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Client briefing
June 2008

Japan's Inaugural Covered Bond Issue

Japan's Shinsei Bank announced on 11 June 2008 that it is issuing a 10 year JPY30 billion (USD280 million) covered bond. It would be the first covered bond issue from a Japanese issuer. This briefing looks at the terms of Shinsei's proposed issuance and discusses certain aspects of the transaction, in particular how it differs from structured covered bonds seen in other jurisdictions without specific covered bonds legislation.

What are covered bonds?

Covered bonds are full recourse debt instruments typically issued by a financial institution that are fully secured (or "covered") by a pool of high quality on-balance sheet assets. The assets are usually mortgage loans and/or public sector loans.

The advantages for an issuer for issuing a covered bond include cheaper funding costs for issuers, the ability for an issuer to issue long term debt with a higher credit rating than the issuer's own credit rating and investor diversification. From an investor's point of view, it has recourse against the ring-fenced assets as well as to the issuer and it can generally enjoy preferential regulatory capital treatment.

In many jurisdictions, covered bonds are issued under specific legislation which provides for the ring-fencing of assets for covered bondholders. In other jurisdictions such as the UK (where until very recently, there was no covered bond legislation) and Canada where no such legislation exist, contractual and security arrangements and other securitisation techniques are used to achieve the same objective. Japan does not have specific legislation dealing with covered bonds and the Shinsei covered bonds fulfil the expectation that the first Japanese covered bonds will be more akin to covered bonds issued in jurisdictions without covered bond legislation.

Key Issues

Legal true sale under Japanese law

Pass-through payments

Acceleration on issuer default

No hedging; high over-collateralisation

No security

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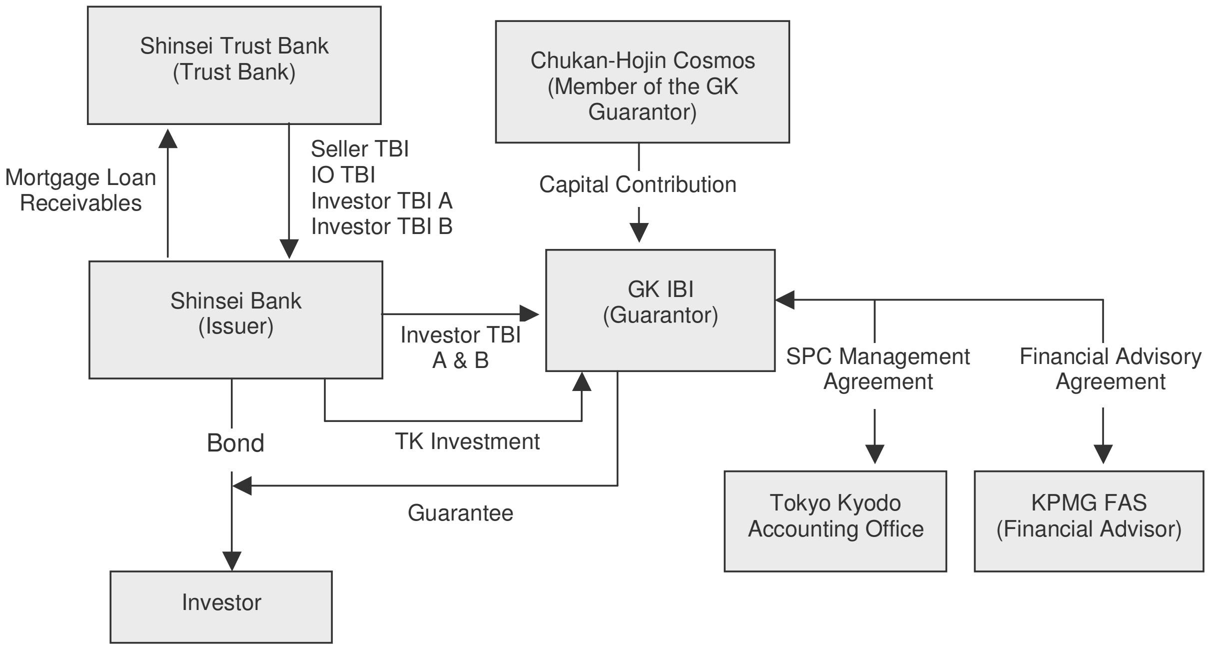
Shinsei's covered bonds

Shinsei Bank had originally intended to issue JPY50 billion of covered bonds at the beginning of this year but that issue was cancelled. This latest announcement represents a revival of the cancelled issue, retaining substantially the same structure but in a reduced amount of JPY30 billion.

