

Securitization in Asia

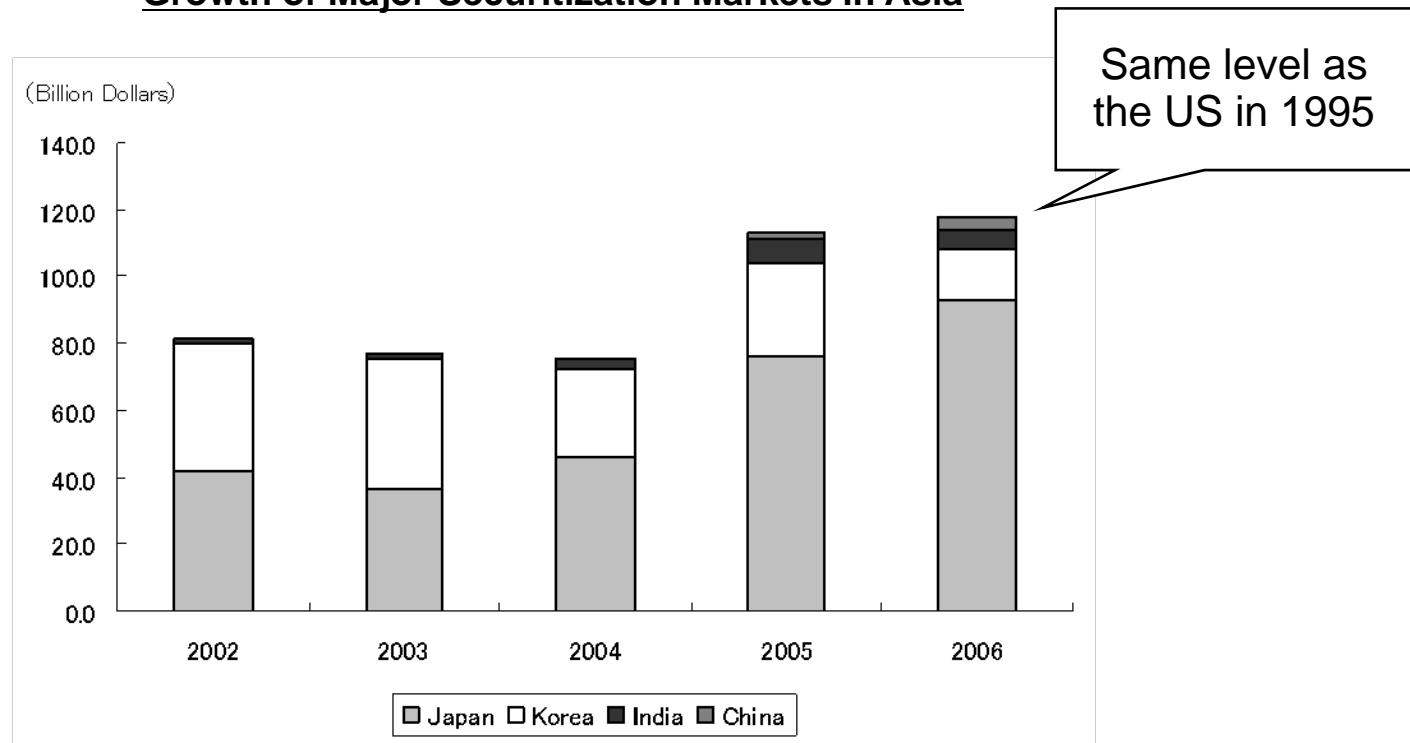
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Nomura Institute of Capital Markets Research

Era of securitization over ?

- Securitization has just begun in Asia, and its sound growth expected to continue, though at a moderate pace.

Growth of Major Securitization Markets in Asia



Source: Nomura Securities, R&I, ChinaBond.com, Vinod Kothari "Indian Securitization Market"

Why?

