an excess funding account and held until the seller can generate more receivables. The risk of early amortisation gives the seller adequate incentive to maintain the seller's participation at the level well above the minimum. The revolving period continues for a predetermined length. Investors will receive only interest payments during this period.

Controlled Amortisation/Accumulation: At the end of the revolving period, the controlled amortisation or controlled accumulation period begins. In the case of controlled amortisation *(see Controlled Amortisation chart, page 8)*, principal collections are no longer reinvested but paid in equal controlled amortisation payments. Any principal collections exceeding the controlled amount will be reinvested in new receivables, as in the revolving period. Interest will be paid only on the outstanding amount of the securities as of the beginning of the monthly period.

Controlled accumulation follows similar procedures, except that the controlled payments are deposited into a trust account, or principal funding account (PFA), every month and held until the expected maturity date. At the end of the accumulation period, the full invested amount will have been deposited into the PFA and investors will be paid their principal in a single payment *(see Controlled Accumulation chart, page 8)*. Interest payments will continue to be made each month on the total invested amount. With this structure, investors will not see any difference in monthly payments when the deal converts from a revolving to accumulation period.

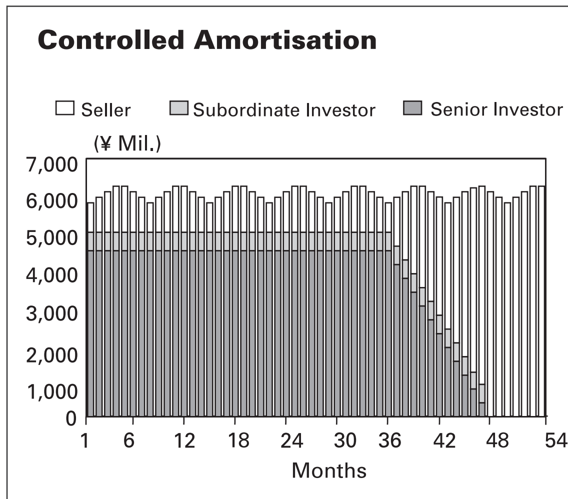
Early Amortisation: Severe asset deterioration, problems with the seller or servicer or certain legal troubles can trigger early amortisation at any point in the deal, whether it is revolving, amortising, or accumulating. In such cases, the deal automatically enters the early amortisation period and begins to repay investors immediately. All principal collections and any amounts in the PFA will be distributed to investors, with senior certificates being paid off first and then subordinate classes of debt.

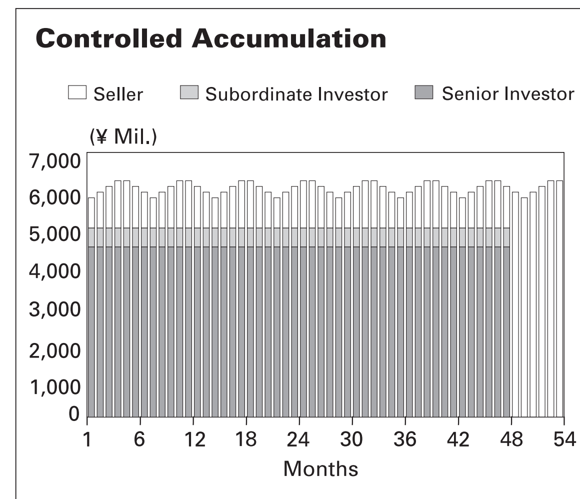
■ Fitch IBCA's Cash Flow

Although Japanese credit card and card loan receivables vary greatly in terms of yield, writeoffs, and repayment rate, as an illustration Fitch IBCA has selected a composite credit card portfolio believed to be widely shared by major bank issuers. The portfolio, on a dynamic basis, shows yield of 13%, writeoffs of 2.5%, and MPR of 4%. The steady state yield has been adjusted to 11% to reflect the rapid growth of a portfolio in recent years. Similarly MPR was reduced to 2.5%, which is equal to the pool's required minimum payment level. Writeoffs consisted of accounts delinquent 180 days or more prior to presentation to the guarantor. The 12.5% 'AAA' writeoff level was determined by using a 4.5 times multiple over the steady state projection of 3%. Finally, a purchase rate stress was applied to account for a declining portfolio balance, as well as the risk of a cessation in card loan usage in the event of the issuing bank's insolvency.

