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Securitization Forum of Japan

Hatsumeikaikan 3F 2-9-14 Toranomon,minato-ku,
Tokyo 105-0001 Japan
TEL: +81-3-3580-1156 FAX: +81-3-3580-1157
E-mail: info@sfj.gr.jp URL: http://www.sfj.gr.jp/e/

2 August 2012

Comments on Global Developments in Securitization Regulation

Securitization Forum of Japan

I. Introduction

A. The Securitization Forum of Japan welcomes IOSCO's initiative and appreciates the opportunity to comment on the Global Developments in Securitization Regulation ("the Consultation Report").

B. Our comments on the Consultation Report are based on our members' current understanding, as well as the existing regulations and practices in Japan. We would like to present our comments regarding the proposals in the Consultation Report, mainly from the perspective of the applicability and adaptability in Japan.

C. A number of jurisdictions have developed certain measures to address various issues, including, but not limited to, alignment of incentive issues and disclosure requirements and practices in relation to securitization transactions. As to disclosure practices, a number of regulations, voluntary regulations and market practices are already in place in Japan. For example, the Financial Instruments and Exchange Act (Act No. 25 of 1948, "FIEA") provides disclosure procedures to further investor protection. The capital adequacy or solvency regulations for banks, insurance companies and financial instruments business operators (i.e., securities

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firms) provide requirements on collection of specific information relating to securitization exposures or securitized products, which are based on the Basel Committee's so-called "Basel 2.5" requirements on the use of credit ratings on securitization exposures. In addition, the Japan Securities Dealers Association has promulgated voluntary regulations for disclosure and dissemination of certain information on securitized products. The JSDA has developed reporting packages consisting of certain lists of information items called the "SIRP".[1]

II. Comments on the proposal regarding Issue One: risk retention requirements (p. 26)

A. The Consultation Report describes the significant differences in the approaches to regulation between the European Union and the U.S.A. with regard to risk retention requirements, and poses certain issues arising from the incompatibility of risk retention regulations in the EU and the U.S.A., such as cost implications and impediment of cross border issuance.

Although we understand, to some extent, the above-mentioned finding, we have no strong concerns over the regulatory differences at this stage. This is mainly due to the fact that, few, if any, securitization products originated in Japan are sold to European or U.S. investors.

We believe that, essentially, each nation has a right to implement supervisory frameworks solely at their discretion. Such discretion enables regulators in each nation to exercise proper supervision based on the country's specific circumstances in terms of market size and investor profile. Therefore, we think these differences should be well respected in each nation because of their inherently different market circumstances.

The concern about costly negative impacts originating from the differences to cross border issuances of securitized products is a fair point. But, since we can understand that despite the regulatory differences between the U.S.A. and EU, such

[1] In 2008, major market participants in Japan discussed the data integrity in Japan's securitization market and established the Standardized Information Reporting Package ("SIRP") to be used for industry-level self-imposed regulation.

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differences in the approaches share the same purpose, i.e., to keep sponsors or originators prudent, also it would be difficult to arrive at an operationally effective worldwide guideline on cross border issuances, which fully maintains compatibility with local requirement.

B. The risk retention requirement has been discussed since the September 2009 Pittsburgh Summit when global leaders stated that securitization sponsors or originators should retain a part of the risk of the underlying asset. The main purpose of this idea was to encourage these sponsors or originators to act prudently, by aligning their incentives with the investors'. Some of the market participants in Japan then showed some understanding to the idea from the viewpoint of investor protection. But today, several other measures, including better disclosure practices, have been discussed by market participants as a means to achieve the same purpose. The risk retention requirement is by no means a panacea to the issues relating to the securitization food chain, such as poor mortgage underwriting standards and CDOs originated from correlation desks of major financial institutions that the relevant sentences in the September 2009 Pittsburgh Summit Leaders' Statement were meant to address. Our current understanding is that encouraging disclosure (including those relating to risk retention by related parties) may be another effective approach by which these sponsors or originators would be encouraged to act prudently. It may be an alternative to disclose the retention status undertaken by the sponsors or originators, so that investors can easily distinguish those transactions whereby no or limited risk retention is made or committed by related parties thereby assisting their risk recognition.