- The primitiveness of Asia’s securitization markets ironically explain their soundness.
- In contrast, the US market was “developed” in terms of quantity but not quality. Sophisticated schemes run by industry experts eventually turned into unsound mechanisms of alchemy.

	Investors	Participants (servicer, arranger, originator)	Initiative Public/Private	Structure
Under-developed Market (Asia)	Domestic Banks	Bundled (Banks)	Public Sector	Simple
“Developed” Market (US)	Domestic/Foreign Various Institutional Investors	Unbundled	Private Sector	Complex (re-securitization & multi-tranche)

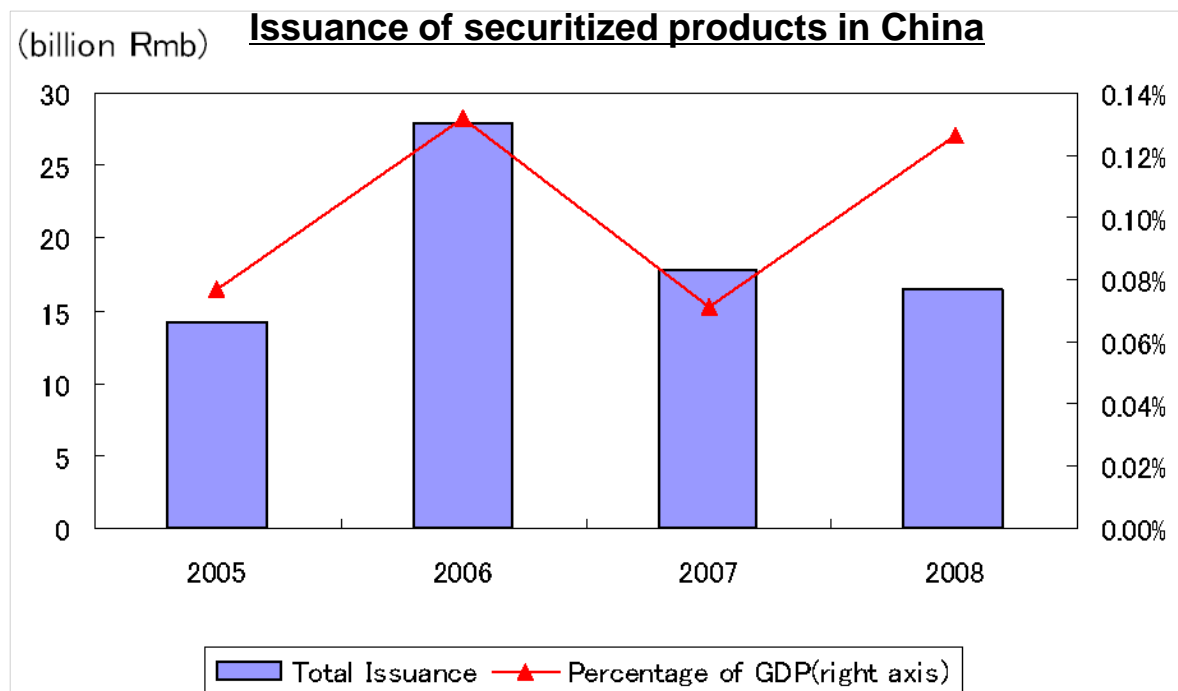
Pivotal role of public sector in Asia

- Asia's securitization markets developed under the public sector's initiative.
- The involvement of the public sector in Asia made government intervention in the early stages of turbulence possible, and thereby made the maintenance of a sound market more likely.

	Japan	China	Korea	Malaysia
Principal Regulator	Financial Services Agency	Peoples' Bank of China CSRC, CBRC	Financial Services Commission	Securities Commission
Major Originator (public sector)	Japan Housing Finance Agency	State-owned Banks	Kamco Korea Housing Finance Corporation	Danaharta Cagamas

Securitization market in China

- Securitization in China started in 2005 as a pilot program. The purpose was to:
 - a) transfer and spread the risk of banks' loan assets
 - b) dispose of banks' nonperforming loans
 - c) make it easier for nonfinancial companies to raise funds
 - d) give investors a greater choice of investments.
- Thus far, RMBS, CLOs, and securities backed by non-performing loans, auto loans, and nonfinancial companies' specific cash flows have been issued.