Credit Enhancement

As unsecured revolving debt obligations, credit cards, card loans, and consumer loans offer no collateral in the event of borrower default. As a result, recoveries





are limited. To achieve investment-grade ratings, credit enhancement is needed to insulate investors from fluctuating payment patterns and writeoffs. Common forms of credit enhancement are excess spread and subordination.

Excess Spread: The yield on certain consumer loan products is high relative to other types of consumer loans. This yield should cover the payment of investor interest in addition to the servicing fees and still be sufficient to reimburse the trust for any receivables written off during the month. The remaining yield, or excess spread, provides an approximation of the financial health of a transaction. Available excess spread may be shared with other series, used to pay fees to credit enhancers, deposited into a spread account for the benefit of the enhancers, or released to the seller.

If the deal is performing as expected, the cash flow from the pool of loans or cards will be sufficient to make all principal and interest payments to investors and pay all expenses, with plenty remaining. The excess spread would have to be depleted (i.e. decrease in yield, increase in coupon, and/or increase in writeoffs) before there would be a cash shortfall. However, if excess falls below zero, other credit enhancement must be available to make up the shortfall.

Subordination: A senior/subordinate structure offers two different types of investor ownership in the trust — senior and subordinate participation. The subordinate piece will absorb losses allocated to the senior that are not already covered by excess spread. Draws on the subordinate certificate may be reimbursed from future excess spread. Principal collections will be allocated to the subordinate investors only after the senior certificates are fully repaid.

■ Servicing

A key factor in evaluating and rating a pool of consumer loans is the quality of the operations and procedures of the underlying loan originator/servicer. In Japan, as well as many other emerging markets, there is a pronounced need for quality servicer operations. A direct correlation exists between origination and servicing functions and the performance of a collateral pool. A more experienced lender will have better collections operations and, therefore, fewer defaults. Fitch IBCA may increase or decrease credit enhancement based on the quality and experience of the originator and administrator. Underwriting guidelines and collections procedures are of particular importance. The limited history of a backup servicer industry in Japan increases the risk associated with a servicer transfer in a transaction. Depending on the structure of a securitisation, Fitch IBCA may require that a reserve fund be set aside to cover any delay in collections due to a transfer in servicing.

Fitch IBCA reviews the operations of the originator/administrator to determine whether the company's procedures, controls, and performance are acceptable. Interviews and procedural reviews are performed not only to determine if operations comply with industry and investor guidelines, but also to ensure that the proper controls are in place for a given transaction.

An additional issue particular to Japan is the role of the trustee in a securitisation. In a situation where the seller/servicer is related to the trustee, a potential conflict of interest arises. Provided that the trustee operates in the trustee role for outside parties and cannot act in a manner that may affect investors, Fitch IBCA may allow a seller-related trustee to participate in a transaction.

Backup Servicer

Fitch IBCA will require a backup servicer in cases where the originator is not highly rated. If the

existing servicer has a sufficiently high rating, Fitch IBCA might not require a backup servicer at the start of the transaction but, instead, would require the trustee to appoint one if certain circumstances arise and assuming that there are a sufficient number of backup servicers available in the market willing and able to replace the original. In this situation, Fitch IBCA would ensure that the servicing fee was high enough to attract replacement servicers.

In Japan, a shortage of qualified backup servicers exists. In addition, there are limitations on which entities are permitted to service loans, thus making it difficult for experienced third-party servicers to participate in the market. A bill addressing debt servicing and recovery, known as the Servicer Act, requires that the servicing entity: have minimum capital of ¥500 million and be licensed by the Minister of Justice; have an approved Japanese lawyer on its board of directors; if it is not a Japanese company, may not service loans it has purchased; and may service only approved assets, including loan receivables held by financial institutions and non-banks, specified claims under the MITI Securitisation Law, and some other claims. The law was enacted to suppress illegal debt collection activity in Japan.

