CMBS Special Servicer
Japan
Servicer Report

# Capital Servicing Co., Ltd.

## Ratings

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|---|---|
| Special Servicer | CSS1- (JPN) |

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## Related Research

**Applicable Criteria**

- *Rating Criteria for Japanese Servicers (September 2009)*

**Other Research**

- *Global Rating Criteria for Structured Finance Servicers (August 2010)*

## Summary

Fitch Ratings assigns a CMBS Special Servicer Rating of 'CSS1- (JPN)' to Capital Servicing Co., Ltd. (Capital, or the company). The rating reflects sustained strengths — such as its experienced senior management and asset managers, highly integrated and versatile servicing system, and comprehensive risk management infrastructure.

Capital's assets under management declined as a result of the sale of Lehman Brothers' assets and those of its affiliates in 2009. Accordingly, Capital reduced its staff, implemented various cost-savings measures, and also reviewed the organisation of the teams in its primary and special servicing divisions — and their operations. Offsetting this, Capital's servicing contracts from new clients have steadily increased as a result of strengthened efforts to obtain new business, with concurrent diversification of servicing needs by clients. The agency will continue to monitor Capital's servicing contracts and its response to managing the diversifying needs of its clients.

Capital was licensed by the Ministry of Justice and commenced its servicing business in 1999, and has become one of the leading independent servicers providing primary and special servicing in the field of CMBS. As of end-December 2009, the company's servicing assets consisted of approximately 10,800 performing and non-performing loans worth JPY1,162bn in total (in terms of principal balance). Included in the assets were 24 securitised transactions (of which 21 were CMBS) for which Capital was the named servicer.

Fitch's servicer rating is based on the agency's *"Rating Criteria for Japanese Servicers"* (dated 4 September 2009), which can be found on Fitch's website at www.fitchratings.com.

## Strengths

- Experienced senior management and asset managers.
- Highly integrated and versatile asset management system.
- Comprehensive and well-organised risk management infrastructure.

## Challenges

- To ensure recovery and a stable increase in the volume of servicing assets.
- To maintain and improve the quality of servicing as client needs become more diversified.

## Approach to Challenges/Mitigants

- New contracts have steadily increased in 2010 as a result of strengthened efforts for obtaining new servicing contracts.
- Capital reviewed the organisation of teams in the servicing divisions and their operations, and structured a more efficient and flexible servicing platform.

## Company Overview

Capital's holding company, Capital Services Holding Corporation (CSHC), together with CSHC's parent company, One-Chome LLC, holds all the shares of Capital — which mainly provides primary and special servicing for third parties.

CSHC operates Capital Services Group (CSG), consisting of subsidiaries engaged in loan servicing and real estate asset management businesses in Asia, and Capital is its flagship operation.

In 2009, assets related to Lehman Brothers were sold off as part of Lehman's liquidation procedures. Capital was clearly affected by this, resulting in a decrease in its servicing assets. To cope with this situation, Capital reduced employees and cut expenses, and worked to expand its client base to increase servicing volume.

As of end-June 2010, Capital's new servicing contracts not related to Lehman had grown to about 1.9x the figure at end-2009. However, Fitch believes that the decrease in Lehman-related assets is largely offset by the steady increase in non-Lehman assets.

On another front, as the number of clients has increased, their servicing needs have become diversified. The company has been entrusted with types of assets that it had not previously handled, and its servicing structure needed to be partially adjusted. Accordingly, Capital reorganised its servicing division in January 2009. In order to provide efficient servicing that suits the characteristics of various asset types, the company integrated the asset management, loan administration and investor reporting departments into one unit for flexible operations. When taking on new assets, the company thoroughly examines the risks involved.

Ensuring compliance and risk control is an important business policy for Capital. The company has intensified the risk management committee's monitoring of the impact of staff cuts and organisational changes, and of the cash flow situation. Fitch notes that Capital's management of business risks and other risks is flexible, and the agency will continue to monitor the company's flexible handling of assets and performance.

## Financial Details

Capital's revenue declined by approximately 27% in 2009, while net income grew by around 36% as cost-cutting measures were implemented. Since it is not standard practice for Capital to purchase loans on its own balance sheet, there is no concern about liquidity — as even the small debt balance it held as of December 2009 had been repaid in full by March 2010.

