

# *Structured Finance* Servicer Evaluation

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## Capital Servicing Co. Ltd. Residential Loan Primary Servicer

*Ranking:*  
**ABOVE AVERAGE**

On June 8, 2009, Standard & Poor's Ratings Services assigned its ABOVE AVERAGE Servicer Evaluation Ranking to Capital Servicing Co. Ltd. (CSC) as a residential loan primary servicer. The outlook on the ranking is stable.

The ranking is mainly based on the following:

- The company's track record as a residential loan primary servicer;
- The ample servicing experience of its management team and other employees;
- The recruitment of a new servicing manager knowledgeable in commercial and residential loans, with the aim of reinforcing its servicing department;
- The clear definition of responsibilities in its administration and servicing departments;
- Its detailed and comprehensive policies and procedures;
- Its solid internal auditing;
- Its efforts toward establishing an internal control framework;
- Its firm internal training programs;
- Its sound backup data system;
- Its appropriately designed disaster recovery plan, and the execution of system recovery tests using a backup site;
- An excellent computer system that boosts its operational efficiency;
- Its experience in servicing securitization transactions recognized in the market;
- Its appropriate cash management methods;
- Its ability to report to investors, trustees, and other relevant parties; and
- The appropriate control and oversight of third parties to which CSC outsources a part of its servicing business.

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*Outlook:*  
**STABLE**

The outlook on the ranking is stable. CSC's main business as a residential loan primary servicer involves the servicing of residential loans arranged for securitization. CSC began focusing on residential loan servicing in 2002, and has experienced an increase in servicing volume since 2006. As of December 2008, CSC had acted as servicer for three securitization transactions involving residential loans. Additionally, CSC has an ample track record in the overall servicing of securitization transactions, given that the company has participated in eight securitization transactions involving apartment loans, five involving real estate-backed distressed loans, and eight involving commercial real estate-backed loans.

The stable outlook reflects Standard & Poor's view that CSC will continue to focus its efforts on expanding its servicing of residential mortgage loans.

### **Company Profile**

CSC was established in September 1998. The company was licensed by Japan's Ministry of Justice as the 23rd servicer in Japan a year later, and was allowed to conduct servicing operations as regulated under Japan's Law Concerning Special Measures for Servicing Business (Servicer Law), which came into effect in February 1999. In December 1999, the company actually commenced its servicing business.

Capital Services Holding Corp., which is 100% owned by a private company owned by a CSC director, maintains a 75% share in CSC, while the same private company holds a 25% share.

Since August 2003, CSC has effectively shared its personnel and technology resources with its group company, Global Commercial Real Estate (Japan) Inc. (GCRE) in areas such as corporate accounting, human resources, systems management, and other office administrative support. In January 2008, the support department of GCRE was integrated into CSC, including its employees.

CSC's core business lies in the servicing of commercial real estate-backed distressed loans, performing loans, and residential loan and apartment loan receivables. In July 2007, Andrew Hughes became the managing director/representative director of CSC, which had 117 employees as of Dec. 31, 2008. Group companies include Capital Realty Inc. (CRI), which is responsible for real estate asset management, including hotels, and REOs. As of Dec. 31, 2008, CRI and CSC employed 121 permanent workers in total, a slight decrease from 123 permanent workers as of December 2007. CSC's previous managing director/representative director, Carl Everett, currently oversees the entire Capital Services Group of companies as Chief Executive Officer (CEO), and remains a director of CSC.

In addition, Standard & Poor's has assigned its ABOVE AVERAGE Servicer Evaluation Ranking to CSC as a commercial loan primary servicer mainly handling commercial real estate-backed loans.

### **Performance data**

CSC's figures for residential loan servicing as a primary servicer are shown in tables 1 and 2.