■ Sovereign Risk

Fitch IBCA currently rates the foreign and local currency obligations of Japan 'AA+' and 'AAA', respectively. The government's foreign currency rating normally acts as a ceiling for resident issuers, since there is ample empirical evidence that countries, when in a default scenario, have imposed exchange controls and other measures that precluded otherwise creditworthy issuers from servicing their foreign currency debt. On the other hand, the local currency rating is not usually a cap, as governments have few incentives to limit access to their own currency.

For an international rating, breaching the foreign currency ceiling requires structural provisions that isolate relevant cash flows from any government interventions. These include, but are not limited to, offshore reserve accounts, currency swaps, and alternative mechanisms to access foreign currency. When assessing different factors that can diminish sovereign risk, even if one alone is not enough to eliminate it, Fitch IBCA takes a probability approach combining all relevant aspects.

In addition, devaluation risk may need to be addressed within a transaction if the issuance is denominated in a foreign currency while the underlying pool of receivables are in Japanese yen. Depending on the desired rating on a transaction, Fitch IBCA may apply a devaluation scenario on cash flows to ensure that the transaction can withstand worst-case economic stresses.

■ Setoff Risk (Relevant for Banks)

Setoff risk exists in Japan for those sellers that are allowed to take deposits from the public; thus, the issuer of card loans (a bank) carries such risk when it is a seller, while a non-bank credit card issuer does not.

Banks are permitted to set off the debt against deposits of the borrower if the borrower is unable to cover his obligations to the guarantor. Conversely, the borrower is able to set off his or her deposits against the loan payment obligation to the extent that the bank fails. To protect investors from incurring losses due to setoff, Fitch IBCA will require credit enhancement to cover this risk. The amount of credit enhancement will vary depending on the existence of deposit insurance, stability of the seller, and amount of setoff, as well as obligor perfection for banks.

Deposit Insurance: There is Deposit Insurance Corp. coverage available on all yen deposit accounts, with no maximum limit until March 2001, after which the

Base Case Stresses

	'AAA'	'AA'	'A'	'BBB'
Fixed Yield (%)	35.00	30.00	25.00	20.00
Monthly Payment Rate (MPR) (%)	45.00	40.00	35.00	30.00
Writeoffs (x)	4.50–5.00	3.75–4.25	3.00–3.50	2.25–2.75

Base Case Example: 'AAA'

Variable	Steady State	Scenario	'AAA'
Yield (%)	11.00	Minimum Eligibility Requirement	8.00
MPR (%)	2.50	Maintained at Minimum Contractual Rate	2.50
Writeoffs (%)	3.00	Increased to	13.50
Purchase Rate (%)	Variable	Cut to	0.00

maximum coverage is expected to be ¥10 million. The amount of insurance coverage will not be affected even if the depositor owes debt to the failed financial institution. However, according to the Deposit Insurance Law of Japan (Law No. 34 of 1971, as amended), there is no requirement for a depositor to make a claim from deposit insurance prior to exercising its right to setoff. The depositor may choose to set off its deposit with the bank prior to filing a claim for deposit insurance or may file the claim for insurance and only set off the amount remaining after the claim has been paid. In Fitch IBCA's opinion, the depositor and borrower would be interested in getting their deposits back in cash rather than requesting a set off of their cash for the card loan balance. In addition, as a practical matter, most borrowers are not knowledgeable about their rights to set off and, therefore, may not exercise this right. Fitch IBCA gives partial credit for deposit insurance.

Stability of the Seller: If the originator is highly rated and has a high support rating, the risk of failure is reduced and, therefore, so is the risk of setoff. In this case, although credit enhancement may still be needed to cover the risk of setoff, the amount of such credit enhancement may be less than otherwise required.