Considering that there has been a steady stream of new servicing contracts in 2010, Capital forecasts that 2010 revenue will exceed the company's budget figures. Capital's expenses will remain conservative under its current cost-control programme, and the company expects only a slight decrease in its net income in 2010.

## Employees and Training

As of end-December 2009, Capital had 83 employees (including management), 43 fewer than a year earlier. This reflects the result of optimisation of the staff size based on the expected volume of servicing assets. Allocation of employees in the company's various departments is shown in the table Staffing. Resource reductions were mainly carried out in IT-related support, finance and reporting operations.

Top executives and asset managers, including those in managerial positions, had, on average, more than 25 years and 15 years, respectively, of relevant industry experience as of February 2010. Even after staff cuts, Capital retains highly experienced employees.

In 2009, the company appointed a new portfolio manager and servicing director. The servicing division was reorganised, and a new servicing director with more than 20 years' industry experience was put in charge of the asset management, loan administration, and investor reporting functions. Two new portfolio managers were appointed to assist the servicing director to better identify and support client interests. The portfolio managers on average have more than 13 years of experience.

Capital encourages employees to reach 40 hours (20 hours for non-exempt employees) of training per year. Managers in each department assist the staff in developing personalised training plans and help them to achieve their goals. The HR department organises the training programme, to which every employee applies individually. In 2009, external training decreased due to cost-cutting measures, but overall there were no significant changes to the training programmes. Employees achieved far more hours of training than the minimum to which they are encouraged.

Although external training has been limited, Capital plans to continue to provide those external training programmes deemed necessary for employees.

**Staffing**

| | Dec 2008 | Dec 2009 | Feb 2010 |
|---|---|---|---|
| Management | 6 | 5 | 5 |
| Asset management | 22 | 18 | 19 |
| Loan administration/investor reporting | 42 | 26 | 31 |
| IT | 22 | 12 | 8 |
| Internal audit | 2 | 2 | 2 |
| Legal and compliance | 4 | 2 | 3 |
| Finance | 16 | 9 | 7 |
| HR and training | 4 | 3 | 3 |
| Sales and marketing | 4 | 3 | 3 |
| Office management and other | 4 | 3 | 3 |
| **Total** | **126** | **83** | **84** |

Source : Capital Servicing Co., Ltd.

## Internal Control

Capital maintains internal control through its compliance, internal audit functions and activities of the risk management committee (RMC).

The RMC meets both at the holding company (CSHC) level and at the company level on a monthly basis, to oversee corporate governance and risk management of CSG as a whole as well as that of Capital. Capital is the group's flagship company, and its risk management is the RMC's top priority. The RMC conducts an annual risk analysis and assessment, and initiates risk-mitigation strategies based on the COSO model (a risk management model proposed by the Committee of Sponsoring Organizations of the Treadway Commission of the U.S.) with regard to Capital and other major CSG companies. The effectiveness of these measures is monitored by the company's internal audit, and improvements are made reflecting the results.

In 2009, Capital intensified the RMC's monitoring of risks arising from staff reductions and organisational changes, and their impact on operations as well as cash flow. Specifically, risks arising from staff cuts, organisational changes and the diversification of client needs — as well as the effect of the decrease in Lehman-related assets — were added as new areas for enhanced monitoring and control by the RMC.

The Compliance Committee (CC), established in 2008 (and chaired by the representative director), oversees and manages corporate-level risks regarding compliance with related laws and business ethics. It also directs two sub-committees created to cope with two major issues: private information protection, and the books and records that servicers are legally required to maintain (respectively called the Private Information Protection Committee and the Steering Committee).

Compliance activities are enforced in all of the company's departments by the legal and compliance department. This department has a staff of three, and oversees general legal affairs and the compilation of rules and manuals. The department serves as the secretary of the CC and its sub-committees, monitors the data entered in the legally required books, and organises compliance-related training programmes.

Capital has a comprehensive set of policies and procedures (P&Ps) based on proper corporate governance exercised throughout the company. The P&Ps are updated and amended when necessary by the department managers, and inspected by the legal and compliance department on an annual basis. Since the last rating review in March 2009, Capital has adopted and implemented four new P&Ps and updated 11.

