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**Japanese securitization market trends  
amid the subprime crisis**



In Japan's securitization market, issuance has held firm even amid the subprime crisis, but spreads have widened, reflecting investor caution. The market is offering advantageous opportunities for investors able to capitalize on them with sophisticated risk management.

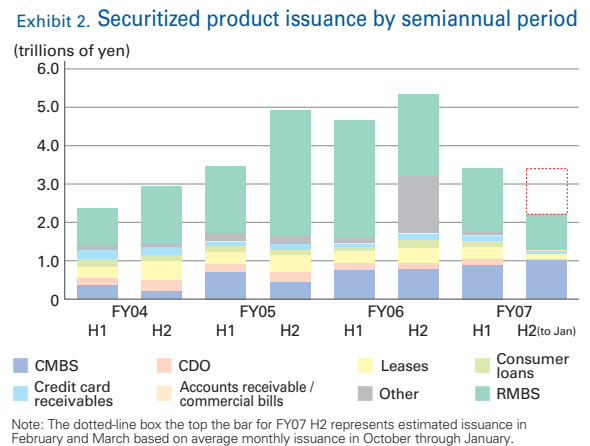
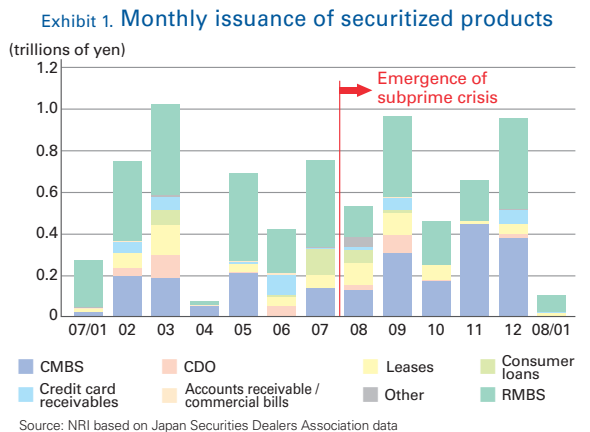
Subprime mortgage woes originating from the US remain a major concern. Securitization, widely hailed as a seminal financial innovation, continues to draw flak from some quarters on the grounds that it has impeded price discovery, complicated risk management, and delayed detection of subprime problems by widely dispersing risk. Below we look at how Japan's securitization market is faring in such an environment.

type that complicated the subprime crisis (e.g., ABSCDOs, CDOs-squared), where securitized paper is resecuritized once or even twice, are relatively rare in Japan. Of the two-layer structures that do exist in Japan, most differ from the types that fueled rampant credit creation in the subprime sector. When two-layer structures are utilized in Japan, the objective is typically to make securities more marketable to investors, such as by tranching a residential mortgage-backed securities (RMBS) issue into multiple maturity classes.

### Japan's securitization market has held surprisingly firm (!?)

As shown in Exhibit 1, monthly issuance of securitized products has not fallen much since last August, when the subprime crisis erupted in earnest. From the data plotted in Exhibit 1, the subprime crisis does not appear to be having much impact on Japan's securitization market. Even from a somewhat longer-term perspective (Exhibit 2), securitized issuance held up reasonably well in FY07 when special factors are taken into account. One special factor is a sharp falloff in consumer loan securitization in FY07 in the wake of a Supreme Court ruling that consumer finance companies had charged usurious interest rates. Another is that FY07 was preceded by a major surge in securitized issuance in FY05-06, reflecting Softbank Mobile's whole business securitization valued at over ¥1 trillion coupled with a spike in residential mortgage securitization ahead of the new BIS capital adequacy standards' adoption effective 31 March 2007. Issuance of commercial mortgage-backed securities (CMBS) in particular is projected to set a new semiannual record in FY07 H2 as flotations of large CMBS issues have continued even since last August<sup>1)</sup>.

