SFJ

Securitization Forum of Japan

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27 March 2015

Comments on the Revisions to the Standardised Approach for credit risk

Securitization Forum of Japan

I. Introduction

A. The Securitization Forum of Japan[1] (SFJ) welcomes the opportunity to comment on the proposals submitted by the Basel Committee on Banking Supervision (BCBS) for the "Revisions to the standardised approach for credit risk" (the "Consultative Document").

B. Market participants in Japan have certain concern about some aspects of the proposed revisions as described in the Consultative Document. This is in part because the vast majority of Japanese regional banks, who are active investors in securitized products and at the same time once were active originators of securitisation transactions, adopt the standardised approach. Based upon discussion with our members, we would like to take this opportunity to provide some comments from a practical viewpoint of the securitisation market participants in Japan.

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

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II. Responses to Specific Questions

Question 8: Do responders agree that introducing the specialized lending category enhances the risk sensitivity of the standardised approach and its alignment with IRB?

1. The risk weights for specialised lending of 120% (for exposures classified as project finance, object finance, commodities finance, and income-producing real estate exposures) or 150% (for exposures classified as land acquisition, development and construction exposures) are relatively higher than what is now applicable under the current standardised approach to non-recourse loans backed by real estate. As the specialised lending (SL) currently exits under the IRB approach of credit risk, the SA banks currently treat such exposures as securitisation exposures in accordance with guidance by the Financial Services Agency, the Government of Japan.

2. For example, the current standardised approach allows for a much lower risk weight at the level of 20% according to external ratings relevant to non-recourse loans when treated as securitisation exposures. The proposed risk weights will bring about difficulties in the origination of non-recourse loans for income-producing real estate transactions that would then dampen CMBS transactions since CMBS are structured using these non-recourse loans as typical underlying assets.

3. Although the results of quantitative impact studies on these exposures under the revised risk weights should be considered, we recognize that existing risk-weighting when treated as securitisation exposures, thus, using the External Ratings-Based Approach (credit ratings provided by ECAIs) as a basis of determining the applicable risk weights, under the current standardised approach is relevant enough to address the risks associated with such specialised lending exposures.

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Question 10: Do responders agree that LTV and/or DSC ratio (as defined in Annex 1 paragraph 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on residential real estate?

1. The debt service coverage (DSC) ratio proposed in paragraph 41 is proposed as based on after-tax income. We would like to note that the mortgage lenders in Japan, including banks, have long used before-tax income of applicants as a basis of credit underwriting of residential mortgages. It is of general practice in Japan that mortgage lenders obtain copies of applicants' tax withholding statements or tax returns, thus verifying the applicants' before-tax income for the most recent year. Considering its usefulness in assessing the capacity of debt service by housing loan borrowers, we would like to propose that DSC ratios based on borrowers' before-tax income should also be used in the revised approach. In this case, the threshold for the before-tax DSC ratio should be calibrated on a before-tax base accordingly. The background of this comment is as follows.

2. The residential mortgage market in Japan has been relatively stable for many years. This is in part because mortgage lenders, including banks, have conducted proper credit screening of individual borrowers in terms of their debt service capacity. Here, we understand that there are two main factors that affect mortgage credit: one is the collateral value, and the other is the debt service capacity (ability to pay) of the borrowers. Given that we can expect certain recovery from defaulted mortgage loans, valuation of mortgaged property is one of the key factors for the eventual collectability of mortgage loans.

3. On the other hand, we believe that the borrowers' stable ability to make monthly payments is another crucial factor for sound credit. Put differently, borrowers' monthly payments that are well-matched with their ordinary stream of income enables lenders to enjoy stable cash collection from the mortgages, thereby eliminating the possibility of burdensome foreclosure. Therefore, in jurisdictions where employment income is generally not volatile and can be predictable, financial institutions usually determine credit limits by paying attention to the before-tax DSC ratio ahead of LTV. In addition, provided that employment income and effective taxation rate are generally predictable, the DSC ratios based on borrowers' before-tax income (which can be easily verified by mortgage lenders, by obtaining the applicants' evidence of income), is as good a measure as the DSC ratio based on borrowers' after-tax

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income in evaluating borrowers' credit.

4. Tax considerations differ from jurisdiction to jurisdiction, so discretion as to how the DSC ratio is defined and how it is utilised should be left to local authorities so that they can implement rules practical enough to reflect existing market practices.

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ANNEX

Securitization Forum of Japan

The **Securitization Forum of Japan (SFJ)** was founded as a voluntary association in 2005 and was established as a corporation in 2007. The SFJ aims to contribute to the sound development of the asset securitization market and to carry out the following operations: (1) research and study associated with asset securitization; (2) exchanges and cooperation with internal and external organizations involved in asset securitization; (3) diffusion and enlightenment of asset securitization; (4) policy recommendations concerning asset securitization; and (5) any other operations incidental or relevant to the operations in the above items. The SFJ operates experts committees on a regular basis to discuss issues on securitization, 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 securitization such as the Basel III securitization framework. The SFJ also delivers a high-quality educational system to its members, providing opportunities to attend seminars on securitization or to attend professional development programs.
For further details, please see the SFJ's website: http://www.sfj.gr.jp/e/index.html.