

Japanese mortgage-backed securities market and the possibility of covered bonds in Japan

... and some thoughts on future developments of the Japanese securitization market



일본 MBS 시장의 현황 및 장래에 있어서의 CB의 가능성

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History of Japan's securitization market

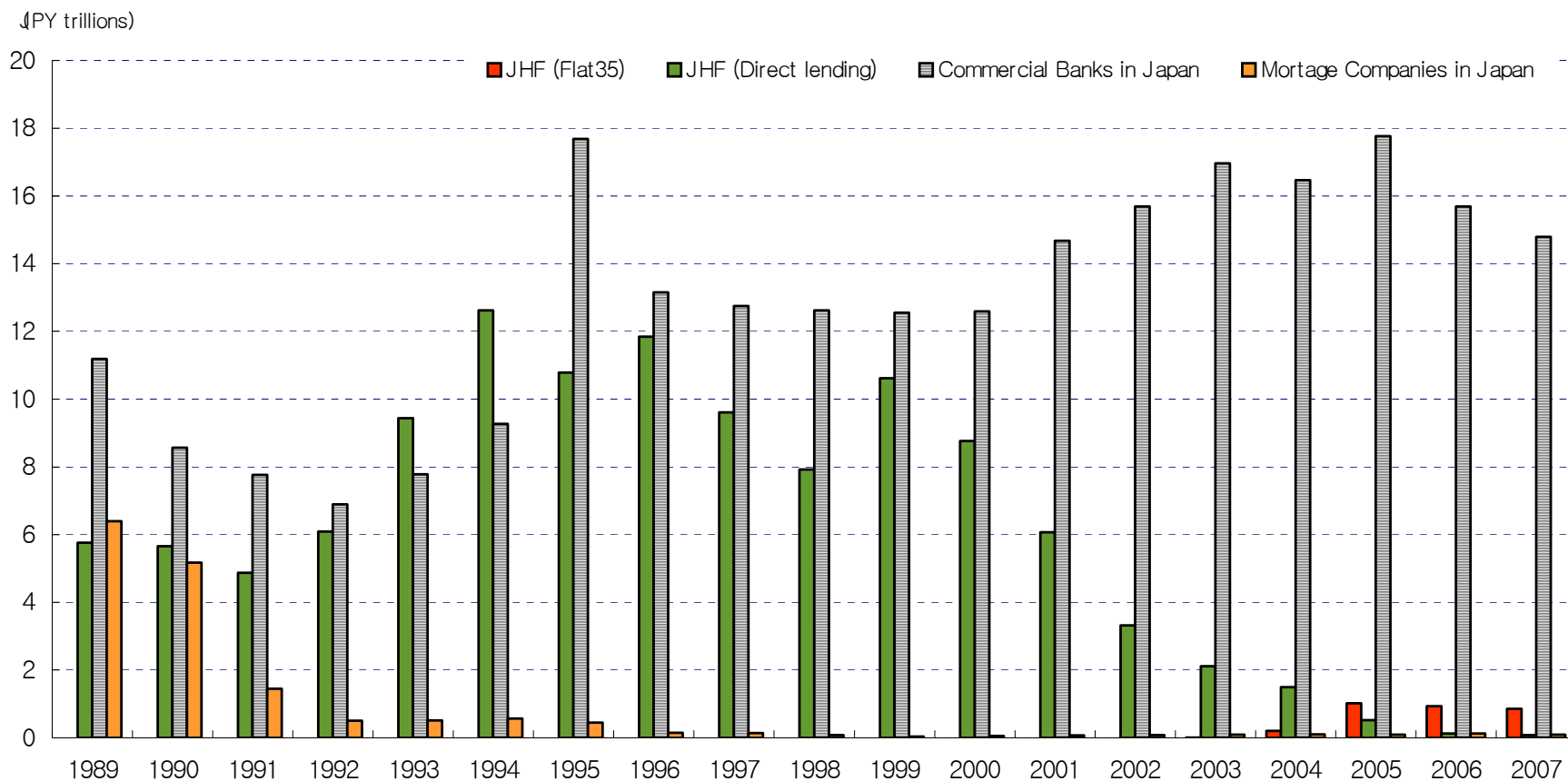
- First quasi-ABS (property trusts, lease-back and sub-leases whereby senior-subordinated structure was employed) started to emerge in 1989
- Specified Claims Law *koguchi saiken* in 1993 (pooled equipment lease and consumer credit receivables, senior/sub structure, resale not permitted in principle)
- First ABS as euroyen bonds (repackaged *koguchi saiken* through a Cayman Islands SPC) in 1994
- First domestic (Japanese law) ABS in 1996
- First private-sector RMBS in 1997
- First CMBS in 1999
- First public-sector RMBS in 2001 by Government Housing Loan Corporation
- First securitization by the government (Ministry of Finance) in 2008
- Annual issuance volume exceeded JPY 1 trillion (US\$ 10 billion) in 1998; surpassed JPY 11 trillion (US\$ 100 billion) in 2006; sharp decline expected in 2008 (this year)—JPY 6 trillion
- Primary market quickly diminishing in 2H 2008

Primary housing loan market

- Government Housing Loan Corporation (established 1950, abolished 2007) had been the dominant lender of fixed-rate housing loans until late-1990s.
- Private-sector banks increased their market share in mid-1990s; while they offer a wide variety of loan products, switchable fixed rate (whereby interest rate can be fixed for any number of years at the borrower's option, typically 3 years) loans are the most popular.
- GHLC started issuing MBS in 2001; between 2001 and 2006, it scaled down on direct lending.
- A newly established independent administrative corporation, Japan Housing Finance Agency (JHF) assumed GHLC's assets, liabilities and businesses in 2007. JHF does not act as a lender (except for rare cases, such as to victims of natural disasters).
- A number of "mortgage banks" (deposit-taking is not allowed) are becoming active providers of housing loans—they heavily depend on JHF's purchase and guarantee programs.
- High concentration to the top lenders.

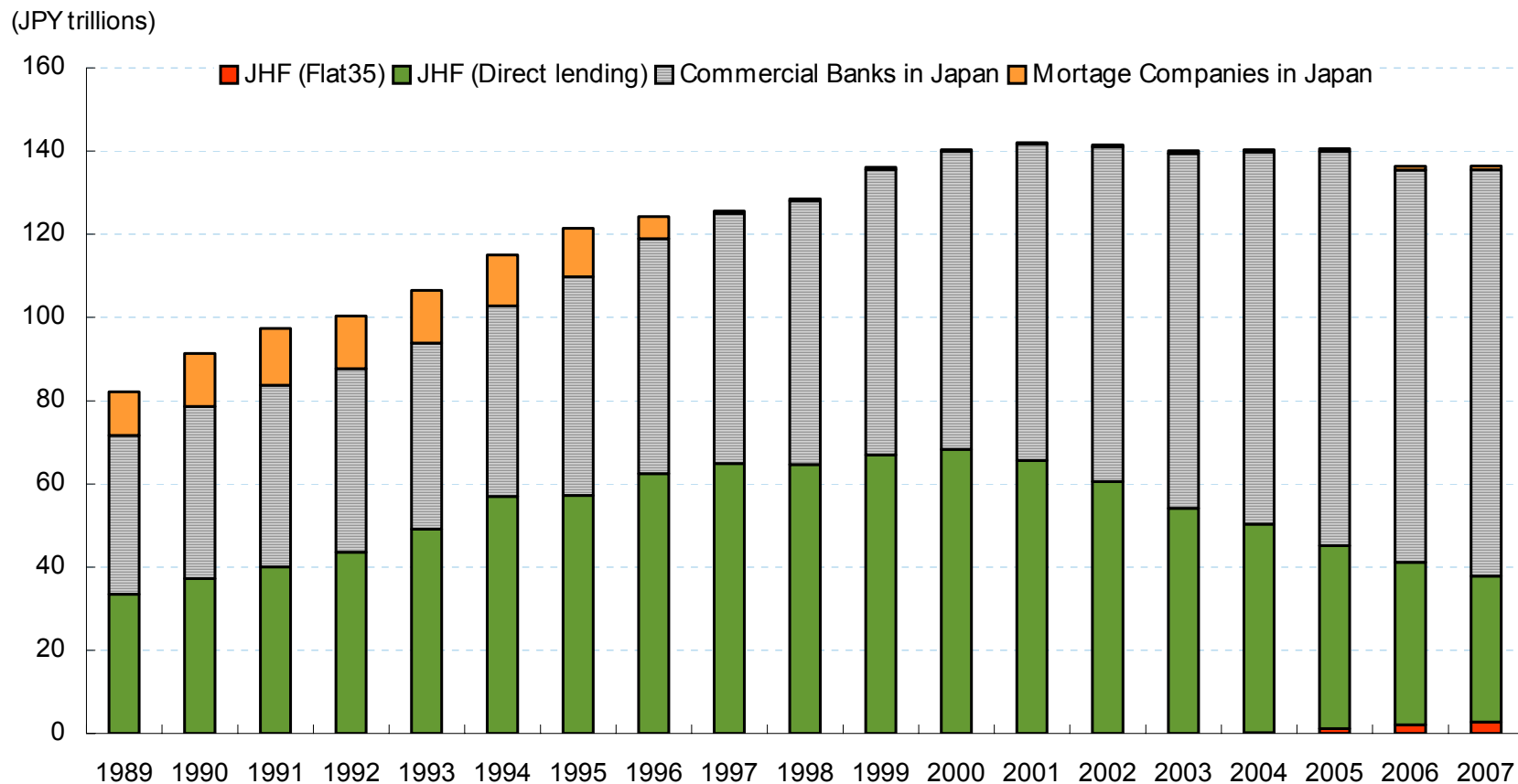
New origination of housing loans by sector