One distinguishing characteristic of the Japanese securitization market is that most deals are relatively simple, single-layer structures. Multilayer structures of the



## A buyers' market for securitized products

Brisk issuance of securitized products means that investors have been buying them, but at what terms? Publicly available information is limited, but CDS spreads, a key determinant of synthetic CDO yields, decoupled from regular corporate bond spreads last August and have recently been widening further (Exhibit 3). This widening trend unaccompanied by downgrades of CDS reference entities means that returns have been increasing per unit of credit risk. According to securities firms' research reports and contacts with market participants, synthetic CDO spreads have been widening in sympathy with CDS spreads. Other securitized products have apparently also been exhibiting similar behavior.

This widening of spreads presumably reflects investor caution toward securitized products, but it has created advantageous buying opportunities for investors capable of investing in securitized products<sup>2)</sup>.

## Significance of including securitized products in one's investment universe

In other words, whether an investor can capitalize on these advantageous investment opportunities hinges upon whether it has the capability to invest in securitized products. To do so, an investor must of course have the requisite risk management and valuation capabilities and exercise considerable due diligence. However, in a highly volatile market environment, it is crucial to be able to respond quickly when apparent bargains present themselves.

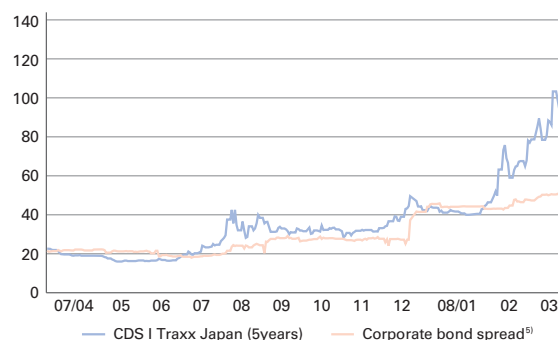
Although securitized issuance in Japan has recently held firm even in the face of subprime headwinds, the Japanese securitization market is smaller than its US and European counterparts<sup>3)</sup>, giving it scope for medium- to long-term growth.

To realize such growth potential, further development of market infrastructure is essential. In fact, recent months have witnessed several events with beneficial implications

for Japan's securitization market. On the regulatory front, the Financial Instruments and Exchange Act and amended Trust Act, both effective from 30 September 2007, aim to promote securitization and increase flexibility in terms of deal structures. In February, the Japanese Government securitized ¥100 billion of FILP (Fiscal Investment and Loan Program) loans in the first issue of its kind. It plans to issue securities backed by FILP loans on an ongoing basis. From April, asset-backed securities (ABS) will be added to the Nomura Bond Performance Index, a key benchmark for bond investors<sup>4)</sup>. While a number of foreign securities firms are downsizing or discontinuing their securitization businesses, Japanese securities firms are reportedly targeting the CMBS market. This recent series of events bodes favorably for the Japanese securitization market's continued development.

For investors, the path to gaining a competitive advantage in Japan's securitization market lies in upgrading risk management practices, building a team with the requisite investment capabilities, and amassing experience in nimbly capitalizing on advantageous investment opportunities.

Exhibit 3. CDS spread and A-rated corporate bond spread (in basis points)



Source: NRI based on Bloomberg data

#### Note

- 1) The large CMBS issues include issuance by foreign securities firms to divest loans in response to subprime losses (per 14 February 2008 edition of Nikkei newspaper).
- 2) In a similar opportunity arising from the subprime crisis, mezzanine loans to private equity funds and other such borrowers are reportedly being offered for sale at extremely advantageous terms.
- 3) For a market size comparison between Japan and the US/Europe, see "Is Japan ripe for a securitization boom?" in the November 2007 Financial Information Technology Focus.
- 4) According to a Nomura Securities Quantitative Research Department press release dated 27 December 2007.
- 5) Spread between A-rated corporate bonds and US Treasuries (5-year maturity).

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