Capital has a comprehensive risk management infrastructure, and manages in a flexible manner the business risks arising from various market and regulatory changes. Fitch views Capital's risk management platform as most advanced.

## Technology

Capital uses a self-developed asset management system called the Servicing Company Operating and Reporting Engine (SCORE). SCORE handles information on obligors, guarantors, and collateral and other relevant information, as well as the legally required books and records. SCORE is designed to be flexible enough to allow access to a vast combination of data to help prepare various reports that meet the requirements of investors, management and its regulator. SCORE also allows entrustors access to the performance data of investment portfolios on a real-time basis.

In 2009, improvements were made to SCORE's functions for preparing and monitoring recovery plans (so-called business plans) to make it possible to complete all the necessary approval procedures leading up to a resolution. The system was also equipped with the additional function of changing the scenario of the business plan and assessing the effect of change. Moreover, the transfer from primary to special servicing can be carried out smoothly.

SCORE is equipped to function in a multi-currency, multi-lingual environment, and is licensed to third parties in several countries, and Capital has continued to improve the functions of SCORE since the system went into operation in 2003. Fitch notes that SCORE is a highly integrated, versatile and efficient servicing system.

Capital is prepared with a business continuity management and disaster recovery plan, and internal regulations and manuals, which are reviewed every year. These constitute a comprehensive set of business continuity plans with clear instructions on how to restore the system, secure staff, office space and equipment in the event of a disaster affecting the Tokyo office.

In accordance with its internal regulations, Capital operates a back-up centre in its Osaka office, to which data is sent electronically for storage. The back-up centre is fully equipped with 20 personal computers to be used for business operations in case of a disaster such as an earthquake that could damage the Tokyo office and disrupt normal operations.

Capital has conducted disaster recovery tests annually since 2005, and taken measures considered necessary as a result of the tests. The latest test was performed in November 2009, and necessary measures were reviewed and implemented.

## Special Servicing

From its inception to 2009, Capital has serviced approximately 9,800 non-performing loans worth JPY4,636.2bn (in terms of principal balance), and has collected approximately JPY340bn. As of December 2009, it services about 2,300 non-performing loans worth JPY840.5bn, of which about 18% are sub-performing loans.

At the time of Fitch's previous rating review (March 2009), most of Capital's servicing assets were loans provided by Lehman and Lehman-related affiliates. Those Lehman-related assets which are securitised are basically not affected by the collapse of the investment bank, and are being serviced by Capital. Most of the asset portfolios not securitised were sold off in the process of liquidation of Lehman-related assets, but Capital successfully retained the servicing on a significant portion of those assets by reaching an agreement with the purchaser. However, Capital's assets still decreased in 2009, as some of them were taken over by other servicers.

New servicing contracts have been increasing steadily, particularly for new investments made by overseas investors. Capital's servicing assets have grown from 2009 to 2010.

### Loan Administration

As new servicing contracts have increased, the clients and their assets entrusted to the company have become diversified. As previously mentioned, Capital made an appropriate organisational change to deal with this situation.

Specifically, the three departments of the servicing division — the asset management, loan administration and investor reporting departments — were brought together for integrated operation under the overall oversight of the servicing director. Two portfolio managers were put under the supervision of the servicing director, and their job is to properly identify the characteristics of assets and the needs of investors who entrusted assets to the company, and to reflect these in servicing operations.

At the same time, Capital reviewed the organisation of teams in the servicing division, and reorganised them according to their functions — to improve overall business efficiency. Fitch believes that if proper cooperation and coordination among the teams are assured under the new system, information will be shared to a greater degree, and more staff will become multi-functional.

The loan set-up process, cash management and reporting at Capital have not significantly changed since the last rating review. Fitch continues to regard these processes as mostly efficient and supported well by SCORE.

Capital's loan set-up process is for the most part automated. When the company receives all the necessary data on newly assigned loans, the data is reformatted using a standard template and uploaded into SCORE. The information on borrower repayments is obtained daily from banks and uploaded to SCORE.

The printed repayment record is sent from the treasury department to the asset management and other related departments. The next business day, repayment information is uploaded into SCORE by the treasury department, and the asset manager in charge confirms the collection amount in SCORE. Unusual or irregular payments, such as payments in cash or by check, have to be reported to the treasury department, which investigates the details.

