15 June 2009

Comment on the IOSCO Consultation Report on Unregulated Financial Markets and Products

Securitization Forum of Japan

I. General Comments

A. The Securitization industry in Japan welcomes this IOSCO initiative and appreciates the opportunity being provided for comment in the consultation process.

B. Since we are very concerned about the issues regarding the securitization market, our comments here relate mainly to the securitization issues proposed in chapters 1 to 4 of the IOSCO Consultation Report on Unregulated Financial Markets and Products ("the TFUMP Report".) And since we basically agree with the observations, recognitions and opinions stated in the TFUMP Report, we would like to comment mainly on the TC interim recommendations (i.e., TC interim recommendations #1 to #3.)

C. In Japan, the Securities and Exchange Act (Act No. 25 of 1948) was totally revised and renamed the Financial Instruments and Exchange Act ("FIEA"), and was promulgated in September 2007. Now that most Japanese financial transactions, including securitized products, are regulated under the FIEA, we would like to comment on the TFUMP Report from primarily a FIEA viewpoint.

II. Comments on TC interim recommendation #1

A. We agree with the observation stated in this section. In particular, since we strongly recognize that securitization will play an important part in credit availability in the real economy, adequate regulation as well as industry initiatives will be essential.

B. Item 1. of TC interim recommendation #1 considers requiring originators and/or sponsors to retain a long-term (until the termination date of the structured products) economic exposure to the securitization. We agree with this recommendation. Another opinion would be for the adequacy of the structured products to be attained by reflecting the originators' creditworthiness on the products' credit. But this would usually involve difficulty in determining to what extent we should reflect the originators' creditworthiness in order to realize adequacy equivalent to requiring them to retain economic exposure. By simply

requiring originators to retain economic exposure to the securitization, we could safely eliminate moral hazard on the part of originators as well as attain adequacy of the products.

C. Item 2. of TC interim recommendation #1 stresses the integrity of the disclosure of all checks, assessments and duties that have been performed, or risk practices that have been undertaken, by the underwriter, sponsor, and/or originator. We basically agree to this idea. However, we need to keep in mind who should be liable for the cost in the market. Such cost problem will also be a factor in item 4. of TC interim recommendation #1. If we place the burden of considerable cost always on the originator, the originator will eventually adopt a fund-raising tool other than securitization to avoid such cost. This situation tends to become more obvious where alternative fund-raising tools are available. If originators could easily access such alternatives with relatively moderate disclosure requirements, it is likely they would use them instead of securitized products. Therefore, cost allocation in the securitization market regarding disclosure is an important matter.

D. It should also be noted that all types of securitized products, including products in the form of Asset Backed Loans (ABL), which are often used in Japanese securitization, should be regulated in accordance with the individual features of the products and investors. In this context, we believe that the regulation would consist mainly of three forms: (a) regulation by authorities, (b) self-regulation by industry organizations and (c) exemption or no regulation at all (leaving regulation to market practices). In terms of "regulatory responses" stated in the TFUMP Report, we should consider what form of regulation should apply and to what extent. For example, in cases where the transaction is to be issued on a private placement basis, or where investors of the transaction are all sophisticated institutional professionals, disclosure regulation by authorities would seem to be too rigid; self-regulation or no regulation at all would be more suitable. This is partly because it is reasonable to require such investors to take responsibility for attaining information relevant to investment decisions. Mere rigid and standardized regulation by authorities, and its uniform application to all types of securitized products, would lack the necessary case-by-case flexibility and could serve individual cases inadequately, leading to market stagnation.

E. In addition, there may be some cases where it is appropriate to require not the issuer but the originator to disclose the detailed performance information about the underlying asset, including the default rate and the result of ongoing due diligence. From this point, FIEA has flexibility in identifying who is liable for disclosing the information.

