SFJ

Securitization Forum of Japan

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Comments on the criteria for identifying simple, transparent and comparable securitisations

Securitization Forum of Japan

I. Introduction

A. The Securitization Forum of Japan[1] (SFJ) welcomes the opportunity to comment on the proposals published by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO) for the "Criteria for identifying simple, transparent and comparable securitisations" ("the Consultative Document").

B. With regard to the Consultative Document, SFJ obtained over 120 comments from our members as well as non-member firms in Japan, ranging from nonbank originators, bankers, brokerage firms, institutional investors to industry groups. This clearly reveals that market participants in Japan have strong interest in the STC criteria proposed in the Consultative Document, and particularly in its implementation in the market. As such, our comments on the proposals in the Consultative Document come mainly from the perspective of applicability and adaptability of the proposed criteria for simple, transparent and comparable securitisations ("STC criteria") in Japan.

[1] Please refer to Annex 1 for a description of the Securitization Forum of Japan.

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C. We generally support and agree with the proposed STC criteria. The criteria should become an effective benchmark for investment decision-making in the Japanese securitisation market.

D. At the same time, consideration should be given to the implementation and application of the criteria to the market and to each transaction. We would like to take this opportunity to provide comments from a practical viewpoint.

II. General comments

Effectiveness of STC criteria depends on the implementation

1. SFJ believes that the STC criteria will serve as a benchmark for analysis of securitised products.

2. Having said that, in order to ensure that the criteria will assist the development of the securitisation market, the following should be considered in its implementation:

3. First, on the assumption that the STC criteria will be referred in the context of Basel III securitisation framework, we agree that the preferential treatment under the framework to securitised products that comply with the STC criteria will assist the development of the securitisation market. On the other hand, we are concerned that unfavorable treatment of non-STC products under the framework, for example, additional risk weight to be applied to such non-STC products, could lead to a further slowdown of the securitisation market. This is particularly true for the Japanese market, where investors are predominantly banks. Banks' incentive to invest in non-STC products would recede, given the higher risk weights applied to these products over other products. This could also impede the development of innovative products.

4. Second, we believe it is important to discuss issues relating to the ongoing application of the STC criteria. Such issues would include the party responsible for assessing or certifying the securitised products that are compliant with the STC criteria for the purpose of calculating regulatory capital requirements under Basel III, and whether it is necessary to provide investors with multiple options to use a third party to conduct the assessment or certification. Various factors, such as access to information, whether a designation or assessment as to compliance with the STC criteria can be relied upon by investors as final, and cost-effectiveness, should be

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considered when examining these options.

III. Response to specific questions

Question 1: Do responders agree that the criteria achieve the goals they aim to achieve? In particular, do responders believe that the criteria could help investors to identify "simple", "transparent" and "comparable" securitisations?

1. We generally agree. However, we are concerned that the STC criteria could potentially lead to a renewed "cliff effect". In this respect, the following should be taken into account in implementing the STC criteria:

2. On the assumption that the STC criteria will be referred in the context of Basel III securitisation framework, a "cliff effect" may emerge if there is a significant divergence between the regulatory capital treatment for securitised products that comply with all 14 STC criteria (STC fully-compliant securitisations) and those that do not comply with all criteria (STC partially-compliant securitisations). To mitigate such cliff effect, a clear-cut differentiation of STC and non-STC securitisations should be avoided. We should instead introduce a gradual categorisation of securitised products (e.g., transactions that lack to satisfy one criterion, those that lack two criteria, and so on).

Question 2: Do responders agree with the STC criteria set out in the annex of this paper? In particular, are they clear enough to allow for the development by the financial sector of simple, transparent and comparable securitisations? Or do respondents think they are too detailed as globally applicable criteria? The annex provides guidance on each criterion. Which additional criteria would respondents consider necessary, if any, and what additional provisions would be useful or necessary to support the use of the criteria? What are respondent's views on the "additional considerations" set out under some criteria in the annex? Should they become part of the criteria? Are there particular criteria that could hinder the development of sustainable securitisation markets due, for example, to the costliness of their implementation?

Who should assess compliance with the STC criteria?

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1.1 The implementation of the STC criteria should be associated with clear provisions as to (i) who should assess or certify each securitised product to determine its compliance with the STC criteria, (ii) how information will be provided to investors, and (iii) how investors should make their final decision based on the information. Some of the criteria refer to information that is not readily available to investors. Therefore, the STC criteria will not function if it is the investors who are to determine whether a securitisation is STC-compliant or not.