Banks are dominant lenders



Source: Japan Housing Finance Agency (JHF)

Housing loan outstanding by sector

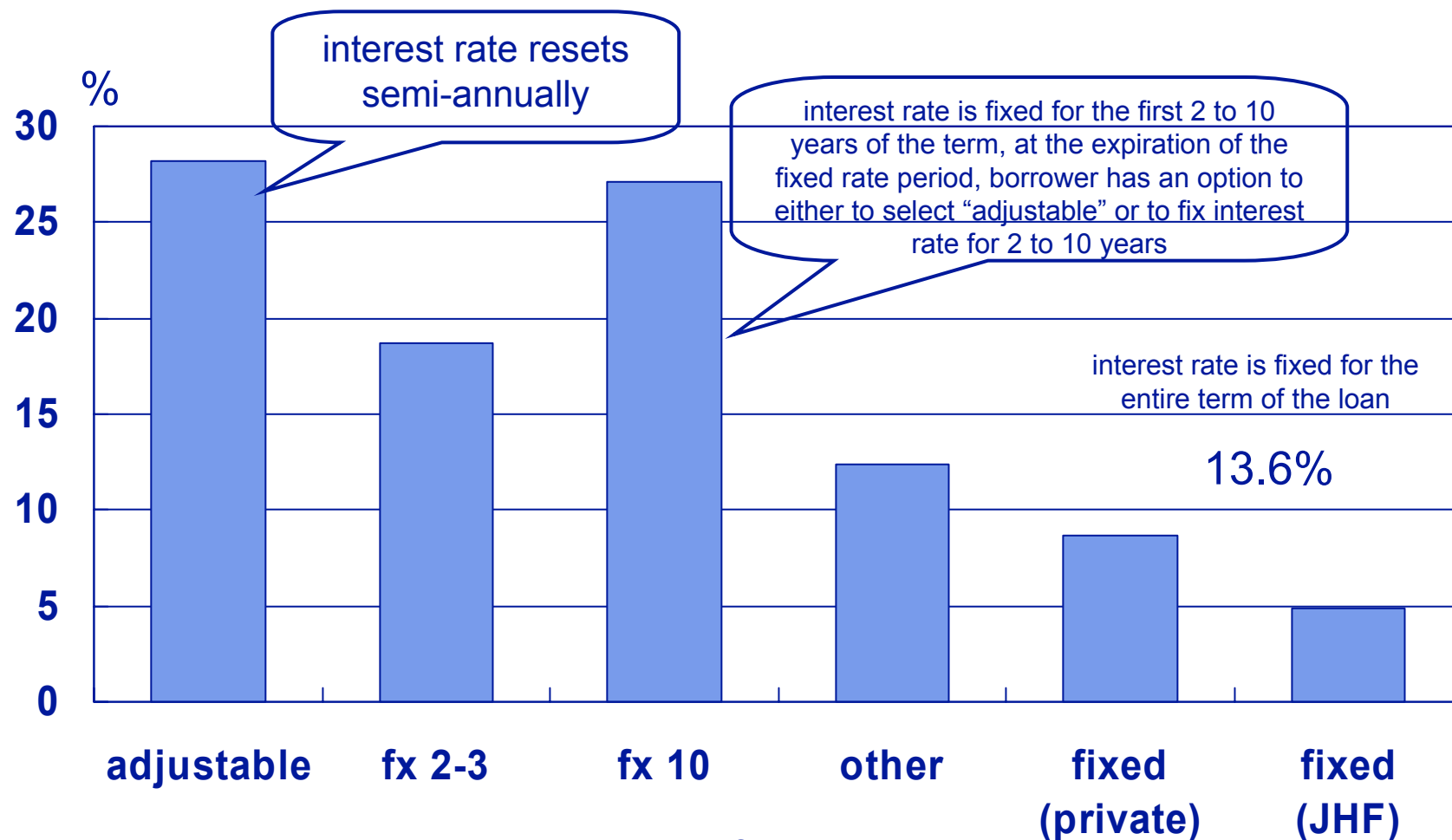


Source: Japan Housing Finance Agency (JHF)

Note: The above graph does not reflect loans originated by insurance companies, cooperatives, etc. Housing loan balance exceeds JPY 190 trillion as of the end of 2007.



Composition of new origination by interest rate type (%)