### Collections

Capital's cumulative collection of non-performing loans from its inception to the end of 2009, and its annual collection for 2009, is shown in the table Collection and

Resolution. There were major changes in 2009, and those results therefore differ from the cumulative figures.

In servicing non-performing loans, Capital draws up and maintains collection plans (business plans) to attain target collection amounts. It maintains the following approach to the business plans.

1. Assets with a target collection amount of JPY100m or more.

   For each individual asset, a business plan is to be completed, with approval from the representative director and the investor within 120 days of receipt of the underwriting package, and is reviewed annually or as necessary.

2. Assets with a target collection amount of less than JPY100m but JPY10m or more.

   For each individual asset, a business plan is to be completed with approval from the investor within 120 days of receipt of the underwriting package, and is reviewed annually or as necessary.

3. Assets with a target collection amount of less than JPY10m:

   If the target collection amount is small, business plans are made for each pool. However, like other assets, these plans are to be completed within 120 days of receipt of the underwriting package, and are reviewed annually or as necessary.

## Collection and Resolution (for NPL only), as of December 2009

| Collection amount (on resolved assets only) | | | |
|---|---|---|---|
| **Inception to 2009** | **(JPYm)** | **2009** | **(JPYm)** |
| | 340,087 | | 7,749 |

| Types of resolution by collection amount | | | |
|---|---|---|---|
| **Inception to 2009** | **(%)** | **2009** | **(%)** |
| Voluntary sales | 36.0 | Voluntary sales | 62.6 |
| Loan sale | 19.8 | Foreclosure sale | 14.4 |
| Discounted pay-off | 14.9 | Discounted pay-off | 9.3 |
| Foreclosure sale | 11.3 | Voluntary payment | 5.5 |
| Insolvency | 2.6 | Insolvency | 4.1 |
| Other | 15.4 | Other | 4.1 |
| **Total** | **100.0** | **Total** | **100.0** |

Source: Capital Servicing Co., Ltd.

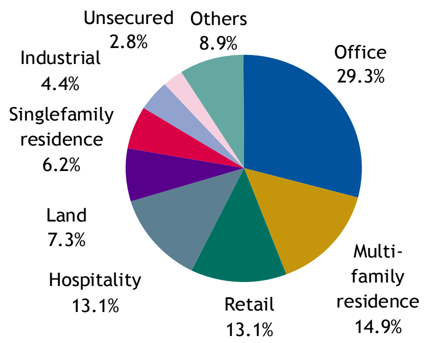
The asset management team, a core unit in the special servicing division, had eight asset managers as of December 2009, with an average of more than 23 years of industry experience (including 12 years in NPL workouts). The asset managers are under the direct management of the servicing director, and primarily handle large and important assets. Smaller loans, including personal loans and residential loans that have been transferred from primary to special servicing, are managed by a separate specialist team, the Collections/Personal Loan Team.

Each asset manager is responsible for, on average, about 50 loans that are collateralised by real estate, and is given an annual collection target of about JPY9bn. Allowing for the progress being made in these cases, Fitch believes the workload of asset managers is manageable.

When an asset resolution is proposed to the investor, the asset manager submits a resolution approval memo/action approval memo to the servicing director and representative director for approval (via SCORE). In case the expected collection in the proposed resolution falls short of the target amount in the business plan, the proposal must be approved by the investor.

Collateral handled by Capital as classified by property type is shown in the chart Collateral by Type, Cumulative on Resolved Loans up to 31 December 2009 for loans recovered through December 2009. The percentage of large commercial real estate (offices, multi-family residences, retail stores and hotels) is more than 70%.

**Collateral by Type, Cumulative on Resolved Loans up to 31 December 2009**




Source: Capital Servicing Co., Ltd.

Capitalising on its various servicing experiences, Capital takes effective measures to maximise collection. Senior management closely monitors day-to-day administration of servicing processes through SCORE, and often provides instructions as necessary, such as requesting a review of business plans. Capital has largely met and exceeded the collection targets on which it agreed with the entrustors. Fitch believes that the company operates a highly efficient special servicing operation, as shown by its collection record.