1.2 For example, it would be impossible for investors to assess whether a securitisation transaction satisfies **B.11 Documentation disclosure and legal review** (i.e. verification of the legal documentation), even if the transaction's disclosure is sufficient. Practical reason for this is that only certain parties, such as the arranger, underwriter, and rating agencies, have access to information on all documentation including, for example, legal opinion by transaction lawyers which is not supposed to be disclosed to investors.

1.3 Furthermore, the language used in the STC criteria is rather abstract. Therefore, the results of the assessment may differ by investor, leading to a lack of consistency in the implementation of the criteria. The criteria therefore should be clear enough to be applied. As mentioned previously, the use of a third party that may appropriately assume the responsibility of assessing or certifying each securitised product to determine its compliance with the STC criteria, including the degree of documentation disclosure and legal review, may be a viable option. The criteria should be clear enough to be used as an interpretation guideline such that such third party may properly conduct the assessment or certification.

1.4 Therefore, we believe a third party should be involved even if investors are to decide whether a transaction is STC-compliant or not. More specifically, we propose to introduce a framework that allows a regulated rating agency to certify and/or the arranger to provide prima facie evidence to ease the process.

1.5 With regards to eligible third parties, we believe that certification by rating agencies would be ideal. Most securitised products in Japan are rated by rating agencies that are regulated by the Financial Services Agency (FSA). Moreover, rating agencies have access to undisclosed documents, including legal opinions on the terms of the contract. We also suggest keeping

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multiple options open regarding the certifying parties and the certification processes. For securitized products that carry no external rating, other third party who could provide similar assessment service for non-rated products to assess STC should be acceptable.

1.6 If 1.4 above is not provided for in the new framework, investors would be required to assess whether a transaction is STC-compliant or not for every purchase of a securitised product. This could inhibit market liquidity.

Mitigating additional costs

2.1 We should give consideration to additional costs, in order for the implementation of the STC criteria to be successful. Additional costs may be incurred by originators and arrangers to adopt the new criteria, given the need to enhance their management systems (e.g. STC-compliant credit screening, IT, etc.). Such additional cost burden could be reduced with the measures mentioned below:

2.2 **A.3 Payment status** requires caution, as the implementation of this criterion could result in significant cost burden on the part of originators, such as independent nonbanks and captive companies. For example, the definition of "default" varies by these nonbanks and captives; hence, it could be costly for them if they were to adopt a uniform definition under the STC criteria. Their incentive to securitise could recede as a result.

2.3 Instead, the STC criteria should require originators to clarify their definition of "default". This would allow investors to understand and compare across different transactions of the same asset class issued by various originators.

2.4 As for **A.6 Initial and ongoing data**, a securitised product should be deemed STC-compliant if originators, trustees or underwriters are prepared to provide such data at the request of investors. Strict rules that would require disclosure of detailed information at all times should be avoided. Such disclosure would be inefficient and ineffective, in our view.

2.5 Regarding **B.11 Documentation disclosure and legal review**, prima facie evidence justified by certification from third party should be accepted when disclosure is deemed inappropriate. An example would be the legal opinion provided for a securitisation scheme. Law firms

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provide their opinion to originators, but such information is not intended for disclosure to unspecified, potential investors. In this case, it would be practical for the originator and/or securitiser to provide prima facie evidence regarding the existence of the legal opinion on which investors could rely, provided that such prima facie evidence is supported by certification from third party.

Question 3: What are responders' views on the state of short-term securitisation markets and the need for initiatives with involvement from public authorities? Do responders consider useful the development of differentiating criteria for ABCP, in a manner similar to that of term securitisation? The BCBS and IOSCO would particularly welcome any data and descriptions illustrating the state of short-term securitisation markets by jurisdiction and the views of respondents on concrete comparable criteria that could be applied to short-term securitisations.

ABCP and other short-term securitisations

3.1 From the viewpoint of ABCP investors, it would be useful to introduce a separate set of STC criteria for ABCP and other short-term securitisations. Considering the nature of ABCP and other short-term securitisations, however, the criteria could be simpler than that set out in the Annex of the Consultative Document. For example, the credit of fully-supported ABCP is linked to the credit of the sponsor bank. In this case, there is no need to analyse the credit quality of the underlying portfolio. Criteria related to asset selection and transfer could be eliminated in this case.