The structure of the transaction can be summarised diagrammatically as follows:



The pool of assets is entrusted with a Trust Bank which in turn issues to Shinsei Bank a Seller Trust Beneficial Interest, an IO Trust Beneficial Interest, an Investor Trust Beneficial Interest A and an Investor Trust Beneficial Interest B. The Investor Trust Beneficial Interest A and Investor Trust Beneficial Interest B are transferred to the Guarantor, a *godo kaisha* (the Japanese equivalent to an LLC) owned by a *chukan houjin* (the Japanese equivalent of a charitable trust) and thereafter consolidated into a single class of Investor Trust Beneficial Interest. Shinsei Bank issues the covered bonds and the Guarantor issues a guarantee with respect to Shinsei's obligations under the bonds.

See the box on the right for a summary of the issue terms.

Issuer:	**Shinsei Bank, Ltd.**
Guarantor:	**GK IBI, a special purpose vehicle**
Lead manager:	**Shinsei Bank, others to be announced**
Tenure:	**10 years**
Amount:	**JPY30 billion**
Coupon:	**Pricing to take place on 8 July 2008 but there is press speculation that it will be 35-40bp over Japanese government bonds**
Cover pool:	**Residential mortgages**
Over-collateralisation:	**30 per cent. initially**
Offering:	**Domestic public offering**
Rating:	**Aaa (provisional) by Moody's**

Analysis

As expected, the structure is not dissimilar to that of structured covered bonds seen in jurisdictions such as the UK and Canada (what we will call "traditional structured covered bonds"): the financial institution itself issues the bonds which are guaranteed by an SPV which owns the pool of ring-fenced assets backing the guarantee. However, there are a number of unique features in the Shinsei structure which makes it quite different from traditional structured covered bonds.

Cash flow and legal true sale

The cash flow under the Shinsei structure differs from that of a traditional structured covered bond in two related respects.

First, unlike in most traditional structured cover bonds, there is no intercompany loan between the issuer and the guarantor under which the issuer makes a loan to the guarantor to purchase the cover pool. Instead, under a guarantee agreement between Shinsei Bank and the Guarantor, Shinsei Bank is obliged to pay to the Guarantor on day one the amount equal to the principal and interest of the bonds on the premise that the Guarantor will pay interest and principal on the bonds directly to the covered bondholders. Such day one payment obligation of Shinsei Bank is satisfied by transferring the Investor Trust Beneficiary Interest A to the Guarantor as a payment-in-kind (*daibutsu bensai*).

Second, while the Issuer is Shinsei Bank, under the guarantee agreement, the Guarantor agrees with the Issuer that it, not Shinsei Bank, will make the actual payment of interest and principal under the covered bonds (and only if it fails to do so will Shinsei Bank pay). Payments from the cover pool passes through the Guarantor to service the payments under the covered bonds which makes the structure look more like a asset-backed securitisation than a traditional structured covered bond.

Interest payments under the cover pool will fund interest payments under the covered bonds. Any shortfall will be funded by collection of principal payments in the cover pool. Otherwise, principal repayments are paid to Shinsei Bank as a distribution under the Seller Trust Beneficial Interest. Shinsei Bank in turn is obliged to entrust additional mortgage loans with the Trust Bank in order to maintain the requisite collateralisation level of the cover pool. Prior to Issuer's default, principal payments will not be used for early redemption of the covered bonds.

These aspects of the structure do not necessarily affect the credit analysis. It is possible that they are driven by investors in Japan who, being used to securitisation structures, expect payment to pass through a bankruptcy remote SPV rather than to flow through the SPV into the originator. Whether or not this is in fact the case, one advantage of this structure is it strengthens the argument that the particular requirements of Japanese law that need to be satisfied in order to achieve legal true sale of the cover pool have been satisfied. In a traditional structured covered bond, the guarantor's ability to perform its obligations under the intercompany loan depends on the performance of the cover pool. Under Japanese law, it can be argued that, if an intercompany loan funding structure was to be used, a true sale of the cover pool is not achieved because the issuer of the covered bonds is still exposed to the risk of the assets forming the cover pool. If this argument is held to be valid and a true sale is not achieved, then the cover pool would remained owned by the issuer and be subject to certain types of insolvency proceedings that might affect the issuer. In the Shinsei structure, by placing the obligation to make payments under the covered bonds on the Guarantor and passing such payments through the Guarantor straight to the covered bondholders, Shinsei Bank can be said to be no longer exposed to the performance of the cover pool, hence achieving true sale.