Amount of Setoff: Fitch IBCA will quantify the amount of setoff risk at the start of the transaction based on historical deposit rates and the proportion of deposits versus the loan balance of the borrowers in the portfolio to be securitised. The risk of setoff in consumer loan transactions is less than in residential mortgage securitisations for at least three reasons. First, the balances of consumer loans tend to increase or remain steady throughout the life of the transaction compared with mortgage balances, which decline, causing increased risk of setoff. Second, the maturity of a residential mortgage-backed securitisation is about 10 times longer than that of consumer loan transactions, thereby increasing the risk of exposure to setoff in mortgage deals. Finally, it is unreasonable to assume that a borrower would incur any high interest charges against a loan while the borrower has a significant amount of cash deposited at the bank.

Nevertheless, to limit the amount of credit enhancement required to cover losses due to setoff, the loans selected for securitisation should be those from borrowers with limited deposits at the bank. (However, selecting borrowers with lower deposits may be considered more risky. To protect against this, Fitch IBCA will compare performance data for the portfolio to be securitised against the bank's overall portfolio of similar loans to ensure that the risk profile of the borrower is similar. In addition, Fitch IBCA will insist that the bank's underwriting guidelines limit loans to borrowers who meet conservative credit standards.) Credit enhancement or a seller piece must be available to cover potential setoff risk for a bank portfolio. Fitch IBCA will monitor setoff risk throughout the life of the transaction. Fitch IBCA may require triggers in a transaction's structure that cause excess cash to be trapped to cover this risk instead of releasing excess cash to the seller.

Obligor Perfection (Relevant for Banks): Japan's Perfection Law (Saiken Jouto Tokureiho) permits the perfection of an assignment against third parties upon the filing of a registration document with the Legal Affairs Bureau. The law does not allow a perfected assignment against underlying obligors, such that the obligors may declare setoff against the bank. To eliminate the risk of setoff, the bank will need to obtain the consent of the obligor "without reservation." This consent will eliminate all rights of setoff, including those occurring before consent of the borrower is received. Alternatively, the bank may give notice to the obligor or send it a registration certificate issued by the Legal Affairs Bureau. The latter two options will eliminate the right of setoff when the certificate has been delivered. To the extent that the bank perfects against the obligors, no additional credit enhancement will be required to cover setoff risk, except in the case of the latter alternatives. In these cases, credit enhancement or the seller piece must cover the risk of setoff that may exist prior to delivery of the registration certificate. Of note, the cost of registration must be reserved for within a securitisation if registration is to take place upon a downgrade trigger linked to the originator's rating. However, a trigger mechanism has its limitations. In cases where Fitch IBCA is most concerned about setoff risk, it is because of the low rating of the originating bank. It is not unusual for originating institutions that securitise to have low ratings, since one of the benefits of securitisation for lesser creditworthy institutions is to raise funds at an 'AAA' rate. A trigger mechanism would serve no benefit in this situation.

■ Legal Issues

When rating a consumer loan receivables transaction, Fitch IBCA evaluates the legal structure's strength. Key areas of focus include the bankruptcy-remoteness of the structure, the perfection of the assignment of receivables, mandatory notification to the obligor, the usury law, the assignment of future receivables, the potential conflict of interest arising when a bank is the seller and trustee bank, and certain tax-related issues. (Sources of the following discussion include "Hanrei Tokuhou [Special Report on Recent Court Decisions] in Kinyu Shoji Hanrei," dated 15 March 1999, and "Securitisation of

Consumer Loan Receivables in Japan" in The Asian Securitisation and Structured Finance Guide 2000.)

Credit card receivables and card loans are regulated by different sets of laws in Japan. The Money Lender Restriction Act of 1983, the Revised Law of Subscription, and the Law regarding the Regulation of business concerning specified claims, etc. (the MITI Law or Tokusaihou) are applicable to credit card receivables. On the other hand, the Banking Law, the Interest Rate Restriction Law, and the Law regarding Special Rules for Assignment (The Perfection Law or Saiken Jouto Tokureiho) regulate the card loans, a banking product. As a result, legal requirements for the securitisation of these two types of consumer assets differ significantly with respect to the perfection of the transfer of receivables, mandatory borrower notification at the time of assignment, and the application of usury rates.