3.2 From the viewpoint of the sponsor banks, on the other hand, a set of practical criteria should be developed for ABCP liquidity facilities. We provide a sample list of criteria in Annex 2 of this comment letter. The basis of our proposal is as follows:

3.3 According to statistical data compiled by SFJ, the outstanding size of the short-term securitisation market in which the Japanese banks are involved (including receivables purchased and securitised products) was roughly 7 trillion yen as at end-March 2014. ABCP and ABL accounted for roughly 2 trillion yen and 5 trillion yen, respectively.

3.4 As indicated above, the short-term securitisation market involving the Japanese banks is relatively large. Meanwhile, as mentioned in the comments provided by the Japanese Bankers

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Association (JBA) dated 15 March 2013 in response to the Consultative Document disclosed by BCBS on 1 December 2012, Japanese banks have never experienced a default on the underlying assets of short-term securitisation exposures, including ABCP liquidity facilities. The credit quality of short-term securitisation transactions originated or sponsored by Japanese banks are extremely high.

3.5 There are several reasons why Japanese securitisations are of such high quality. First, most transactions are backed by receivables with maturities of less than one year; in other words, the obligor risk associated with the underlying asset pool is generally short-term. Second, most of the underlying assets are so-called "commercial receivables"; i.e., receivables that are generated as a result of the sale, supply or offer of products or services to the underlying obligors.

3.6 We believe it is appropriate to address the above in a separate set of criteria for high-quality, short-term securitisations. For a sample set of criteria, please see Annex 2 of this comment letter.

Considerations regarding CMBS

3.7 In relation to **B.7 Redemption cash flows**, we note that CMBS tend to be more idiosyncratic and less granular than ABS backed by credit claims or receivables. Therefore, CMBS are likely to be categorized as "non-STC securitisation" under the proposed STC criteria. However, on the back of the importance of CMBS in the area of real estate finance, a separate set of criteria for CMBS should be discussed in the future.

3.8 CMBS transactions are not homogeneous, given that redemption structures rely largely on the refinancing or the sale of the underlying properties. The separate criteria for CMBS should therefore be focused on enhancing transparency and comparability of transactions. CREFC's "CMBS 2.0"[2] is one example of an initiative that aims to enhance the comparability of transactions backed by non-recourse loans (NRLs) and/or commercial mortgages. "CMBS 2.0" could be a starting point to begin a productive discussion on the separate set of criteria for CMBS.

[2] http://www.crefc.org/committees.aspx?id=19381

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Question 4 : What are respondents' views on the level of standardisation of securitisation transactions' documentation? Would some minimum level of securitisation of prospectuses, investor reports and key transaction terms be beneficial? Do respondents think there are other areas that could benefit from more standardisation? Would a standardized template including where to find the relevant information in the prospectus be helpful? The BCBS and IOSCO would particularly welcome a description, by jurisdiction, of the extent to which different elements of initial documentation are standardized.

Defining a "Checklist", not Standardisation

4.1 Given the difficulty in standardizing documentation, a viable option would be to adopt a "checklist approach" instead of standardisation. Specifically, general items, terms and conditions that should be set forth in the transactions' documentation may be listed for each jurisdiction to be used as a documentation checklist by investors. The checklist could assist investors to compare across similar transactions in determining the appropriateness of legal structure, the way of addressing legal issues in the transaction, and the degree of the limitations regarding representations and warranties.

4.2 We know from experience that standardisation is not easy or practical. In Japan, there was an attempt to standardize prime RMBS, which are relatively simple and comparable. However, we found that even prime RMBS have specifications that are unique to each transaction, which lead to difficulties in compiling a standardized template.

4.3 Even the representation and warranties clause may differ by transaction and/or by law firm. Such items need not be standardised.

4.4 Legal documents should be disclosed to ensure that investors are fully informed when making investment decisions. In particular, disclosure on financial covenants and triggers is essential in assessing the potential outcome of a credit event and the conflict of interest between holders of different tranches. In Japan, documentation for primary transactions is disclosed to facilitate the investment decision-making process.

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IV. Comments on the proposed criteria

A.1. Nature of the assets

A1.1 We agree with the proposal that requires underlying asset pools to be "homogeneous". However, consideration should be given to the definition of "asset type". For example, corporate bonds and loans are fundamentally the same; they are both mid- to long-term corporate debt. The STC criteria should allow for asset pools comprised of both bonds and loans to be considered "homogeneous".

A1.2 Also, some corporate loans in CLO pools are extended under a loan facility with a "multi-borrower" option. A company may draw on a multi-borrower facility at the parent level or at the subsidiary level. In other words, a CLO pool may consist of receivables originated in multiple jurisdictions. We believe that the STC criteria should take into consideration the fact that loans to a single company may involve multiple jurisdictions in the case of large corporates, unlike those to individuals or SMEs. In some cases, warranties through implied comfort or keep-well could function as supportive evidence that exposures across multiple jurisdictions could be viewed as single company exposure.