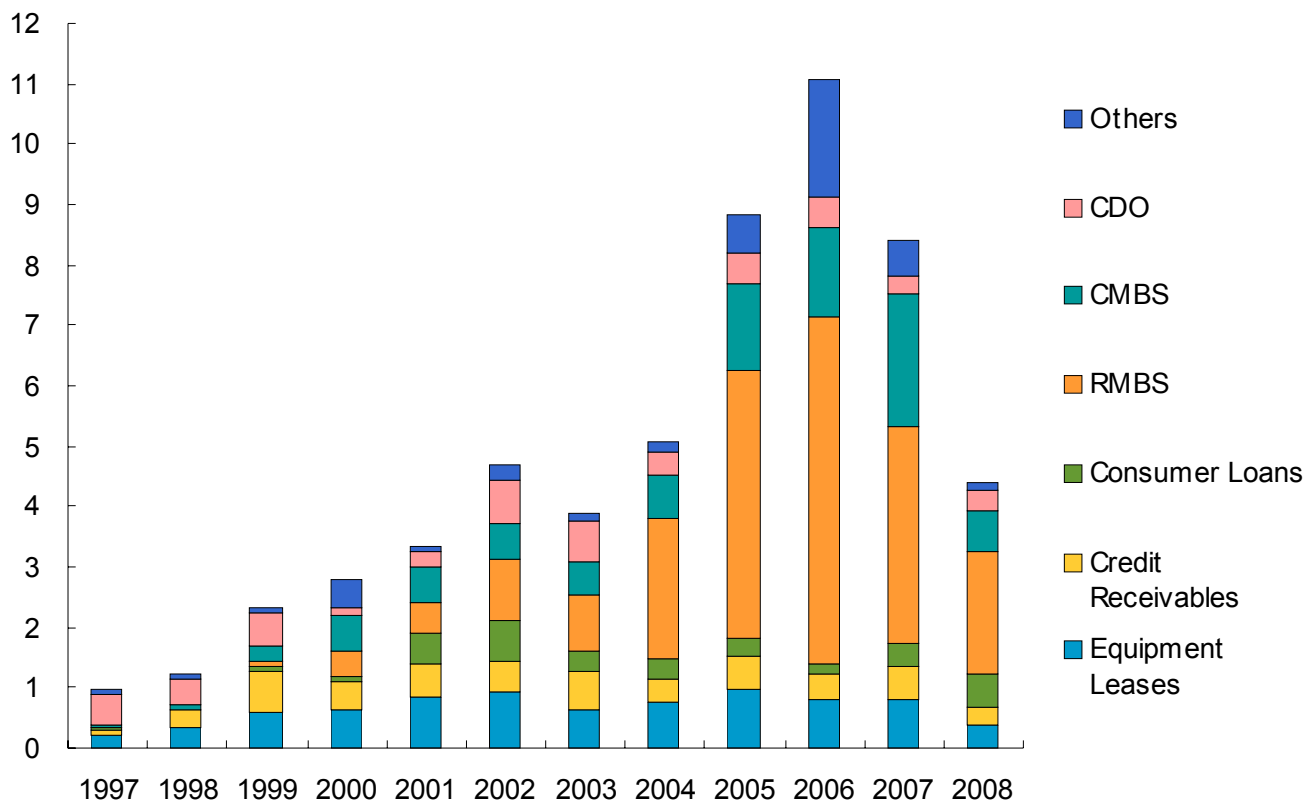


Note: housing loans originated between April 2007 and September 2007

Source: Ministry of Land, Infrastructure, Transport and Tourism

Annual issuance of Japanese ABS (securitized products)

Sharp decline in issuance expected this year...

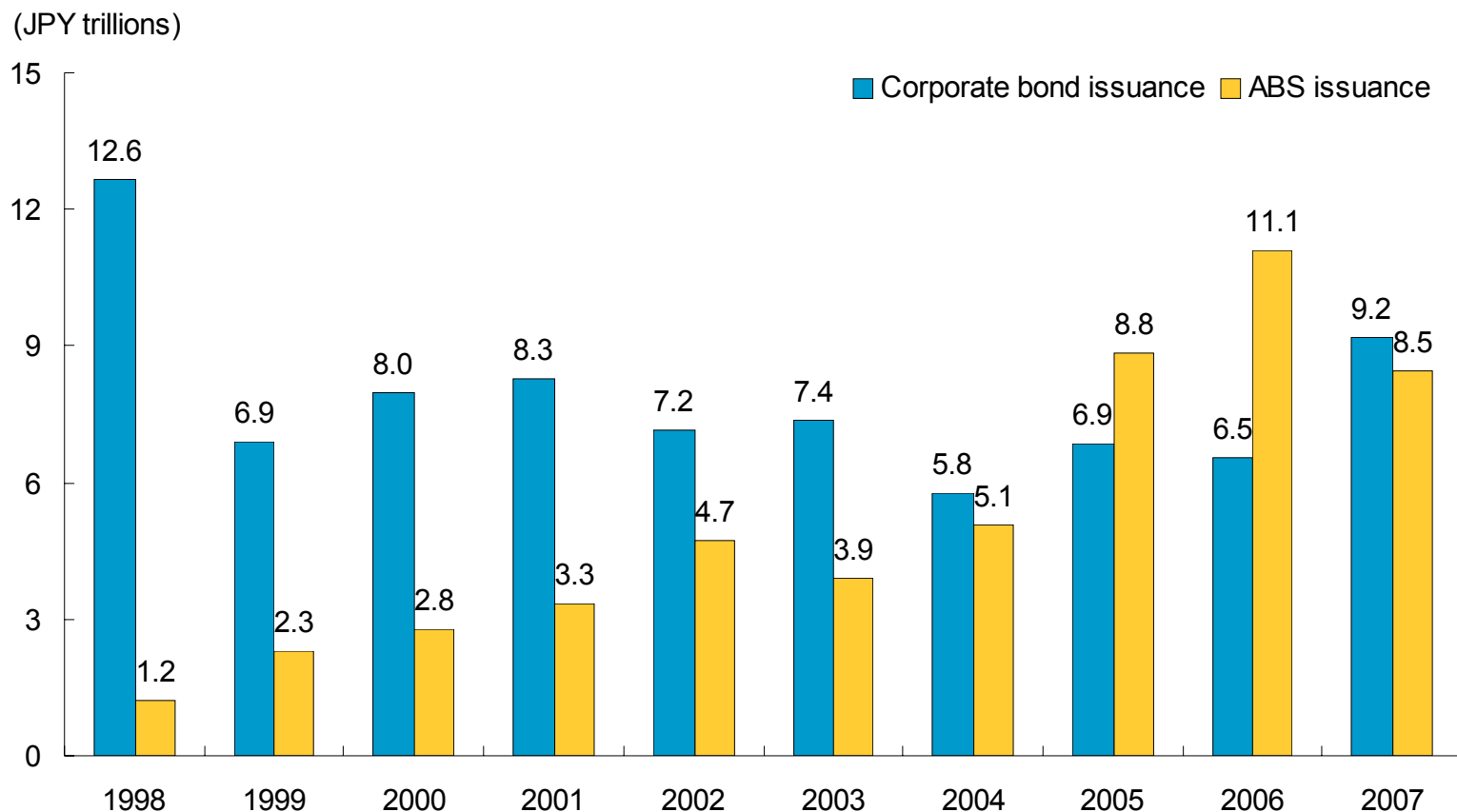


Source: Deutsche Securities Inc.

Note: Figure for 2008 is for the first 9 months of the year



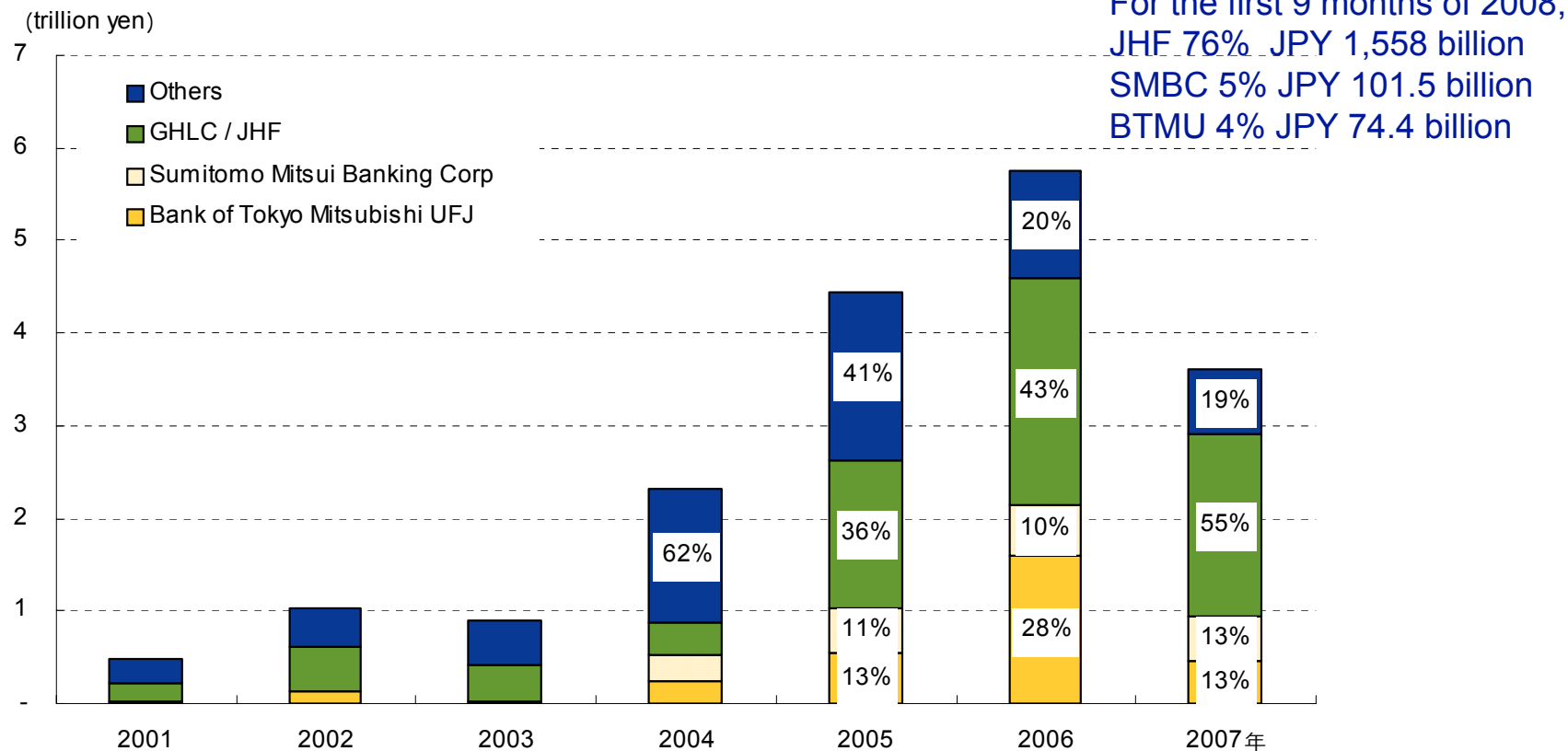
Corporate bonds vs. securitized products



Source: Deutsche Securities Inc., JSDA

Issuance of RMBS by originator

High concentration to the top originators/issuers



Source: Deutsche Securities Inc.