C. In any event, based on our recent discussions among regulators and market participants, we believe that relying solely on the retention requirement to address incentive issues is not effective. Uniform retention requirement may cause more harm or unintended consequences (such as effectively prohibiting certain securitization transactions that should socially be justified) than benefit. In our view, it is more appropriate to provide a policy package that suits the actual situation of each jurisdiction to enhance prudence on the part of sponsors or originators; a package consisting of guidelines on disclosure, data availability, documentation

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especially regarding representations and warranties, and investors' due diligence. Even if the risk retention requirement regulations are to be introduced into jurisdictions other than the EU and the U.S.A., they should be carefully designed so that they do not obstruct justifiable transactions.

D. Another technical question will arise when we discuss the reasonable amount to be retained under this rule. There are so many classes of underlying assets, which are used as collateral for securitization, ranging from prime auto loan receivables to highly-volatile assets. It may, therefore, be difficult to set a uniform ratio, say 5%, for retention. In addition, based on the fact that credit structures adopted to address the default risk of certain asset classes often vary, setting a specific retention ratio for specific asset classes would often lack economic rationale. Regulators would have to stipulate many exemptions under such a standardized system, which then would reduce accountability to the rule. To avoid this obstacle to application, even if we introduce a global standard for the retention requirement, such a standard should only be regarded as a guideline on retention policy, leaving detailed treatment to the local regulators' discretion, as well as allowing local regulators to provide rational alternatives to the requirement.

E. When we experienced workouts of certain non-performing and sub-performing loan assets of Japanese banks back in late-1990s and early-2000s, securitization was effectively utilized as a cleanup tool for such assets by Japanese banks. In this case, certain distressed assets were disposed of through securitization techniques, utilizing senior/subordinate structure. We believe such use of securitization techniques are well justified, as the investor base for the "low-risk low-return", highly creditworthy instruments (such as senior tranches in securitized products) and that for opportunistic instruments (such as equity or deeply subordinated positions in securitization transactions) are clearly different.

We would like to also point out that, in 1989, securitization techniques (by creating senior and subordinated tranches backed by a pool of assets) were used in the disposal of certain properties by the Japan National Railways Settlement Corporation (a liquidation company set up in 1987 to take over the Japan National Railways' debt and assets, which was liquidated in 1998). Such use of securitization techniques,

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without any risk retention by the originators, should also be well justified, in our view. Without utilizing securitization techniques, such disposal of all assets upon liquidation might have been substantially more difficult. We are afraid that if the retention requirement were to be introduced without flexibility, it would in effect prohibit such sound use of asset securitization.

This concern is also true for the exit strategy, in which a corporation sells out its business assets in order to get out of the business. In the early-2000s, we witnessed several transactions by Japanese life insurance companies securitizing substantial portion of their consumer and home mortgage assets. In such transaction, the originators (life insurance companies) had already ceased their consumer finance business, and senior tranches in such securitized products were sold to banks while equity tranches were typically sold to non-bank finance companies. Based on such experiences in Japan, we believe that securitization will be, again, an invaluable tool in the event of another financial crisis stemming from budget squeezes in European nations, for example, a tool for securitization of government-owned properties.

F. In order for this tool to be effective in the above-mentioned situations, retention requirements should be carefully designed and flexible in application. On this point, voluntary self-imposed regulation requiring disclosure of certain information relating to risk retention will be an alternative.

G. In summary, we believe that in the current environment, risk retention may not be the most practical approach to address the incentive alignment issues, and further discussion should be made about the reasonability of the requirement.

III. Comments on the proposal regarding Issue Two: stress testing and scenario analysis (p. 27)

A. The Report states that IOSCO will provide disclosure guidance for issuers about stress testing and scenario analysis of pooled assets.

B. Stress testing and scenario analysis may provide key information for investment decisions. But, we are afraid that the manner in which this information should be provided by issuers will introduce some problematic concerns, besides conflict of

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interest. The concern revolves around the technicality of such information. For example, stress testing should be performed under the clear rules of definition and assumption, this seems unrealistic because listing comprehensive scenarios to meet every investor's concern is not easily realized. Another concern is that the burden for the issuer will lead them to refrain from securitizing their assets and adopt a fund-raising tool other than securitization.

C. At present, stress testing and scenario analysis are usually exercised and disclosed by credit rating agencies (CRAs) in Japan, in accordance with the CRA regulations that are already in place in Japan. For example in Japan, the FIEA and the Cabinet Office Ordinance for Disclosure of Specific Securities (Regulation No. 22 of 1993, a lower-level regulation from FIEA, "Ordinance") set forth the detailed rules for these disclosures, which now function well and are broadly accepted in the market with confidence. In some cases, the CRAs are also prepared to provide investors with an additional dataset to examine the credit of the underlying pool. It used to be pointed out that investors heavily relied on CRAs' credit analysis. But, it is not the case that, at least in the Japanese securitization market; information provided by CRAs is effectively used among investors. Considering the fact that recent CRAs provide information to meet investors' individual needs, it is safe to keep the proposal an unbinding minimum guideline, leaving discretion of treatment to regulators, CRAs and investors.