A.2. Asset performance history

A2.1 We propose that the wording "should be clearly disclosed to all market participants" be rewritten "should be disclosed to investors and potential investors". The language "all market participants" is too broad. Furthermore, disclosure to "potential investors" should allow for cases where disclosure material can be provided on a timely basis at the request of investors. As for the means of disclosure, regular disclosure of information on the internet or through third-party vendors should not be required.

A2.2 As regards to "for a time period long enough to permit meaningful evaluation by investors", we suggest five years as the minimum time period. We understand that in certain cases, banks are required to accumulate five years of data when calculating PD (probability of default) under the IRB framework for Basel III. Also, although five years is not sufficient to cover a full economic cycle, we believe that this could cover both an uptrend and a downtrend in the cycle.

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A.3. Payment status

A3.1 The definition of "default" and "delinquent" should not be standardized if originators are independent nonbanks and captive companies because the definition of "default" and "delinquent" varies by these nonbanks and captives. Rather, the definition of "default" and "delinquent(cy)" should be clearly set out by these nonbanks and captives in the transaction documents for each transaction, so that the investor can appropriately analyse the historical performance data.

A3.2 "Material increase" as mentioned in the proposal is rather ambiguous and therefore ineffective, in our view. Specific technical standards should be complied, or alternatively, the language "or obligations for which the transferor…" should be deleted. The eligibility criteria for underlying assets in a securitisation pool are usually disclosed, and the transferor generally represents and warrants compliance with the criteria.

A.4. Consistency of underwriting

A4.1 Originators may modify their underwriting standards depending on their business strategy. In this case, it would not be appropriate to assume that the originator has intentionally loosened its underwriting standards.

A4.2 The STC criteria should be effective in ensuring that investors are informed of the details regarding the changes in underwriting standards, the purpose of such changes, and the securitisation amount affected.

A.5. Asset selection and transfer

LTV, DTI, DSC

A5.1 SFJ generally agrees with the proposed criteria.

A5.2 However, in relation to footnote 9 "the age of the borrower or the LTV of the property", we note that Japanese residential mortgage lenders focus more on the ability of the obligor to pay than on LTV. In other words, in assessing the creditworthiness of Japanese residential mortgages, emphasis is placed on DTI (debt-to-income ratio) or DSC (debt service coverage

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ratio) over LTV. We therefore believe that the use of DTI/ DSC instead of LTV should be permitted under the STC criteria. Furthermore, the obligors' ability to pay is easier to compare than collateral value, in our view. We therefore suggest specifying a DSC level in the criteria (DSC 35% or below, for example).

Differentiating "Repackaging" from "resecuritisation"

A5.3 We are concerned that "repackaged" transactions could fall under the definition of "resecuritisation" as set forth by BCBS. For example, some repackaged Japanese RMBS simply aggregate the exposures of multiple RMBS. In these transactions, the tranches issued are a simple sum of the underlying RMBS tranches. These simple structures should not be excluded from STC eligibility.

STC eligibility of managed CLO for SME

A5.4 The criteria can be read that managed CLOs are not STC-eligible. The rationale behind the criteria is to exclude inappropriate arbitrary asset selection from portfolios of eligible credit calims or receivables, but in this regard, managed CLOs are actively managed in order to allow the managers to select high-quality assets. So the criteria should be clearly defined to be applied to asset selection from granular portfolios. We should also add that managed CLOs play an important role as a fund raising tool, particularly for SMEs.

A.6. Initial and ongoing data

A6.1 A clear definition should be given regarding "granular" as mentioned in the second paragraph of the proposal. We suggest applying the "effective number of exposures (N)" in Paragraph 633 of "International Convergence of Capital Measurement and Capital Standards" by the BCBS (bcbs128), and consider securitisation pools with N of 25 and above as "granular".

A6.2 Also, with regards to "should be readily available to current and potential investors" as mentioned in the second paragraph, it should be considered sufficient if the originator/ arranger is ready to provide information at the request of "investors".

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A6.3 As for "to provide a level of assurance…" in paragraph 3, even if the initial portfolio is "reviewed for conformity with the eligibility requirements by an appropriate independent third party", it would be difficult for investors to confirm this. We therefore propose that this paragraph be removed.