Japan Housing Finance Agency

Established in April 2007 as an independent administrative corporation, wholly-owned by the government

Operates two types of MBS programs to assist private sector lenders provide fixed-rate housing loans

■ Flat 35 Purchase Type

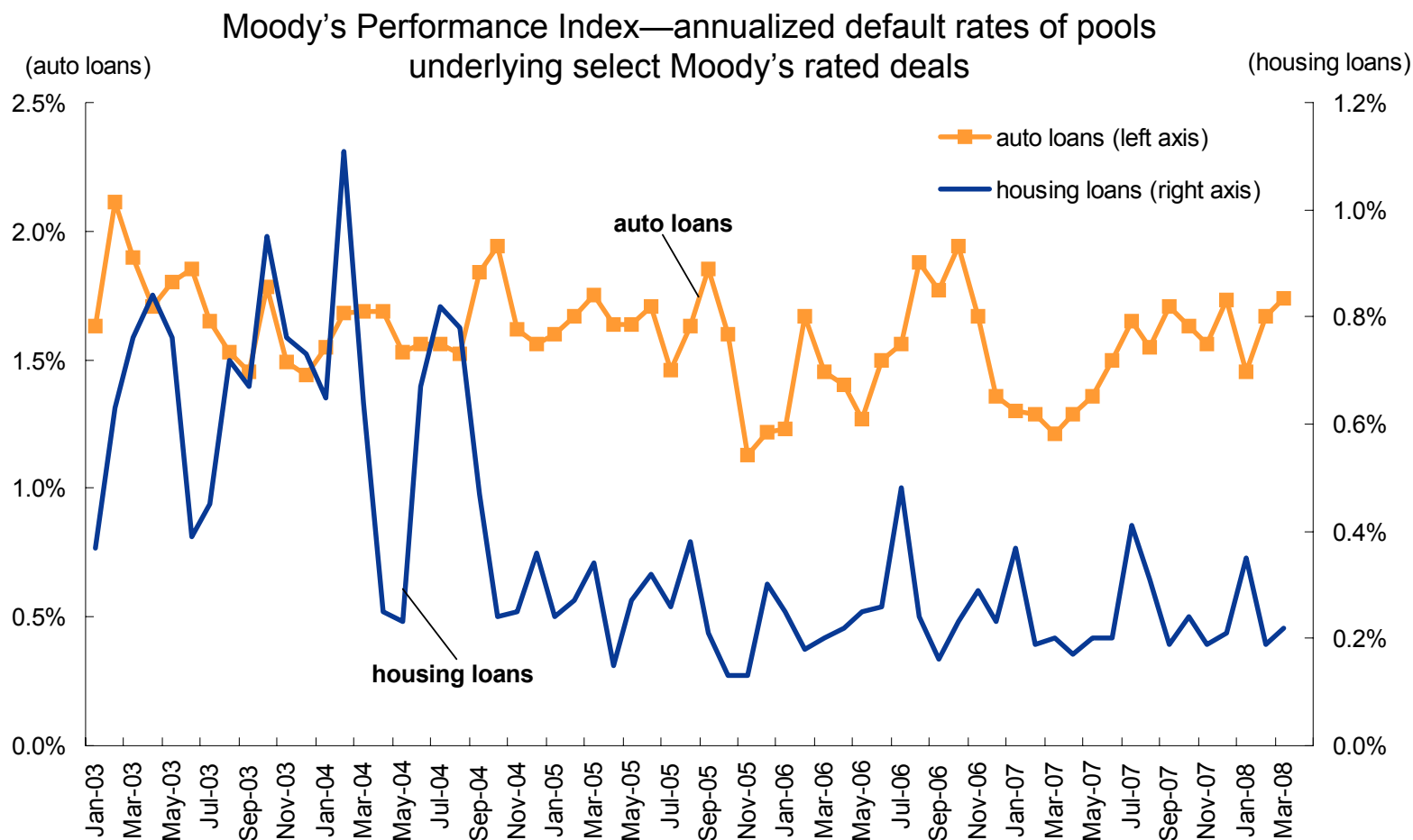
- JHF purchases housing loans at face value on the day of disbursement; lender acts as servicer and collects servicing fee from JHF
- JHF raises virtually all of its funding required for this program by issuing pass-through type RMBS on a monthly basis and straight bond type bonds several times annually

■ Flat 35 Guarantee Type

- JHF provides mortgage insurance (100% coverage) on housing loans satisfying its criteria
- JHF also provides unconditional guarantee of timely payment of interest and ultimate payment of principal on RMBS that are backed by insured housing loans
- JHF's issuer ratings are Aaa/AA/AAA (Moody's/S&P/R&I)

Credit performance of pools underlying Japanese ABS

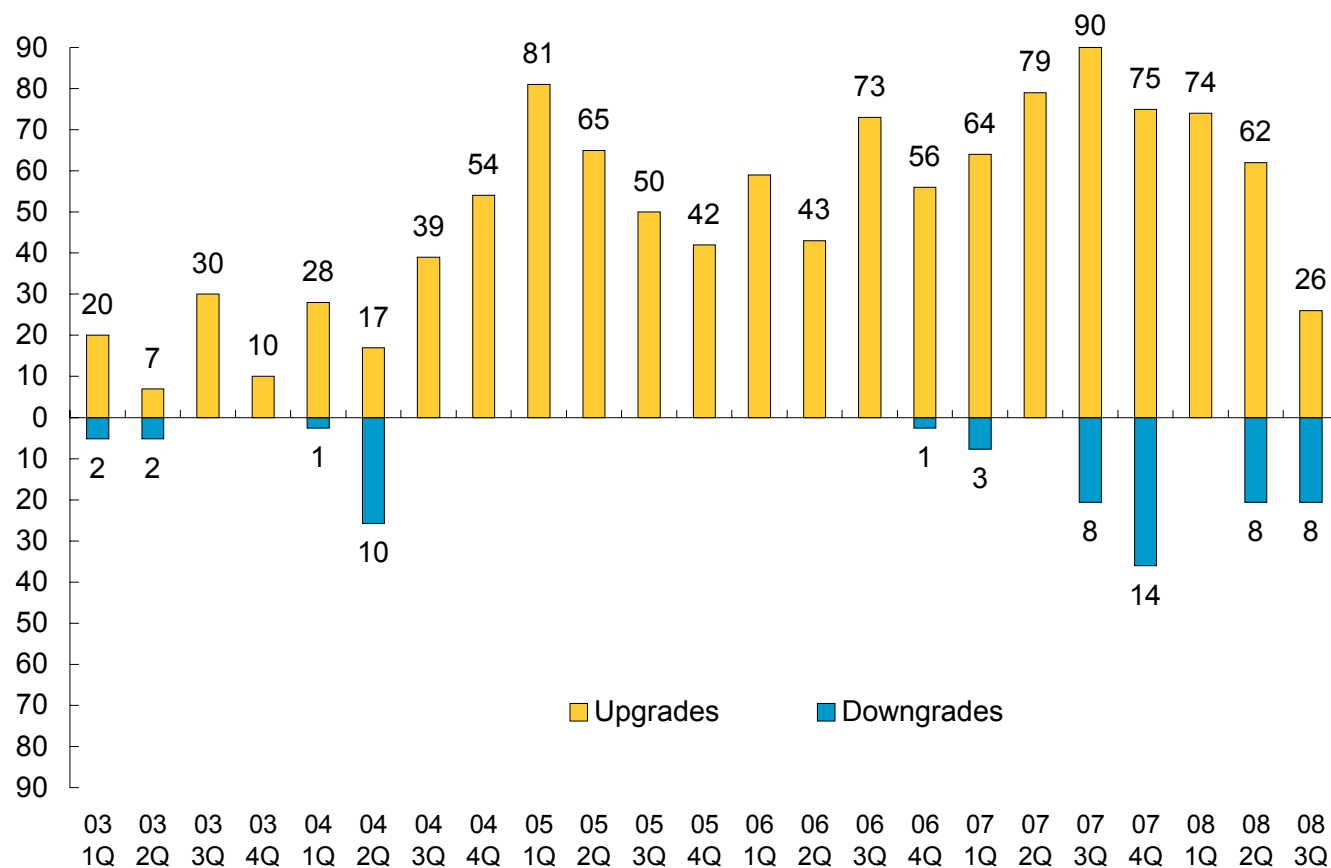
Performance of consumer assets has been quite stable in the most recent years