Source: ChinaBond.com, National Bureau of Statistics

Role of public sector in China

- China was quick to review its regulations in response to the subprime turmoil.
 - In February 2008, CBRC issued notification of stringent securitization regulation, calling for tighter risk control, prevention of moral hazard, further disclosures, etc.
 - Since May 2008, approvals for new issuance have been suspended.

Notice on Further Improving Management of the Credit Assets Securitization Business

Banks to which it applies	China Development Bank, Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank, Bank of Communications, joint-stock commercial banks
①	Pay attention to asset quality and steadily promote securitization
②	Control credit risk and ensure that sales are "true"
③	Accurately judge transfer risk and strictly comply with capital requirements
④	Improve risk management and internal controls to prevent operational risk
⑤	Work out a proper mechanism for assessing loan service performance in order to prevent moral hazard
⑥	Standardize the procedures for transferring creditors' rights in order to mitigate legal risk
⑦	Improve disclosure and protect investors' legitimate interests
⑧	Improve investor education

Subprime crisis in Japan?

- The performance of Japanese structured finance is still stable, except for one deal.
- The senior tranche in “CBO All Japan” was downgraded from AAA to CCC- .

■ Overview of issuance

Issuance amount	¥88.1 billion			
Number of companies	1269			
Bond issuance		Issuance amount	Credit rating (S&P)	Final maturity
	Class A	¥4 billion	AAA	April 2009
	Class B	¥83.1 billion	AAA	July 2009
	Class C	¥700 million	AA	July 2009
	Class D	¥300 million	A	July 2009
SPC	CBO All Japan TMK			
Arranger	Mizuho Bank			
Originators	Mizuho Bank/Bank of Ikeda/Sumitomo Mitsui Banking Resona Bank/Shizuoka Bank/Shimizu Bank/Suruga Bank			
Interest rate	Average of 3.3% (fixed, all-in)			
Issuance format	Public ABS			
Term/Repayment	3yr/bullet repayment			
Funding amount	Maximum of ¥100 million per company			

■ Ratings history

	Class A	Class B	Class C	Class D
Initial March 2006	AAA	AAA	AA	A
July 2007	↓	AA	A-	BBB-
September 2007	↓	BB+	BB+	B
April 2008	↓	B-	CCC-	CCC-
July 2008	↓	CCC-	↓	↓

Subprime crisis in Japan? (Cont.)

- CBO All Japan is a case of model-error and shares the same type of problems with the US subprime crisis
- A case like this is rare in Japan, however, since the structure of Japan's securitized products is kept simple, and a full "originate to distribute" model is not common: the subordinate tranche is kept by the originators.

Quantitative Model Errors

Excessive reliance on quantitative models, limited historical data, etc.

Inadequate Assumption

The number of defaults in the asset pool was higher than assumed

Moral Hazard in an "Originate to Distribute" model

Probability of inappropriate due diligence, etc.

