SFJ

Securitization Forum of Japan

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Comments on Supervisory Framework for Measuring and Controlling Large Exposures

Securitization Forum of Japan

I. Introduction

A. The Securitization Forum of Japan welcomes the Basel Committee's initiative and appreciates the opportunity to comment on the proposed revisions to the Basel Securitization Framework ("the Consultative Document").

B. We would like to present our comments regarding the proposals in the Consultative Document, mainly from the perspective of applicability and adaptability in the Japanese securitization market and practice.

C. Our main point is that, although this regulation is for measuring maximum possible losses, solely focusing on concentration regardless of the creditworthiness of the exposure, it is necessary to set forth exemption rules so that investors or originators can avoid unnecessary workload in origination or ongoing monitoring. We are strongly concerned that this regulation without such exemption rules would reduce the efficiency and advantage of securitization as a fundraising tool, resulting in increased pressure on economic activity for users.

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II. Comments on the rules applicable to securitization and collective investment underwriting

A. After the financial crisis, there have been many regulations focusing on securitization that have already been implemented or are under discussion in the BCBS and other international organizations. These regulations include rules pertaining to credit enhancement of structured products. Typically, the amount of credit enhancement is calculated to address the concentration risk or large spikes that result from low granularity. Considering this credit enhancement is built into structured products, we think measuring large exposure is not always required in securitization.

B. If this rule should include securitization for large exposure, a reasonable exemption should be provided. Such exemption should be made available for high quality tranches that have sufficient credit buffers for concentration risks as well as for pools that consist of unknown obligors but have adequate representation and warranty clauses in the relevant contracts. Securitized products with such reasonable credit buffer or representations and warranties have already addressed the possible losses from large exposures and thus should enjoy the above-mentioned exemption or more moderate thresholds.

C. Recent accounting principles require that the originator of a structured finance transaction consolidate the finance vehicle. For measuring large exposures, however, the amount of exposure to the vehicle should not be added to the exposure to the originator regardless of such accounting treatment. Bankruptcy-remoteness is usually attained through several arrangements, such as: (i) charitable trusts through which the voting rights of shareholders of vehicles are firmly closed up, (ii) independent directors who have no relationships with the originators, and (iii) true-sale structures that distinguish the schemes from other secured financings of the originators and thus enable the schemes to avoid being subject to bankruptcy procedures filed against the originators. Properly established bankruptcy-remote vehicles have no control relationship and no economic interdependence with the originators and hence there is no need to include the exposure to be added to the originator in this context.

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III. Principle of materiality

A. It is recommendable to take into account the principle of materiality when applying this regulation to structured products and collective investment underlyings (CIUs). Accordingly, it is appropriate to apply this regulation only when the amount of the exposure exceeds 1% (or other practical threshold from the viewpoint of applicable institutions) of Tier 1 or Common Equity Tier 1 (CET1), taking into account the principle of materiality. Solely focusing on substantial exposure in terms of CET1 would not only make this regulation relevant, but would also significantly reduce the amount of operational burden on the part of applicable institutions.

B. In addition, the threshold of the underlying asset pool concentration should conform to other existing thresholds applicable in each jurisdiction (e.g., the threshold for existing top-down approaches). Alternatively, another treatment should be acceptable that requires such measuring only at the time of origination or investment. In such cases, the on-going aggregation procedure could be substituted by, for example, additional disclosure or, if applicable, a series of stress tests focused on large exposure concentration. In this regard, regulators should have discretion as to the applicable threshold in each jurisdiction; for example, focusing on up to ten (10) underlying exposures, each of which exceeds the specified threshold and also has relatively weak credit in terms of internal or external ratings.

C. It is also recommendable to differentiate the threshold according to asset types or areas the assets originated from. Another practical example is to measure large exposure based on the amount of the top three (3) concentrations in the underlying pool. In this case, for example, if the aggregate amount of the top three (3) concentrations exceeds a certain specified threshold, such as 9% based on heuristics, only then should the exposure be measured. The financial authority in each jurisdiction should have discretion as to which specified threshold to apply in their local market.

D. With regard to securitized products, any tranches (excluding first-loss subordinated ones) should be treated as a single exposure, provided that the maximum concentration ratio of the underlying pool does not exceed the rate of subordination

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of the product. In this case, the look-through approach (LTA) is not required. Alternatively, it may be worth consideration to set forth a threshold that draws the applicable scope of this rule to carve out securitized products with sufficient credit buffer in the first place.