Another advantage of not having an intercompany loan between the issuer and the guarantor is that there is no need, for regulatory purposes, to consolidate the guarantor with the issuer so that the intercompany loan, which would typically be or become very large, does not appear as an asset on the balance sheet of the issuer, which was an issue that had to be dealt with on UK and Dutch covered bonds in the past.

Investor Trust Beneficial Interest B is purchased by the Guarantor using the proceeds of a *tokumei kumiai* (silent partnership) capital contribution from Shinsei Bank. Any excess cashflow from the cover pool will be paid to Shinsei Bank by way of a profit distribution thereunder.

Issuer default

In a traditional structured covered bond, the covered bonds do not necessarily accelerate on an issuer default. Instead, payments thereunder will, subject to the satisfaction of certain coverage tests, continue to be serviced by the cover pool until maturity. In the Shinsei structure, upon the Issuer's default, the cover pool will be sold to raise funds to redeem the covered bonds. There is no mechanism to allow for the assets to be managed post issuer default to service the covered bonds to maturity.

This aspect of the structure is somewhat similar to securitisation and it would be interesting to see if this feature will evolve as one of the reasons that traditional covered bond investors in Europe generally find covered bonds attractive is the low risk of early redemption as a result of the cover pool being able to service the covered bonds to maturity.

Refinancing period

There is a "refinancing period" of six months prior to maturity of the covered bonds where the assets will be sold in the market regardless of whether Shinsei Bank had defaulted, proceeds of which to be used to redeem the covered bonds on maturity. This is different from traditional structured covered bonds where only following an issuer default will there be an amortisation or extension test carried out typically six months prior to maturity, the failure of which triggers a guarantor default and a sale of the cover pool to raise funds for the redemption of the covered bonds.

Hedging

There is no interest rate swap in place in the Shinsei structure which is slightly unusual when compared to traditional structured covered bonds. We understand that the risk of interest rate differences is mitigated by the high overcollateralisation level of 30 per cent. (as compared to 5 to 10 per cent. in European covered bond deals).

Security

One of the usual expectations of investors in traditional structured covered bonds is that they have security over the cover pool. This is achieved by securing the obligations of the guarantor over the cover pool while the covered bonds themselves remain unsecured. In the Shinsei structure, there is no security over the obligations of the Guarantor. This is to avoid the covered bonds being re-characterised as secured bonds and the transaction falling foul of the licence requirements of the Secured Bond Trust Law in Japan.

Security given in respect of a guarantee of bonds would not, in the ordinary course, fall within the realms of the Secured Bond Trust Law in Japan. The concern in the Shinsei transaction over the Secured Bond Trust Law is perhaps better founded given that the Guarantor is the actual entity making payments of interest and principal on the covered bonds. Investors and rating agencies can (and do, on securitisation transactions) get comfortable that covered bondholders do not have benefit of security since the cover pool is held by an SPV whose activities are highly restricted and whose sole purpose is to hold the cover pool, provide the guarantee and make payments as required under the structure.

Conclusion

The announcement of Shinsei Bank's covered bonds is welcome news as it introduces a new product in the Japanese market and opens up a new channel for other Japanese financial institutions to utilise their assets at a time when securitisation markets remain largely closed. It has certain characteristics which make it different in a number of ways from traditional structured covered bonds and somewhat more akin to a securitisation with recourse as against the originator as well as the assets - a "covered" securitisation may be an appropriate shorthand for this structure. As the domestic market learns more and gets used to this product, it is likely that there will be more issuances in the foreseeable future. As international investors become more interested in Japanese covered bonds, this "covered" securitisation structure may evolve further, perhaps into something closer to traditional covered bonds.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

Clifford Chance had advised on a number of structured covered bonds programmes, including those of Barclays Bank PLC, Nationwide Building Society, HBOS Treasury Services, Bradford & Bingley (all UK), ABN AMRO (the Netherlands) and Royal Bank of Canada (Canada). It was not involved in Shinsei Bank's covered bonds and this client briefing is prepared based on its own analysis of the proposed issue, publicly available information regarding the proposed issue and its experience in covered bond issuances in other jurisdictions.

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