**Table 1 : Residential Loan Servicing Volume Serviced By CSC**

	2005/12	2006/12	2007/12	2008/12
Number of loans	500	1,384	4,379	5,472
Total servicing volume (¥ mil.)	7,206	23,808	81,915	101,191
Delinquent amount (¥ mil.) Total	455	1,373	3,186	5,016
1-30 days overdue	176	1,046	2,845	4,267
31-60 days overdue	92	151	168	545
61-90 days overdue	60	71	115	140
91-120 days overdue	65	25	30	59
121-150 days overdue	27	54	13	0
151-180 days overdue	35	26	15	5
Special servicing loans (¥ mil.)	462	666	1,270	2,838

**Table 2 : Ratios Of Delinquent Loans To Residential Loans Serviced By CSC**

	2005/12	2006/12	2007/12	2008/12
Delinquency ratios (%)				
Total 1-180 days overdue	6.3	5.8	3.9	5.0
1-30 days overdue	2.4	4.4	3.5	4.2
31-60 days overdue	1.3	0.6	0.2	0.5
61-90 days overdue	0.8	0.3	0.1	0.1
91-120 days overdue	0.9	0.1	0.0	0.1
121-150 days overdue	0.4	0.2	0.0	0.0
151-180 days overdue	0.5	0.1	0.0	0.0
Special servicing loans (%)	6.4	2.8	1.6	2.8

## Management And Organization

### Ranking: ABOVE AVERAGE

#### Management and staff experience

CSC's management and staff have extensive experience in servicing operations.

Representative Director Andrew Hughes has been involved in financial accounting for 22 years, and in NPL disposal for five years. Carl Everett has worked in commercial real estate (RE) lending and development for 27 years, and in NPL workouts in the U.S. for 19 years. The company's director/attorney has been in the legal profession for 27 years.

CSC's Loan Administration Department, which includes the Residential Loan team, is led by a director with more than 20 years of experience in the real estate and real estate finance sectors in Japan and the U.S. Additionally, CSC hired a new servicing manager in an attempt to reinforce its overall servicing operations of residential and commercial loans in November 2008. The new servicing manager has 15 years of industry experience. The industry experience of employees engaged in the key servicing operations of residential loans is stated below.

- Three employees focus on servicing residential loans and have, on average, nine years of industry experience.
- Two members of the Resolution team, which is responsible for loan repayments, have an average of 13 years of experience in relevant fields.
- Five employees are involved in servicing delinquent residential loans. Loans that have been delinquent for a long period of time and those requiring time for negotiation with the debtor are handled by two members with over 25 years of industry experience.
- There are also two document custodians and four employees tasked with investor reporting.

The special servicing division that handles nonperforming loans, as well as the Legal and IT/Operations departments, also provide support. Key members of these departments have between 10 and 20 years of experience in their respective areas.

There have been no departures by managers or other senior employees that may have an adverse effect on key businesses.

### **Business strategy**

In its residential loan primary servicing business, CSC is particularly looking to expand its business from third parties. The main points of its strategy are as follows:

- Vigorously explore new markets, using the Sales & Marketing team, established as a department in August 2007;
- Secure high-caliber personnel; and
- Boost operational efficiency, based on operational specialization and ongoing development of systems with high functionality.

### **Policy and procedures**

CSC prepares appropriate policies and procedures for the smooth operation of its daily business. It has prepared a Residential Loan Management Process Manual as a guide to managing residential loan assets. CSC has also created manuals for loan administration and system purposes, including those for the document custody process, cash posting process, servicing system input, data transfer process, investor reporting, and accounting. Most of them are available in both English and Japanese.

The manuals are updated continuously, and all updates are approved by senior management. The latest policies and procedures are accessible online to all employees in the company. In Standard & Poor's view, these online manuals provide an excellent way for all staff to understand functional procedures, and to boost CSC's operational efficiency.

However, Standard & Poor's will scrutinize how these manuals will be adjusted to include other important topics for its residential loan servicing business such as "negotiating with customers over the telephone".

### **Audit and inspection program**

CSC employs an intensive internal and external audit and inspection regimen.

#### **1) Quarterly Internal Audit**

The audit focuses on all administrative and operational aspects of servicing. A director of internal audits, hired in October 2006, is responsible for this audit process.