Characteristics of JHF

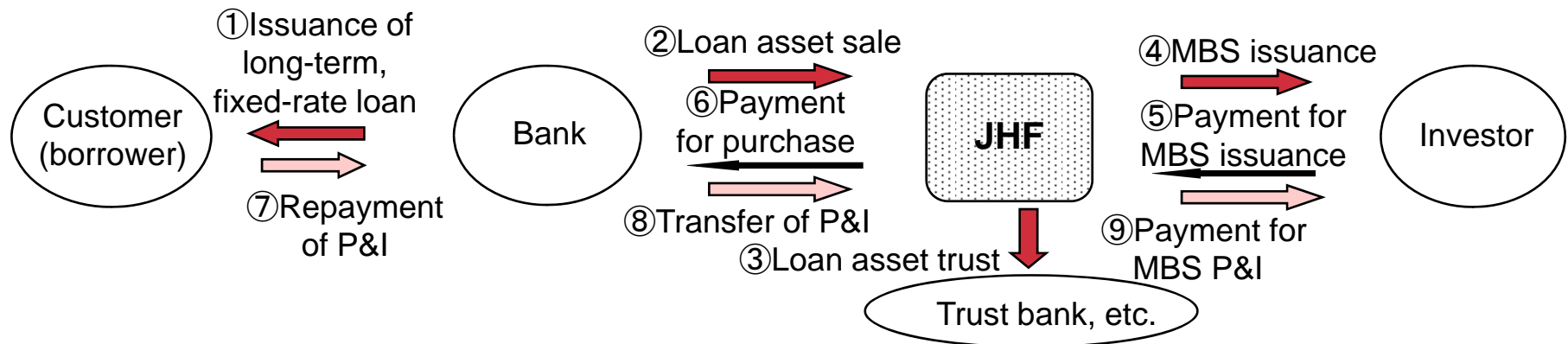
- The structure of RMBS issued by the Japan Housing Finance Agency (JHF) was introduced in 2003 with Fannie Mae as a model.
 - In 2007, the JHF replaced the Government Housing Loan Corporation, a government-run organization.
- However, there are some fundamental differences between JHF and Fannie Mae.

	JHF	FNMA
Purchase/ Guarantee	Both (mostly purchase)	Mainly purchase (GNMA does the guarantee)
Over Collateral	Sufficient	Insufficient
Government Funding	YES	NO (in origin)
Portfolio Management	NO	YES
Credit Evaluation Criteria	Rigid	Not rigid (as it turned out)

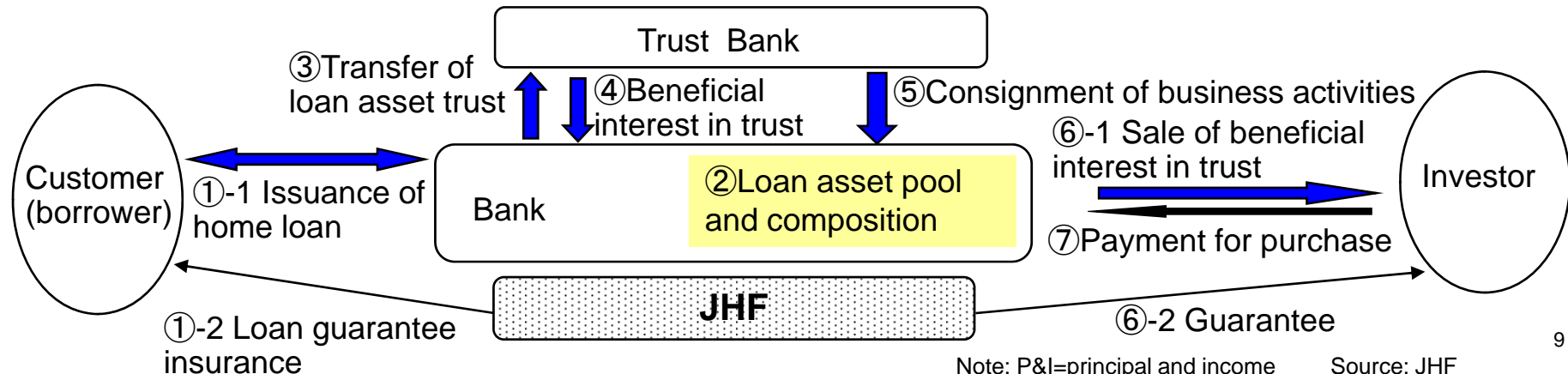
JHF's securitization support business

- Predominantly a purchase program, which resembles that of FNMA
- The guarantee program resembles that of GNMA