True Sale Considerations: To ensure a true sale of assets from the seller to the trust, the Japanese guidelines provide that the transferor must be deemed to have surrendered control over such assets only if: the transferee's right and interest in the transferred assets have been secured against the transferor and its creditors and duly segregated from the transferor's bankruptcy risk; the transferee may enjoy the rights and interests to and in the transferred assets; and the transferor does not have the right to repurchase the transferred assets prior to their maturity, except for an agreed upon clean-up call.

The transaction's structure must ensure that a seller insolvency will not interrupt timely payments of interest and ultimate payment of principal. Under Japanese law, the originator/seller entrusts to the trustee ownership of the existing and additional receivables to be securitised. The receivables become assets of the trust, such that legal title to the receivables would not constitute part of the originator/seller's estate in any bankruptcy, insolvency, or reorganisation proceeding of the seller.

Fitch IBCA will require a true sale opinion or its equivalent, when appropriate, verifying that the sale of the assets from the originator to the trust is considered a true sale (if the originator were to become insolvent, the assets would not be considered part of the bankruptcy estate).

Perfection of the Transfer of Receivables: Currently, Japan has three sets of laws regulating the perfection of asset assignment: the Civil Code of Japan; the Law regarding the Regulation of Business concerning Specified Claims, etc. (the MITI Law or Tokusaihou), which is applicable to financial assets under MITI's jurisdiction, including credit cards, leases, and auto loans; and the Law regarding Special Rules for Assignment (the Perfection Law or Saiken Jouto Tokureiho), which is applicable to non-MITI financial assets, including finance company loans and bank loans.

To the extent that they satisfy the legal definition of credit card receivables, credit card receivables are classified as Specific Claims and regulated by the MITI Law. Therefore, an assignment of these assets as against the third party as well as the obligor can be perfected by filing a registration statement with a Legal Affairs Office.

The Perfection Law permits the perfection of an assignment of card loans as against third parties by filing a registration statement with a Legal Affairs Bureau. But this method is not effective as against underlying obligors. To perfect the assignment as against the obligor, it is necessary to obtain the consent of the obligor without reservation or to deliver a copy of the registration certificate issued by the Legal Affairs Bureau to the obligor. Many sellers have found this notification a burdensome requirement. However, a number of Japanese legal experts observe that, under a likely scenario, the absence of perfection against the obligor in the case of consumer finance companies is not materially detrimental to the assignor or investors, since unlike in the case of banks, consumer finance companies are not permitted to take customer deposits with respect to which the obligors could exercise rights of setoff.

An exception to this likely scenario occurs if the initial servicer (typically the seller) is terminated. In such termination, the assignment of the receivables should be perfected: first, by the seller/servicer or trustee giving notice to the obligors pursuant to the relevant provisions of the Japanese Civil Code and the Perfection Law, and, second, by the trustee delivering registration certificates (tokijikoh shoumeisho) to the obligors. Fitch IBCA will require an opinion of counsel for the transaction stating that the assignment of receivables will be validly perfected against the obligors upon delivery of such registration certificates to the obligors.

Mandatory Borrower Notification: For the purpose of protecting obligors' interest, the Money Lender Restriction Act provides that a notice of an assignment of a loan must be delivered to obligors. This provision is applicable to the assignment of credit card loans but not to card loans.

Borrower notice required under the Money Lender Restriction Act must contain information about the

assigned loan, including the loan agreement date, the assignment date, the unpaid balance, and the interest charged. Borrowers are required to be notified of the assignment not only at the time of the assignment of the loan but also at the time of each drawdown. Given the revolving nature of consumer and small-business loans discussed in this report, this requirement has been often cited as one of the main obstacles to the securitisation of this asset class. Those consumer finance companies that have completed securitisation transactions to date have made changes to their loan agreement and their payment and collection systems to allow compliance with this requirement.