The purpose is to check CSC's overall organizational internal controls and to identify the risk factors in daily administrative and operational activities. After the audit, a detailed report is compiled promptly to indicate areas that need alterations or improvements, and then it is presented to CSC's executive management. The management must promptly provide solutions to problems highlighted by the audit director. Standard & Poor's confirmed that adequate internal audits have been carried out periodically. Reports are presented semi-annually: in the first half of the fiscal year and in the second half.

A thorough report and the management's response were compiled for the first half and second half of fiscal 2008, and there were no significant findings reported in that audit.

## 2) External Audit

Between fiscal 2004 and fiscal 2007, Ernst & Young (E&Y) has been conducting annual audits on CSC, based on the Sarbanes-Oxley Act, which has replaced the Agreed Upon Procedure audit, upon Lehman Brothers' request. The E&Y audit is a more comprehensive audit covering all the critical fronts in CSC's internal control, including IT, asset management, loan administration, finance, and investor reporting. This audit has not been implemented after 2008 given the absence of such requests from investors, but it may be resumed in the future. CSC is prepared to recommence external audits at any time.

In Standard & Poor's view, CSC's internal audits are thorough and well managed.

In addition to the above, CSC was subjected to the two external audits listed below:

- An accounting audit by Shin Nihon & Co., which found no significant issues to date; and
- An inspection conducted over three days by the Ministry of Justice under the Servicer Law at the end of January 2007. The issues pointed out during the inspection have been addressed.

## Internal control system

CSC is focusing on expanding internal controls, mainly via cooperation among the departments and committees mentioned below, as well as internal audit directors and corporate attorneys:

- **Legal and compliance department:** In charge of verifying all contracts concluded by CSC, maintaining and administering internal documents, inspecting and managing legal ledgers, reporting to regulatory authorities, and implementing regulatory training to employees.
- **Risk management committee:** The committee is chaired by the chief financial officer (CFO) and members include managers of the Legal and Compliance Department and other operational departments. The committee aims to identify risks that may have a significant impact on business operations and mitigate such risks to the extent possible. CSC basically promotes internal control based on the framework disclosed by the U.S.-based Committee of Sponsoring Organization of the Treadway Commission (COSO).
- **Compliance committee:** The committee is chaired by the representative director and members include the company attorney, CFO, internal audit director, legal and compliance director, and managers of the IT and servicing departments. The committee aims to promote the observance of relevant laws and advancement of corporate ethics of the entire company. CSC particularly focuses on the management of personal information protection and the maintenance of legal ledgers utilizing its systems.

The risk management committee and compliance committee are convened regularly. Decisions are communicated to employees through managers of each department, and they are addressed according to a timeline that reflects their degree of importance. The status of implementation is confirmed by each committee.

Standard & Poor's recognizes CSC's continued focus on its compliance framework as a positive factor.

## Training program

After 2005, CSC's training program has allowed each employee to design his/her own training program, which is deemed useful in carrying out his/her business activities, with support and advice from his/her supervisor. The effectiveness of these custom-made training programs is examined through dialogue between employees and their department managers on a semi-annual basis. The exchanges serve as a platform for drafting training programs for the next term. The custom-made training programs may include courses offered by external sources, as well as internal training courses given by managers. Starting in fiscal 2006, CSC adopted a timeline for employees to complete their training program, and the company checks that employees are taking courses appropriate for their positions in the firm.

Currently, CSC's main training programs include the following:

- **Technical business training:** Servicing operations, business law-related courses, licensing exams held by the Loan Servicers Association of Japan for loan servicing asset managers, and communication training.
- **Corporate training:** Internal controls, including compliance and protection of personal information, and IT security.
- **Business tools training:** To boost employees' capabilities in servicing systems and other computer applications.
- **Language training:** To raise employees' English- and Japanese-language skills.

In 2008, key employees undertook more than 40 hours of training programs on average from internal and external sources.