JHF's Securitization Support Business (Purchase Program)

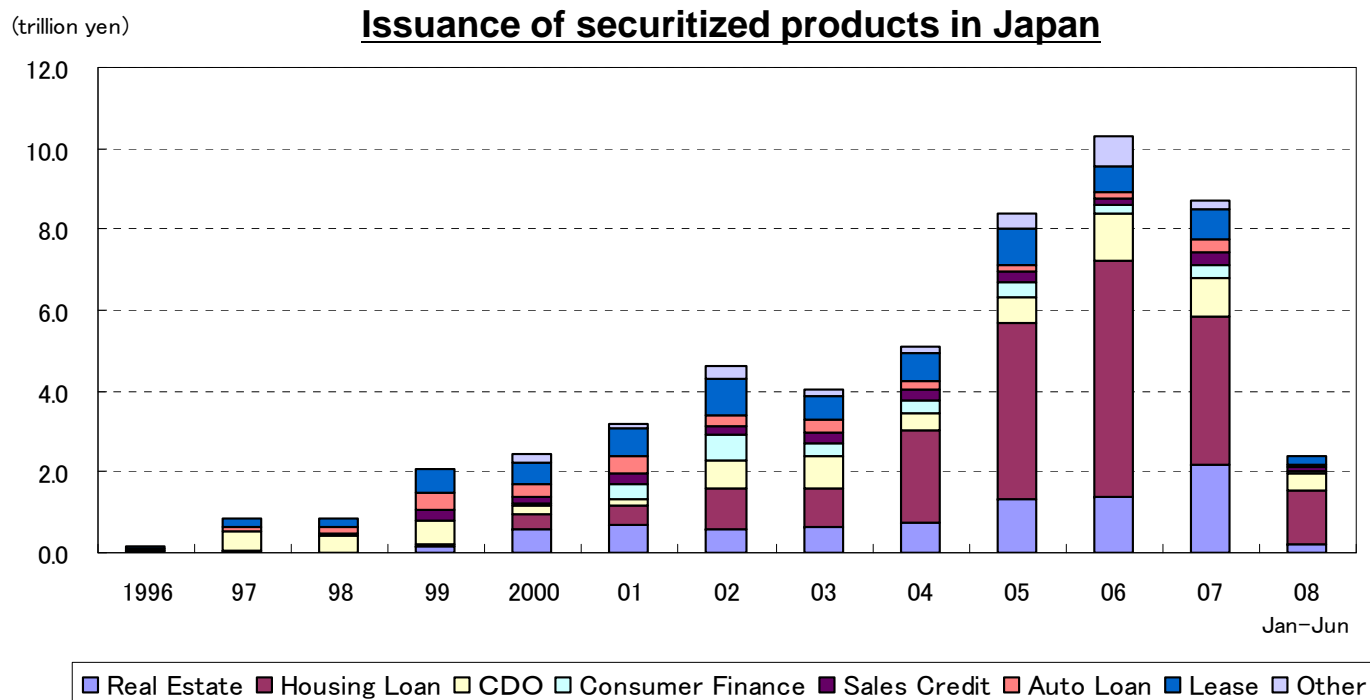


JHF's Securitization Support Business (Guarantee Program)