Source: Moody's Investors Service

Upgrades/Downgrades of Japanese ABS (number of tranches) (2008YTD)

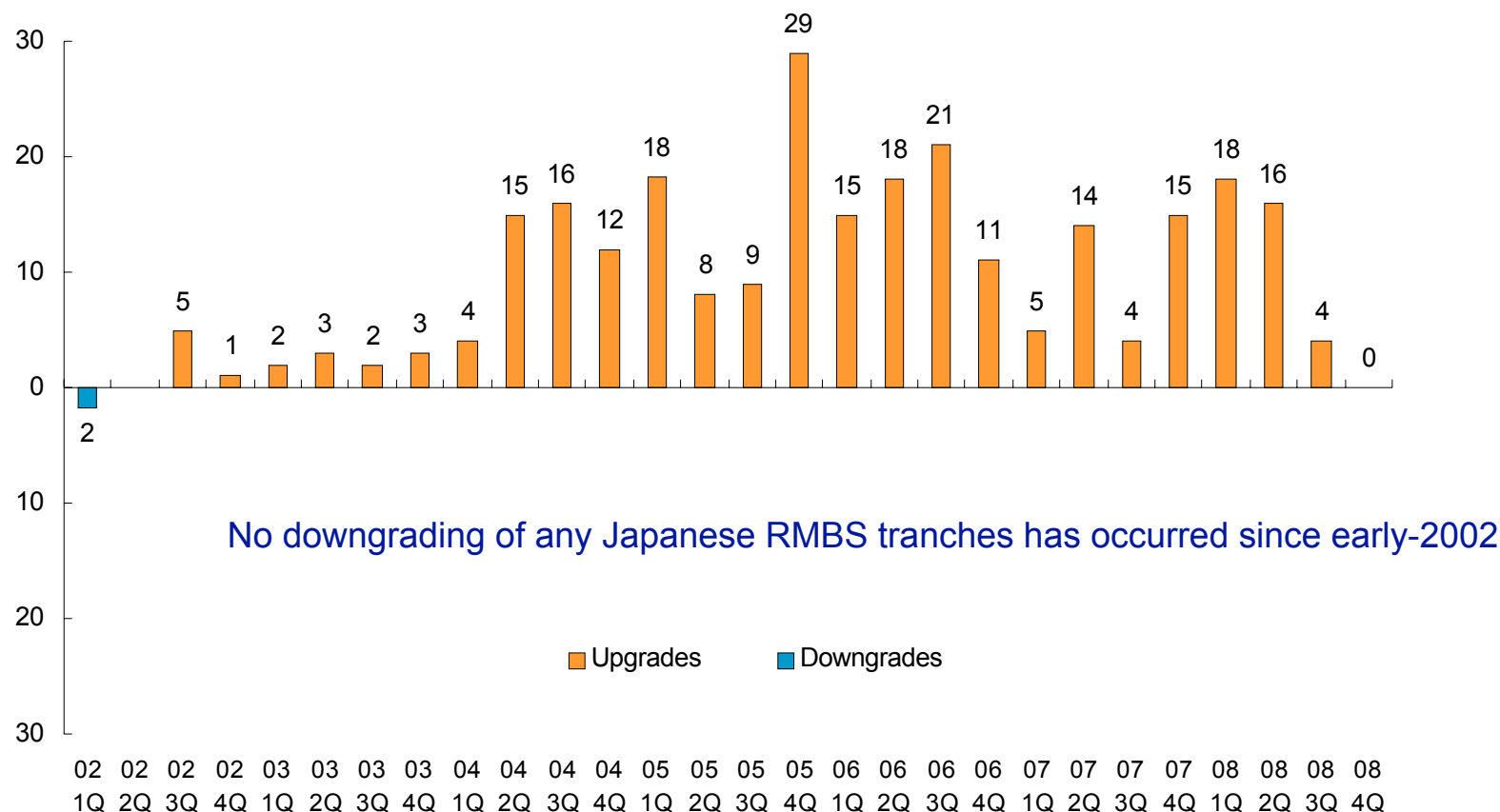
Upgrades continue to outnumber downgrades; downgrades concentrated to unsecured consumer loan ABS and a particular SME CBOs



Source: Deutsche Securities Inc.

Note: Publicly announced rating actions by five rating agencies (Fitch, JCR, Moody's, R&I and S&P) that rate Japanese securitized products.
As of end of September 2008.

Upgrades/Downgrades of Japanese RMBS (number of tranches)



Note: Publicly announced rating actions by five rating agencies (Fitch, JCR, Moody's, R&I and S&P)

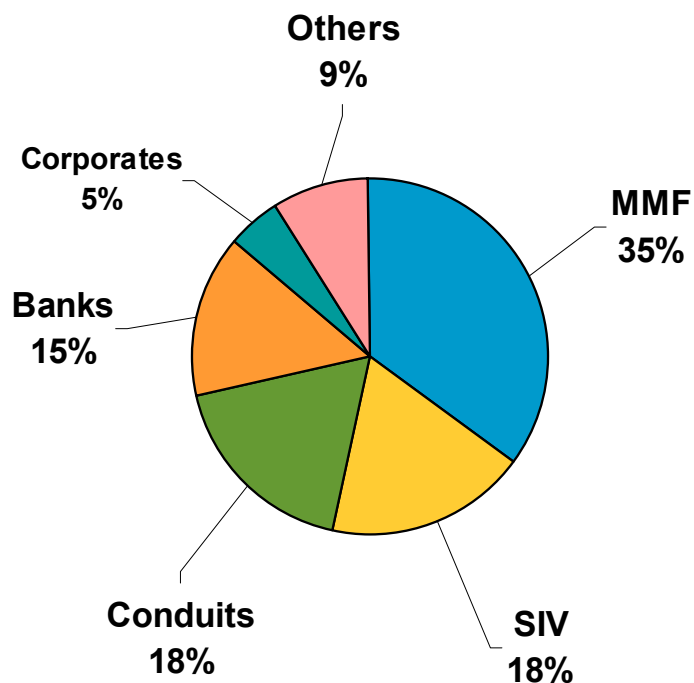
Source: Deutsche Securities Inc. that rate Japanese securitized products