III. Comments on TC interim recommendation #2

A. We basically agree with recommendation #2. With regard to disclosure, however, we have concerns as to the relationship between disclosure and price mechanism efficacy in the market. Originators with well disclosed information typically expect that they can raise money at lower cost (i.e., low interest or spread) than

they do with little disclosure. However, the reality of the market often shows that investors and other market participants pay attention only to the negative factors of the disclosed information (e.g., high default rate of the underlying asset) and disregard the existence of credit enhancement appropriately addressed in the securitized transaction according to such negative factors.

B. We recognize that investors and other market participants should use such disclosed information wisely so that they can avoid misunderstanding the creditworthiness of the securitized product. We therefore think that it is important that in the course of the development of disclosure we should promote among market participants how they can interpret and utilize the disclosed information in their investment decision.

C. We should also clarify the meaning and scope of the term "disclosure" because the term may have two meanings; (a) disclosure to the public and (b) disclosure only to prospective investors of certain transactions. In Japan, most securitized products have been sold on a private placement basis to buy-and-hold investors. In such cases, we believe disclosure only to investors of securitized products (i.e., (b) above) is sufficient. In this regard, FIEA has flexibility in requiring originators to disclose relevant information. Excessive regulation to disclose to the public, even in such cases, would be an unnecessary requirement.

IV. Comments on TC interim recommendation #3

A. We totally agree with the opinions and recommendations stated in this section. At present, we understand that FIEA comprehensively covers and regulates securitization and thus there may be no unregulated areas in terms of securitized products, except for ABL. In terms of disclosure as to an ABL transaction which, as mentioned before, is often used in Japanese securitization, we have a consensus that self-regulation by an industry organization is more suitable than regulation by the authorities. This is not only because it is difficult to distinguish the ABL to be regulated under FIEA from that needless to be regulated, but also because we have found it unnecessary to apply rigid regulation by the authorities to ABL, which are typically sold solely to buy-and-hold investors on a private placement basis. Such treatment also ensures consistency with conventional rules applied to ordinary corporations attempting to raise money on a private placement basis. Anyway, when we introduce and operate market rules, we should always take into consideration their adequacy and suitability based on the individual features of the securitized products and investors.

B. Another issue lies in the scarcity of public issuance in the Japanese market. In Japan, issuers typically issue bonds/beneficial interests on a private placement basis; public issuance is small in volume. In this case, issuers distribute bonds/beneficial interests to these limited, mostly not more than 10, regular investors. FIEA requires a less strict disclosure level in a private placement with limited investors. In general, if we enforce strict disclosure in the securitization market, even though there are a small number of public offerings, originators

would tend to seek alternatives other than securitization so that they could easily raise money with less disclosure. As such, jurisdictions should examine, prior to implementation, the suitability and advantages of regulation by the authorities compared to self-regulation or no regulation at all. And, after the examination, in case jurisdictions decide to implement regulation by authorities, they should determine the scope and exemptions of regulatory requirements for the disclosure in accordance with their respective individual market features.

C. Another consideration we face in the Japanese securitization market is that too strict or conservative regulation would lead to a freeze and decline in the market activity of securitized products. In cases where investors allocate only a small portion of their funds to securitized products, and the rest of their funds are invested in conventional products, such as government bonds or municipal bonds, outsourcing of the credit analysis of securitized products to CRAs (Credit Rating Agencies) is reasonable provided that CRAs play a role as a reliable gatekeeper. As such, a case-by-case approach is necessary when we discuss the degree of reliance on third party valuations.

D. With regard to disclosure requirements, again we would like to stress that adequate rule-making based on the individual features of the securitized products and investors is essential. Mere rigid and standardized regulation by the authorities would lack necessary case-by-case flexibility and might deal with individual cases inadequately, leading to market stagnation. There are considerable areas where self-regulation by industry organizations or exemptions/no regulation at all allow the market to function in the most optimal way.

E. In summary, too strict, broad and open-ended regulation has substantive adverse side-effects which may lead to:

1. originators adopting fund raising tools other than securitization to avoid excessive disclosure requirement;
2. investors refraining from investing in securitized products in anticipation that such investment would violate the regulations; and
3. arrangers decreasing the volume of arrangement of securitized products due to the heavy burden of disclosure.

All these side-effects would lead to a market freeze.

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