Securitization market in Japan

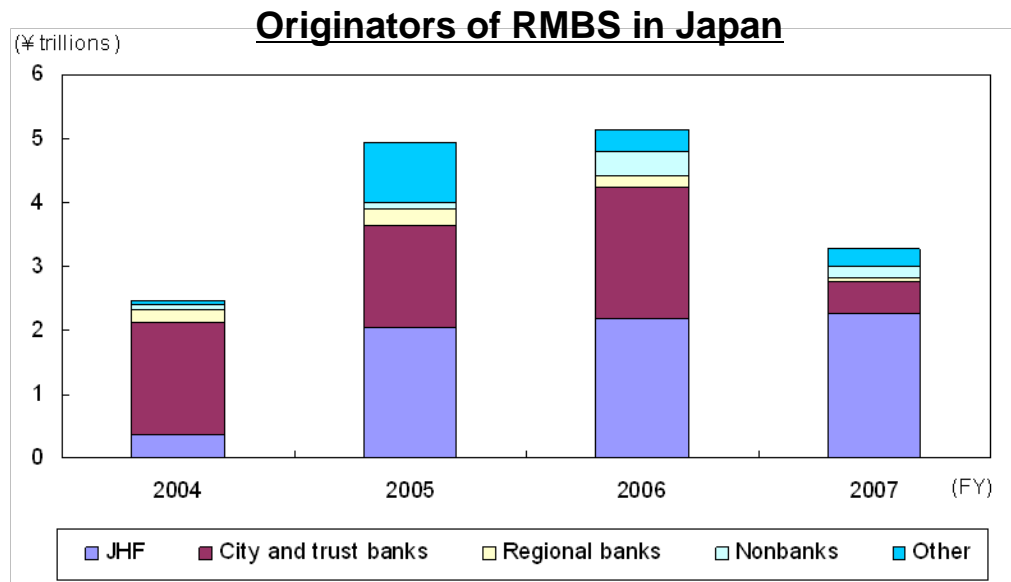
- Issuance of securitized products in Japan started around 1996, and today has reached 10 trillion yen, comprised mostly of RMBS.
- However, the Japanese securitization market has reached an impasse, particularly in the private sector, not only because of the subprime crisis, but also because of factors inherent to Japan, such as the change in lease accounting rules and the abolishment of so called “gray zone” interest rates in consumer finance.



Source: Nomura Securities

Increasing role of JHF

- In the absence of the private sector, JHF has increased its presence, and this trend is likely to continue.
 - The policy objective behind the establishment of JHF was to promote not only housing but also the growth of Japan's capital market via the increased use of securitization, as well as administrative reform aimed at smaller government.
 - Private sector participation in RMBS is limited, due to:
 - a) the mainly private offering of trust certificates (low liquidity)
 - b) the need for banks' to take loans off their balance sheets is limited under the relaxed monetary policy



Source: Japanese Securities Dealers Association

JHF's future is under debate

- In the context of administrative reform, debate over the privatization of JHF is ongoing. Lessons from the US subprime turmoil must be taken into consideration, however.
- As with the GSEs in the US, the privatization and listing of a former large public financial institution would lead to the privatization of returns (profits to shareholders) and the socialization of risks (losses to taxpayers).
- If the JHF is to carry out its policy objectives and have an “implicit guarantee” from government, its present status of “Incorporated Administrative Agency” would be understandable. Becoming a stock corporation wholly owned by the government would make it a more solid and credible entity (e.g.; Japan Finance Corporation*).
- The opposite choice would be to abandon both the policy objective of promoting home ownership and the implicit guarantee by purely privatizing JHF and turning it into just one of many private banks. In this case, however, JHF would lose its credibility as a quasi-governmental organization as well as the economies of scale and standardization it enjoys in the housing loan securitization process.

*Japan Finance Corporation is an entity wholly owned by the Japanese government, and established on October 1, 2008 through the merger of four policy-based financing institutions

Back to basics?

- Although the public sector's participation in the development of Asia's securitization markets may be excessive, it has contributed to the health of the market.
- What is more, the underdeveloped structure of Asian securitization demonstrates the fundamentals required for the sound development of securitization markets.
- In the US, the troubles arose from:
 - High-risk and complex securitized instruments
 - The “Originate to distribute” model
 - Profitability taking precedence over risk management
 - Inadequate regulation of participants (mortgage brokers, rating agencies, etc.)
- The US and Europe could probably learn some lessons from Asia, and going back to basics may be a viable option.
- Before becoming too pessimistic on the future of securitization, we should pay greater attention to the still-small but growing markets in Asia.