B.7. Redemption cash flows

（Please refer to our response to Q3.）

B.9. Payment priorities and observability

Legal comfort

B9.1 We believe that it would be difficult to determine compliance with "legal comfort" as mentioned in paragraph 1, even if investors are able to access and assess the relevant securitisation documentation. We therefore propose to delete this criterion, or to allow for some flexibility in its application (e.g. the originator to provide prima facie evidence regarding the existence of legal opinions, etc).

B.11. Documentation disclosure and legal review

B11.1 It would be difficult to assess whether "the terms and documentation of the securitisation" is "reviewed and verified by an appropriately experienced and independent legal practice", as mentioned in paragraph 2. Moreover, the definition of "verified" is ambiguous; it is unclear as to what procedures should be taken and what should be confirmed and/ or certified.

B11.2 Therefore, we believe that the second paragraph should be deleted as a whole. Alternatively, other options, such as certification by regulated rating agencies or other third parties, or prima facie evidence provided by the originator or securitiser, should be introduced to ease the process for investors.

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B.12. Alignment of interest

B12.1 It is not necessarily clear as to whether risk retention is the most appropriate way to align the interests of the parties involved in a securitisation transaction. Therefore, other means of aligning interest (e.g., appropriate application of lending standards, similar assets held by the originator, etc.) should also be permitted under the STC criteria.

B12.2 Given that risk retention requirements differ by jurisdiction, it would be difficult to implement a single criterion across all jurisdictions. We believe that a requirement to disclose information to investors on who (which party involved in the securitisation) holds what (which underlying asset/ tranche) should be sufficient.

End of document.

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ANNEX 1

Description of Securitization Forum of Japan

The **Securitization Forum of Japan (SFJ)** was founded as a voluntary association in 2005 and established as a corporation in 2007. SFJ aims to contribute to the sound development of the asset securitisation market and carry out the following operations: (1) research and study associated with asset securitisation; (2) exchanges and cooperation with internal and external organisations concerned, etc. associated with asset securitisation; (3) diffusion and enlightenment of asset securitisation; (4) policy recommendations concerning asset securitisation; and (5) any other operations incidental or relevant to operations of the above items. SFJ operates Experts Committees on a steady basis to discuss issues on securitisation, share practical intelligence among members and make policy proposals based on the discussions. Some of the committees run a Subcommittee or Working Group to further address crucial topics on securitisation such as Basel III securitisation framework. SFJ also deliver high-quality educational system to members, providing opportunities to attend seminars on securitisation or to take professional development programs.
Association's web site: http://www.sfj.gr.jp/e/index.html.

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ANNEX 2

Proposed STC criteria for ABCP facilities and other short-term securitisations

A. Nature of the assets

1. The transferred asset pool consists of receivables that are generated through the sales of goods, compensation for services, and other commercial transactions.
2. All receivables are scheduled to be repaid in lump sum on an agreed date or at its maturity; no installment payments.
3. Payment date or tenor of each receivable must fall within 366 days from the date on which the relevant securitisation vehicle obtains the relevant exposures.

B. Structural risk

1. Credit enhancement mechanisms[3] should be structured and built into the issuance program or scheme ("the program"). In case a securitisation program adopts a senior-subordinate structure, the right to the underlying assets may be divided into tranches including portion that serves as credit enhancement. Tranches that do not provide credit enhancement, such as seller interest that is not senior or junior to any other tranche in terms of credit loss allocation, would be acceptable.
2. In case a program adopts a senior-subordinate structure, the cash waterfall rules should prohibit the redemption of the subordinate tranche in a way that would inadequately reduce credit enhancement for the senior tranche.

[3] Each sponsor bank adopts its own measures to address credit risk, depending on their business environment and client relationship. Hence, it will take some time to design the uniform criteria. In discussing the STC criteria for ABCP facilities, the different situations which sponsor banks face should be taken into account. SFJ received feedback from a sponsor bank on this point. In some cases, the originator provides credit enhancement by retaining the subordinated portion that is sized based on a stressed scenario on the underlying default risk, when the underlying assets are transferred. In addition, the originator continues to support the senior tranche through measures such as, but not limited to, 1) a limit on pool concentration and building additional credit enhancement when the limit is breached, 2) a dynamic reserve to increase subordination when the quality of the asset pool deteriorates, 3) a cancellation trigger and the discontinuation of purchases of new assets when the quality of the underlying pool deteriorates. Such credit enhancement may also be achieved through other measures such as overcollateralisation. The uniform criteria should be set forth so as to distinguish the well credit-enhanced facilities from other facilities. At the same time, the uniform criteria should be comprehensive enough to allow for various other measures deemed appropriate.