As of October 28, 2008

Investor base

2007 primary investor base for AAA-rated European ABS

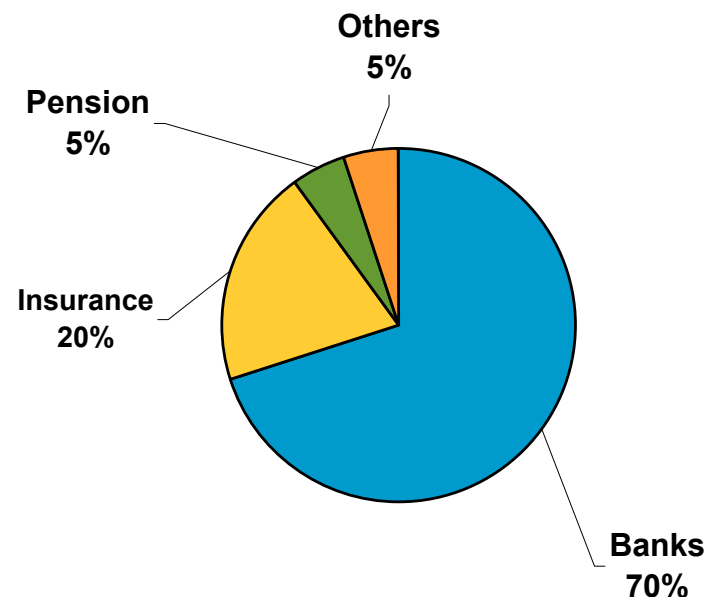
Over 70% of primary demand was dependant on short-term money markets or structured finance



Source: Deutsche Bank estimate

2007 primary investor base for AAA-rated Japanese ABS

Vast majority of Japanese ABS are purchased by banks on their own books



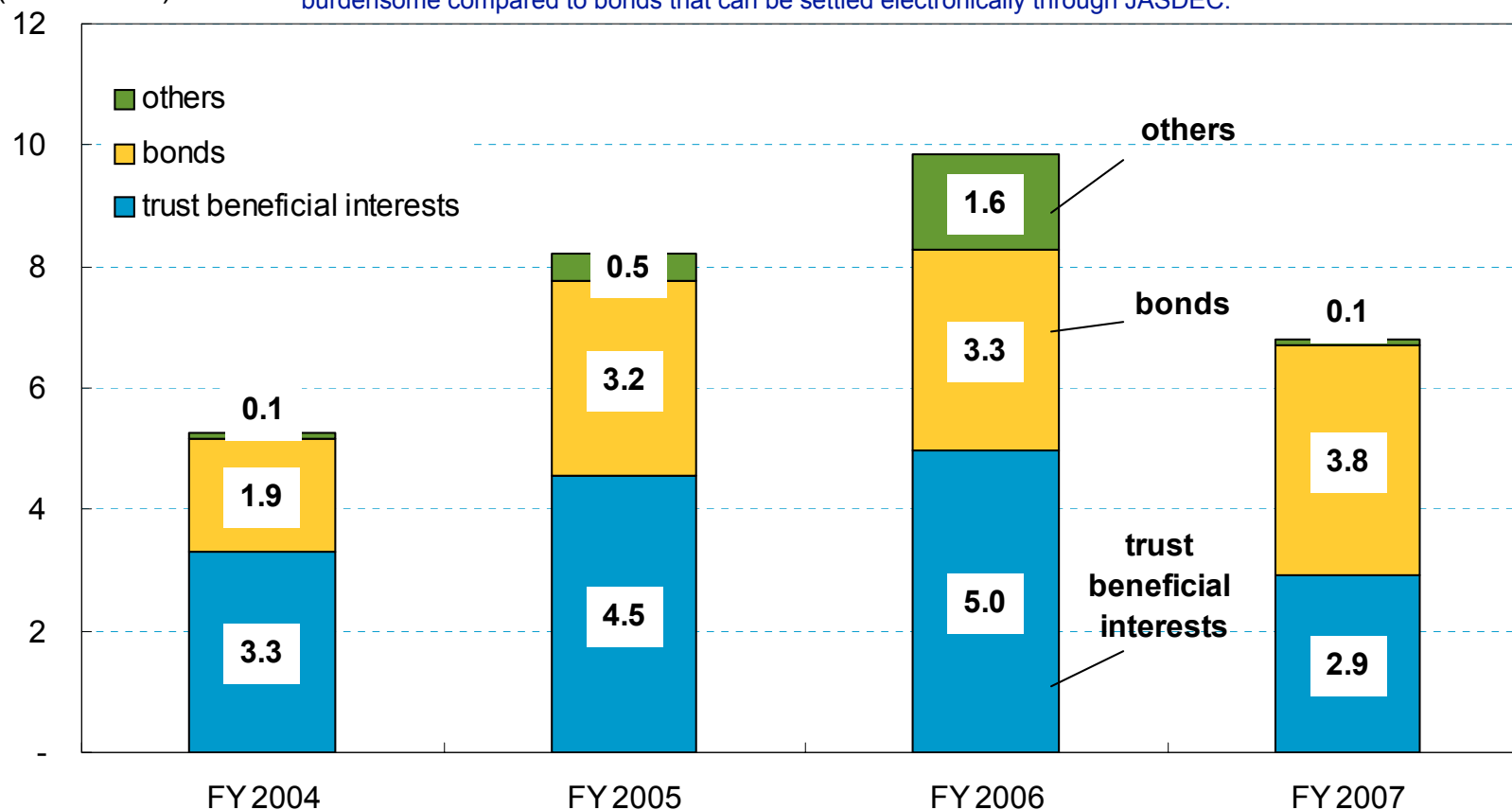
Almost all of the Japanese ABS are sold to domestic investors



Instrument type breakdown

Structuring Japanese asset-backed securities as trust beneficial interests rather than bonds or notes issued by SPCs saves cost (upfront and ongoing expenses). Under Japanese law, assignment/transfer of a trust beneficial interest requires written consent of the relevant trustee—physical paperwork required on seller, purchaser and trustee—which is burdensome compared to bonds that can be settled electronically through JASDEC.

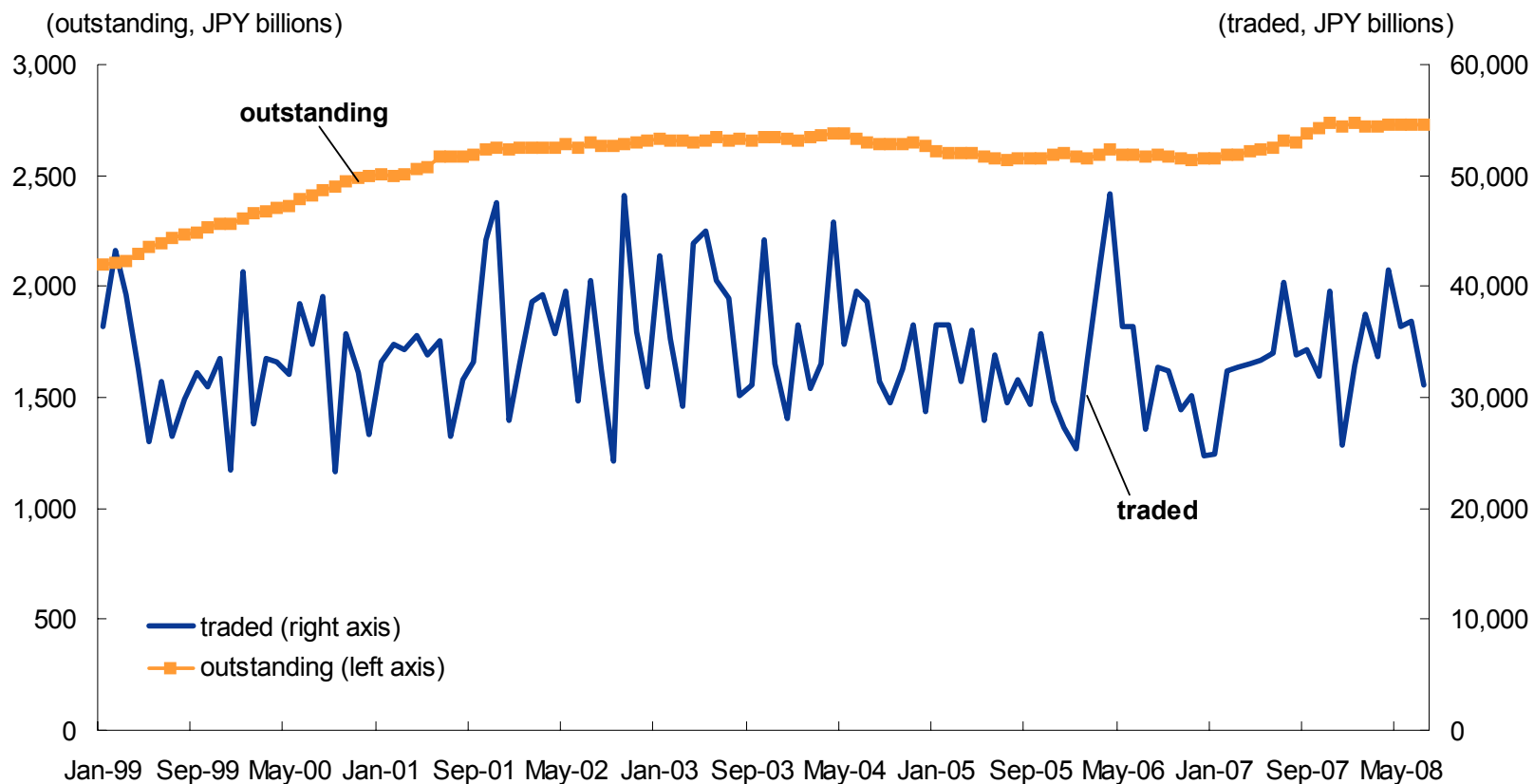
(JPY trillions)