In addition, CSC has a summer internship program for college students from overseas and Japan, and at the same time, through its corporate social responsibility (CSR) program, CSC provides aid to several community programs and charities in the home countries of its employees, and the countries in which its sister companies have branch offices.

In Standard & Poor's view, CSC is undertaking the training of its employees earnestly, and we will scrutinize how the company boosts the effectiveness of its training to raise the operational efficiency of its residential loan servicing business.

## Systems and disaster recovery programs

Since October 2003, CSC's daily residential loan servicing operations have been running on a new system, known as the Servicing Company Operating and Reporting Engine (SCORE; see the "Operation support system" section under "Special Servicing"). There are 18 dedicated IT professionals supporting CSC's system.

Data are replicated daily and stored at the company's Osaka disaster recovery center. In addition, important data are saved daily on a backup tape, which is delivered to a secure data repository managed by a professional data maintenance company, Wanbishi Archives Co. Ltd. The daily backup tapes are also stored in a fireproof safe located in the Wanbishi building. The servers have sufficient capacity for all of CSC's data requirements, and can cope with sudden increases in business volume.

Currently, CSC has backup servers in a professional data center located in Tokyo. Servicing data are also saved on these backup servers on a daily basis.

In the first half of 2001, CSC created a detailed disaster recovery manual. The stringent regulations were designed to protect the company from business interruptions associated with natural disasters. Dedicated management and business resumption teams would be appointed to take the necessary actions should a disaster occur. CSC uses the SECOM Safety Confirmation system to maintain communications with employees in times of emergency. Department level continuity of business plans and the Disaster Recovery plan are updated and tested at least annually. Copies of relevant procedures are maintained at the disaster recovery site and at the homes of key staff. The last comprehensive test of these procedures and of the Disaster Recovery Plan was conducted in November of 2008.

In 2005, CSC designated an alternative backup business resumption site in Osaka. Standard & Poor's regards this as a significant improvement to prepare against unexpected disasters. Additionally, in October 2007, CSC relocated its Osaka office and organized a structure where over 30 employees can engage in business activities. The company periodically implements disaster recovery and business resumption tests more than once a year.

In Standard & Poor's view, CSC would be able to resume important business activities within a relatively short period even when faced with a disaster.

### **Insurance policies**

CSC has insurance policies that meet or exceed servicing industry standards, including Directors and Officers, Errors and Omissions, and Fidelity Bond coverage.

### **Litigation**

CSC does not face any litigation at present.

## **Primary Servicing Ranking: ABOVE AVERAGE**

### **System support**

The introduction of SCORE in October 2003 has bolstered CSC's residential loan servicing system capabilities. The Web-based, multilingual asset management and data warehouse system centralizes CSC's asset data for Japan and all its offices in Asia, maintains detailed property-level information on all portfolios and obligor/guarantor information, payment records, negotiation histories with obligors, and litigation records. SCORE effectively carries out schedule management for each loan so that each asset manager efficiently concentrates on core servicing activities. It also serves as a reporting database repository that can produce reports for third parties and the Ministry of Justice. SCORE is easy to operate and is supplemented by comprehensive, easy-to-understand manuals.

In addition, SCORE is designed to accommodate securitization transactions of various asset types, including NPLs, performing loans, commercial loans, and residential loans, in a flexible manner. In fact, the system is used for securitization transactions in which CSC participates as a servicer.

Furthermore, SCORE seamlessly integrates CSC's policies and procedures into the application, strengthening internal controls and spreading overall knowledge of various parts of the business to all its employees, which ultimately helps the company's operating efficiency.

CSC also introduced a supporting business intelligence tool for asset management, called SCORE Business Intelligence (SCORE B.I.), in 2007. The introduction of this tool and its integration with SCORE, has allowed the company to maximize the use of loan data to create multiple reports detailing whether loans require master, primary or special servicing. This tool has enhanced report preparation by greatly reducing the time involved.

### **Servicing system for new loan assets**

CSC's main business activities as a residential loan primary servicer involve servicing residential loans arranged by investment banks for securitization. Below is a description of how CSC handles and verifies its loan data, before loan servicing begins.