Usury Laws: Under the Subscription Law of 1954 (as amended), a licensed money lender is subject to criminal sanctions if it charges interest rates of more than 40.004% per annum. (As this report went to press, the Japanese government was debating the reduction of this ceiling to the approximate level of 30%.) On the other hand, the Interest Rate Restriction Law (IRRL) imposes interest rate ceilings of 15%–20% per annum depending on the principal amount of loan, namely 20% for loans with a principal amount of less than ¥100,000 and 18% for loans with a principal amount between ¥100,000–¥999,999, and for loans with a principal amount of ¥1 million or more.

The interest rate charged for card loans, a banking product, must observe the ceiling set by the IRRL However, the Money Lender Restriction Act of 1983 (as amended) provides guidelines for money lenders, including credit card issuers to operate legally under this dual standard. The 1983 law provides that the money lenders are allowed to receive interest payments in excess of the ceilings imposed by the IRRL (but less than the level set by the Subscription Law) only if the required conditions are satisfied, including:

- At the time of the execution of a loan agreement, either certain information required under Article 17 including the lender name and address, contract date, loan amount, loan interest, and method, frequency, and period of repayment (or an original of the loan agreement containing the information) is delivered to the borrower without delay.
- At the time of each repayment under a loan, certain information required under the Article 18 (including the name and address of the lender, contract date, the balance of remaining loan, the breakdown of the repayment received into principal and interest) is delivered to the borrower as evidence of receipt.
- The borrower pays the interest voluntarily.
- No administrative sanctions have been imposed on the relevant money lender.

It is clear that given the common use of automated cash dispensing/repayment machines, as well as revolving facility structure, it requires considerable diligence on the part of consumer finance companies to fully comply with these requirements. Furthermore, interpretation of certain notification provisions as applied to a revolver (for example, at the execution of a loan agreement or at each drawdown) is not always consistent among Japanese legal experts.

Assignment of Future Receivables: The validity of future receivables can be a major issue in the securitisation of revolving loans. Until earlier in 2000, the assignment of future receivables was valid in certain limited conditions. However, the Supreme Court of Japan determined in January 1999 that the future receivables considered in the case were validly assigned and held the view that assignments of future receivables are generally valid so long as they are sufficiently specified in the assignment agreement.

Potential Conflicts of Interest: If the seller/originator is a Japanese bank (or bank-sponsored credit card company) with an equity interest in the Japanese trustee, it must be stated that such relationship does not adversely affect the valid assignment of the trust assets to the trustee. Furthermore, the trustee must be a trust bank in the trust business of functioning for third parties in their capacity as trustee. Finally, the Japanese trustee is obligated to execute its fiduciary duty under the trust agreement, such as taking actions against possible affiliated companies, including the originator bank.

Taxes: Fitch IBCA will require a tax opinion that addresses any taxes, such as withholding or corporate taxes, that may affect cash flows to investors. If such taxes exist, credit enhancement may be required to compensate the trust and investors and/or any risk must be disclosed to investors.

Copyright © 2000 by Fitch IBCA, Inc. • One State Street Plaza, NY, NY 10004 • Telephone: New York, 1-800-753-4824, (212) 908-0500, Fax (212) 480-4435; Chicago, IL, 1-800-483-4824, (312) 214-3434, Fax (312) 214-3110; London, 011 44 20 7417 4222, Fax 011 44 20 7417 4242; San Francisco, CA, 1-800-953-4824, (415) 732-5770, Fax (415) 732-5610 • Reproduction in whole or in part prohibited except by permission. Fitch IBCA ratings are based on information obtained from issuers, other obligors, underwriters, their experts, and other sources Fitch IBCA believes to be reliable. Fitch IBCA does not audit or verify the truth or accuracy of such information. Ratings may be changed, suspended, or withdrawn as a result of changes in, or the unavailability of, information or for other reasons. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch IBCA receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from $1,000 to $750,000 per issue. In certain cases, Fitch IBCA will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from $10,000 to $1,500,000. The assignment, publication, or dissemination of a rating by Fitch IBCA shall not constitute a consent by Fitch IBCA to use its name as an expert in connection with any registration statement filed under the federal securities laws. Due to the relative efficiency of electronic publishing and distribution, Fitch IBCA Research may be available to electronic subscribers up to three days earlier than print subscribers.