Source: Japan Securities Dealers Association

Secondary market for corporate bonds

Annualized turnover of corporate bonds hover between 30% and 50% in recent months (exaggerated, because same transaction is double counted when both seller and buyer are JSDA members)



Source: Japan Securities Dealers Association

Secondary market for ABS/MBS in Japan

Quiet, inactive, opaque

- no accumulation of secondary trading data
- (gu)estimated annual turnover—10% or less
- few broker-dealers have dedicated traders
- traders' quotes are often given to clients on request
- some intermediaries provide offer sheets to their clients
- no reporting obligations or practices
- large number of broker-dealers openly quote indicative prices of Japan Housing Finance Agency RMBS (through Bloomberg, QUICK and by other means)
- prices at which securities change hands are not known to third parties
- financial media (who specialize in accumulating and spreading market gossip) don't pay attention to secondary trading of ABS

How secondary market might be activated

Market dominated by “buy-and-hold” real money investors who rarely trade

- continued issuance of long-dated fixed-rate RMBS

Prices not openly quoted (with the exception of JHF RMBS and a few ABS)

- JSDA to ease criteria on indicative trading prices and expand coverage of ABS?
- Bloomberg (BBYF), Markit and other information vendors' attempt to expand coverage on price information?

Does it make economic sense to securities firms?

Too many varieties in cashflow waterfalls, deal information occasionally not easy to access

- standardization of deal structure in high volume sectors (RMBS, equipment lease ABS)
- easier and more comprehensive access to deal information by market participants—action by seller/servicers, trustees, information vendors, industry groups

Diminishing primary market

- active secondary market requires securities that can and will be traded by market participants

Activate primary market (which is quickly diminishing)

- negative bias against securitized products, market sentiment, pricing differentials between other markets
- basic education of securitization and structured “finance”

How is Japan surviving the “global financial crisis”?

		Losses (US\$ billions)
1	Wachovia	96.7
2	Citigroup	68.1
3	Merrill Lynch	58.1
4	WaMu	45.6
5	UBS	44.2
30	Mizuho FG	6.6
<hr/>		
	Americas	407.7
	Europe	227.8
	Asia	24.8
	World	660.3
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Japanese financial institutions remain generally profitable—deposit-taking institutions (banks) lost JPY 2.5 trillion (US\$ 25 billion) since 1Q 2007 from holdings of non-Japanese securitized products (RMBS, CDO, CMBS and ABS) and leveraged loans; they’ve made JPY 9 trillion (US\$ 90 billion) of profits during the 18-month period (FSA, estimate)

Short-term money markets in yen among Japanese market participants have been functioning without any stress

Stock and CDS markets had been severely impacted since mid-2007

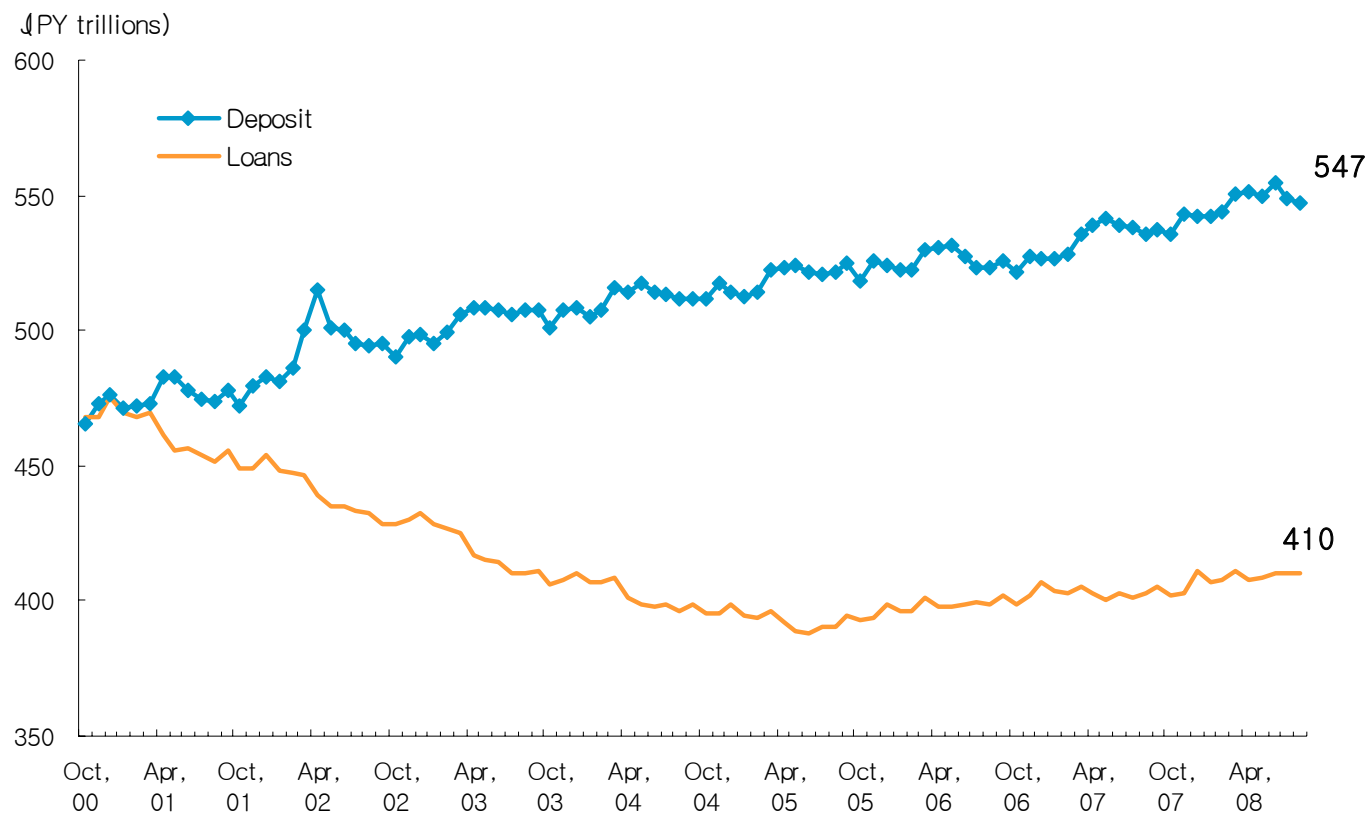
Stress on domestic fixed income market seen since mid-September, 2008

Note: since 3Q 2007, as of October 18, 2008

Source: Bloomberg WDCI

Deposit and loan balances of Japanese banks

Japanese banks have deposit surplus of JPY 140 trillion (US\$ 1.5 trillion)—suggesting limited demand for wholesale funding



Source: Bank of Japan

Possibility of covered bonds issued by Japanese banks

Two attempts this year, no actual deal

- Shinsei Bank attempted to issue structured covered bonds in February 2008 and July 2008—both of which did not materialize and issues were cancelled