- Information on the borrower and property, loan contract details, and other data are sent via a data pipeline from the loan originator and uploaded to the SCORE system.
- A series of logic tests are performed on the data and the Loan Administration Department verifies that certain data fields are accurately reflected in the system.
- SCORE generates a repayment schedule based on the loan data, which is then confirmed by the Loan Administration Department.
- Manual re-verification of the system data and the repayment schedule that have been uploaded into SCORE is completed.

Standard & Poor's regards CSC's procedures as adequately effective. The company accurately inputs the necessary data into its servicing system for the residential loans that it is currently servicing. At the same time, Standard & Poor's will be checking the company's incorporation of future residential loans into its loan data system, and monitoring procedures as CSC expands its servicing of residential loans with more varied conditions originated by third parties.

### **Payment process and cash management**

Cash management is conducted efficiently through automatic withdrawals from bank accounts, as detailed below:

- The Loan Administration Department sends request forms for monthly automatic withdrawals from the borrower's bank account to an agent through a secure digital format.
- The agent compiles the requests by bank and sets up an automatic remittance from each of the banks one day before the payment date. The agent then checks the withdrawals, and sends a cash collection report to CSC within four to six business days. (The date for sending data is determined based on the agreement with the agent)
- The cash from successfully completed withdrawals is placed into CSC's bank by each contractual due date.
- As for withdrawals that were not completed successfully, a representative from CSC will contact the borrower directly.
- Reconciliation of accounts is performed daily and monthly.
- Payment instructions are prepared by staff in the Loan Administration Department, and they are then reviewed by the departmental manager, director, and CFO. If the amount is over ¥20 million or US\$200,000, then approval from the Representative Director is also required.
- A treasury associate inputs the payment applications into SMBC Web21 (online banking), based on the payment instructions and the necessary approvals, and these are then authorized by the treasury manager. If the amount is over ¥2.5 million, additional authorization from the CFO is required.

In Standard & Poor's view, CSC has excellent protection, given that the company is able to monitor its payments and cash management system through electronic banking. Security is also increased because the responsibilities for cash deposits and withdrawals are separated.

### **Asset management**

In primary servicing cases, according to the various deadlines for each loan and each transaction, the representative typically stays in contact with the borrower and sends notices through the use of SCORE.

Delinquent loans are processed according to the specific escalation process of each portfolio by the team in charge of servicing such loans.

- As of Dec. 31, 2008, there were five main representatives appointed to the task of managing and servicing approximately 360 NPLs or delinquent residential loans. Highly challenging loans are mainly handled by two representatives with more than 20 years of industry experience.
- The representatives are expected to build good relationships with the borrowers, and be knowledgeable about their respective financial and personal conditions.
- There is a detailed manual on NPL management, which details the procedures required for following up in writing and by telephone, and the notification methods for loans that are delinquent for a period of between one and six months.
- Each notification letter drafted is checked by the Compliance Department.

### **Investor/trustee reporting**

CSC uses SCORE and/or SCORE B.I. to compile reports for investors and trustees. SCORE contains all necessary information regarding the assets and loans, including the negotiation and collection histories. From this system, asset managers can retrieve any information that is necessary for their reports on loans that they oversee. Reports are generated in formats agreed upon between investors and CSC.

Currently, reports are provided to trustees through a secure Web site.

## **Customer service**

CSC maintains a system that can accommodate accelerated payments of loans by customers, lump-sum repayments, and changes to loan conditions. Through the SCORE system, the company is able to immediately verify the loan's up-to-date payment schedule. Therefore, the company can reply to a customer's inquiry quickly and in a comprehensive manner.

Through its utilization of SCORE's high degree of functionality, Standard & Poor's considers that CSC is capable of handling the loans with its current staffing levels, even if the number of loans increases several times over.

## **Financial Position Ranking: SUFFICIENT**

At present, in Standard & Poor's view, there are no significant concerns regarding CSC's financial condition.

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