D. Based on the fact that we could have many varieties in structuring products, it is too onerous to ask issuers to present all reasonable kinds of results about stress testing and scenario analyses. By leaving this area to well-trained professional analysis from CRAs and adequate CRA supervisory practice from regulators, not only investors, but also issuers will benefit from the best possible arrangement. We are also afraid that this kind of disclosure about stress testing and scenario analyses, if provided by unauthorized entities other than CRAs, would result in contention between issuers and the providing entities, because such information will portray a negative image to investors, resulting in serious controversy in some instances.

E. At the same time, it is reasonable to set forth a rule that issuers should provide investors with adequate information, such as features of underlying assets, key

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historical performances, and screening/selection criteria of the pooled assets, so that investors can attempt to review the creditworthiness of the securitized products in accordance with their preferences and immediate interests.

IV. Comments on the proposal regarding Issue Three: standardization of disclosure (p. 27)

A. The Report states that IOSCO encourages the development of best practice templates, as well as considered developing principles to support harmonization required to compile such templates.

B. Standardization is usually discussed in the context that world-wide standardization will ensure a level playing field, avoiding market fragmentation, protectionism and regulatory arbitrage. But, as we mentioned before, regulatory discretion in each nation should be given priority and respected, so that national authorities can set forth effective regulations based on the actual circumstances in their jurisdictions. We have learned through the market that manners and forms of standardization, as well as required datasets differ according to asset class, structure, business practice, and market maturity.

C. Our recommendation here is that instead of introducing standardization with regard to disclosure, monitoring and coordination of different regulations applied in different nations is the most effective approach. Given the interrelation of global capital markets, we understand harmonization of disclosure principles is relevant for both investor protection and comparability among markets. Although standardization of the reporting format may be a desirable approach to the harmonization, based on the fact that each market in different jurisdiction differs in market features and local regulations, recommending a practice to put guidelines on disclosure items instead of standardization may be more effective. In addition, a guideline in terms of not only numeric but also literal information may be helpful because investors often need information on qualitative aspects of the underlying pool beyond quantitative datasets.

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D. In Japan, there are already several related regulations with regard to disclosure principles, some of which are summarized in the IOSCO Subprime Report.[2] These principles include the above-mentioned FIEA and Ordinance and the FSA's (The Financial Services Agency) Guidelines for Financial Instruments Business Supervision.

E. In addition, there is voluntary self-imposed regulation relating to disclosure and dissemination of certain information relating to securitized products (including, using the Standardized Information Reporting Package, or SIRP, when appropriate) in Japan, which was promulgated by the Japan Securities Dealers Association. It has been effective and in use since June 2009.[3] The SIRP was originally intended to ensure the traceability of securitized products, by which investors could evaluate the credit risk of the products using sufficient and up-to-date information of the underlying asset in a timely manner. The SIRP has been widely recognized and used as a reference guide for disclosure items in Japan.

F. In summary, with regard to disclosure requirements, we would like to stress that adequate formulations of rules should be based on the individual circumstances of each jurisdiction in terms of the market and investors involved. Merely introducing internationally standardized templates would lack the necessary case-by-case flexibility, and might place unnecessary burdens on transaction participants, leading to market stagnation. As an illustrative example, FIEA would not apply strict disclosure requirements to transactions whose investor base is limited to professional investors. We can point out that FIEA is reasonable flexibility in this respect, benefitting market efficiency.

G. There is also the possibility that investors would excessively rely on information, resulting in a distortion of their investment decision. Therefore, it is worth considering placing disclosure at the discretion of the sponsor in such a way that investors can easily solicit more detailed information or supplementary materials,

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[2] The *Final Report of the Task Force on the Subprime Crisis*, dated May 2008 ("the Subprime Report"), Appendix A, p. vii.

[3] The SIRP has recently been revised and restated to ensure better cross reference between the SIRP and the Ordinance. The new versions of the SIRP have been in use since 1 April 2012.

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depending on their individual needs. Such guidelines will be effectively utilized in disclosure practices in each jurisdiction.

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