Legal obstacles for “straight” covered bonds

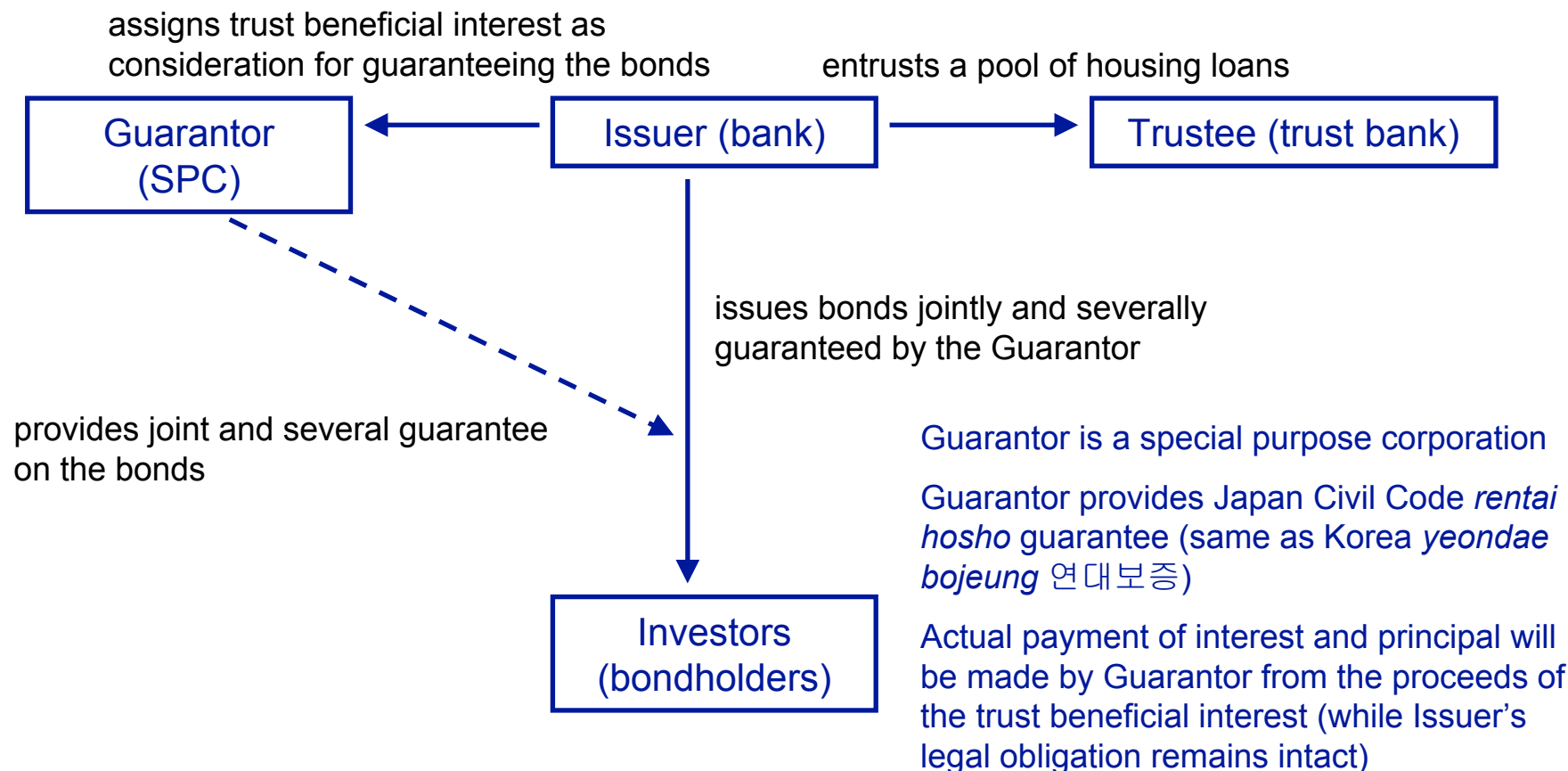
- In Japan, banks can (legally and theoretically) be placed under bankruptcy proceedings (although no such actual case since 1940s)
- In corporate reorganization proceedings, secured creditors’ rights cannot be exercised outside of the judicial proceedings—secured (collateralized) bonds do not mean credit strength far superior to unsecured bonds of the same issuer
- Specific legislation (for covered bonds) in soft discussion stage

Obstacles for “structured” covered bonds

- Anything “structured” or “securitized” are not well received by market participants
- Investors in private-sector RMBS/ABS require spreads over swap rates (or LIBOR) rather than on JGB yields
- Major banks can issue 5 to 10-year unsecured straight bonds at 35 bp to 50 bp over JGBs (even though their CDS spreads are in triple digits); yields that investors might demand on “structured” covered bonds (as they regard them as a kind of securitized products) may be much higher
- Major banks have abundant liquidity in yen—no need to raise wholesale funding at the moment

Attempted “structured” covered bonds

The deal didn't go through but the structure should work...



Source: Deutsche Bank Group, based on publicly available documents

Current status of the Japanese securitization market

Global financial crisis and its aftermath

- Revitalization of Japan's securitization market will be a difficult task.
- Until mid-September 2008 we had yet to see any significant change in the Japanese fixed income market (including the securitized products market, which is dominated by domestic financial institutions and other Japanese institutional investors). A number of corporate bond and *samurai* issues have been postponed or cancelled since mid-September. Since early-October, many municipal bonds had been postponed. Market participants now demonstrating a marked preference for cash as they opt to ride out the storm in overseas financial markets by sticking to the sidelines, it would appear that the Japanese fixed income market can no longer consider itself immune from seemingly unrelated problems originating in the U.S. and Europe.
- As of end-October, 2008, Japan's domestic FI market is almost frozen (no new issues, inactive secondary market trading)
- Japanese investors will likely to stick to cash and short-term high grade FI instruments and avoid structured products, securitized products and non-Japanese assets for the time being.

Tightening regulation, better transparency... reasons for concern

Financial Services Agency (FSA) revised supervisory guidelines for securities firms (April 2008); introduced certain requirements on the seller of securitized products relating to investor reporting.

Japanese banks were the earliest to adopt Basel II Pillar 3 disclosures (started in July 2007)—Pillar 3 disclosure requirements will be reinforced shortly.

Japan's major financial institutions started disclosing holdings of CDOs, RMBS, CMBS and leveraged loans (May 2008) in accordance with the Financial Stability Forum recommendation to the G7.

Japan Securities Dealers Association (JSDA) is currently deliberating for new, self-imposed regulations on sales of securitized products (to be finalized in early-2009).

Accounting Standards Board of Japan is considering certain rules relating to consolidation—off-balance sheet treatment of securitized assets/liabilities likely to be difficult in the near future.

FSA's inspection bureau announced that it would focus on securitized products and syndicated loans, among other items (August 2008).

Recovery and future developments

What will it be like in 3 to 5 years from now?

- No innovation. Retrogression of financial technology.
- Back to 1980s? Mid-1990s? (when structured finance played very limited roles)
- Japanese banks will maintain abundant liquidity—loan balances unlikely to grow due to slowing economy while deposit balance will remain at historically high levels.
- Conversion of Japanese accounting standards to IAS and introduction of tougher consolidation rules—securitized assets/liabilities will be consolidated into seller or sponsor's balance sheets—resulting in sharply decreased demand for using securitization.
- Preference for simplicity, less structuring and less leverage—corporate bonds over securitized products, whole loans over CDOs with thin layers (tranches), plain vanilla credit risk over structured credit risk.
- More bank intermediation.
- Blurred borderline between corporate finance and asset finance or securitization.

Thank you...

대단히 감사합니다.

JHF plays an integral part in Japan's housing finance market.

MBS issuance is most recently dominated by JHF.

Japan's securitization (including ABS/MBS) market is quickly diminishing this year—especially since last month (October 2008).

There were attempts to issue structured CBs but they were called off.

Straight covered bonds require legislative actions; a possibility in the near future.

When will the markets recover?

The Japanese securitization market is losing momentum. Japanese financial institutions and other market participants might ask themselves an important question:

Do we want to do away with securitization?

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Appendix 1

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