IV. Application of the LTA

A. First of all, it is technically difficult to apply the LTA to typical securitization transactions. Since we have a basic understanding that we can realize relatively stable credit performance through granularity within the underlying asset pool, we usually have no information on each obligor in the pool. In addition, credit enhancement is provided in structures that not only cover the normal credit deterioration of pools but also address large default spikes from concentration. As aforementioned, the LTA should not be required for tranches other than first-loss tranches when the maximum concentration ratio of the underlying pool does not exceed the rate of subordination of the product. Alternatively, it may be worth consideration to set forth a threshold that draws the applicable scope of this rule to carve out these securitized transaction with sufficient credit buffer in the first place.

B. It is an excessive restriction to apply the LTA to all underlying assets if exposure of one of the obligors exceeds the threshold of 1%. It is appropriate instead to apply the LTA only to underlying assets that exceed the threshold of 1%.

C. Combining all unknown exposures to regard them as one single exposure (“the unknown client” in paragraph 111 of the Consultative Document) is not useful. Instead of this approach, 5% of such aggregate amount of unknown exposures is sufficient, provided that there is an adequate name-based aggregation procedure for structuring and there is no inappropriate situation that violates the relevant representation and warranty clauses. In well-organized structures with adequate name-based aggregation procedures and representations and warranties clauses, investors can rely on information provided from the originators and conduct, where necessary, on-going stress testing focused on concentration risk.

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D. There is a major barrier to personal information protection law with regard to disclosure of information necessary to identify each obligor in the underlying asset pool. Aside from this barrier, we still face the difficult problem of how to conduct name-based aggregation based on actual capital ties among obligors. Investors cannot always easily obtain reliable data in this regard from originators. To avoid this inexpedience and attain a level playing field among jurisdictions, this rule should include interim treatment to address this point in each jurisdiction.

E. If the above-mentioned barrier to personal information protection law is too high for investors to gather sufficient information required for name-based aggregation, another kind of rule in substitution for aggregation should be acceptable. For example, in cases where it is difficult to gather information for name-based aggregation, the investors should be permitted to depend on reasonable representation and warranty clauses that are set forth in relevant documentation.

F. Another solution could be a treatment that requires such name-based aggregation only at the time of origination or investment. In such cases, the on-going aggregation procedure could be substituted by, for example, additional disclosure or, if applicable, a series of stress tests focused on large exposure concentration.

G. In summary, to keep the LTA reasonable and viable, it is necessary to reorganize the disclosure system and its principles so that investors can attain well organized datasets as to obligors' credit attributes that are sufficient enough to conduct name-based aggregation based on capital chains among obligors. Each regulator should have discretion as to which technical rules to apply in their jurisdiction, taking into account the market situation and practices with respect to disclosure.

V. Deemed exposure to related counterparties such as fund managers or originators

A. In deciding whether the exposure to related counterparties of a finance scheme, such as fund managers, originators, swap counterparties or liquidity providers, should be measured or not in the context of this regulation, we should consider the possible

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magnitude of the loss from the exposure that will be realized on the event of default on the part of these counterparties. This is because the main purpose of this regulation is to recognize the credit loss resulting from the event of default on the part of counterparties.

B. To illustrate this, if the servicer of the underlying asset pool were to default, and thus collection from the underlying assets at the time of the default were to be rendered impossible (the "commingling loss amount"), we should count 100% of the lost amount as an exposure to be measured. However, if a credit buffer, such as subordination, is available to fully address the commingling loss amount, no amount of the impact should be counted as an exposure to be measured since the impact is already covered through the subordination; it is not so meaningful here to measure maximum possible losses.

C. In addition, in typical structured products, there are various kinds of clauses that address and mitigate the credit risk of the counterparties involved in the products. For example, servicer replacement clauses are set forth to address possible credit loss resulting from the servicer's default. This clause enables backup servicers to step in and continue collection after the default of the initial servicer. Another example is the collateral clause in swap transactions by which the credit risk of the counterparties to the swap is covered. If these credit mitigations would not be considered at all, the maximum possible losses would be too large, which is unnecessarily conservative.

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