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Comment on the IOSCO Consultation Report on Transparency of Structured Finance Products

Securitization Forum of Japan

I. Introduction

A. The Securitization industry in Japan welcomes this IOSCO initiative and appreciates the opportunity being provided for comment in the consultation process as to the post-trade transparency of structured finance products ("SFPs").

B. Our comments on the IOSCO Consultation Report on Transparency of Structured Finance Products ("the Report") are based on the characteristics of the market and its participants' trading practices in Japan's securitization market. Although we basically agree with the purposes and the proposed approach stated in the Report, we would like to point out our comments and concerns mainly focusing on the adaptability of the post-trade transparency regime in the Japanese market.

C. Whilst we recognize that the objectives this time do not include an initiative aimed at bringing about the transparency of underlying assets, which was already examined in the consultative report entitled *Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities* in June 2009 ("ABS Disclosure Principles")[1], we would like to mention some related topics on the initiative based on our practical concern about the objectives.

II. General Comments

A. As the Report points out in p. 9, some investors are reluctant to sell into the secondary market because they have already spent substantial resources on performing due diligence. And on the part of secondary purchasers, they are reluctant to buy the instruments due to the heavy burden of due diligence to be committed. From this point, we hope that effective post-trade transparency could reduce the cost and resource for due diligence on both sides and enhance the tradability of SFPs.

[1] For SFJ's comment on the ABS Disclosure Principles, please see "Comment on the IOSCO Consultation Report on the Disclosure Principles for Public Offerings and Listings of Asset-Backed Securities," 10 August 2009, available at http://www.sfj.gr.jp/opinion/data/public/090811.pdf.

B. We acknowledge that a post-trade transparency regime for SFPs is meaningful. But in order to make the regime serve as an effective information tool in the Japanese securitization process, we should first consider the unique nature of the Japanese SFP market such as the following: (1) its relatively small investor base, (2) its prevailing buy-and-hold investment strategy, and (3) the issuance primarily on a private placement basis. Without considering these factors, transparency in terms of price may not necessarily enhance the efficiency of the market.

C. Up to now, there has been no mandatory post-trade transparency regime in the Japanese market; and we have no efficient system in operation for collecting and disseminating trade information even in the sector of corporate bonds and other debt instrument market. We would implement such a regime from scratch, which may mean that market participants incur substantial cost.

D. Prior to the implementation, therefore, we would have to evaluate the benefit brought by the regime and examine whether the benefit well meet cost performance. In this regard, however, market participants of both the buy-side and sell-side are now skeptical about the regime due in particular to the unique feature of SFPs. This will be true even if we introduce a small prototype as a preliminary trial under the *phased-in* approach mentioned in the Report (p. 2).

E. As is the case with other jurisdictions, the buy-and-hold strategy is a common investment style in the Japanese securitization market. This means that most investors try to refer to SFP price provided that it has a reasonable basis supported by relevant information of underlying asset and other deal-specific conditions. Therefore, it may be difficult to provide persuasive reasoning to disclose the pricing information in the context of post-trade transparency whereas ABS Disclosure Principles remain insufficiently treated. In fact, investors could find information necessary to their decision making in some other way; they could estimate reasonable price from typically available market information such as average YTM (Yield to Maturity) of corporate bonds and other debt instruments whose credit is equivalent to the SFPs in which they intend to invest.

F. With information of underlying asset and other deal-specific conditions only provided on a limited basis, not only investors but also regulators could not judge the appropriateness of disclosed market prices, leading to the situation where these prices would never be referred to as fair prices. In this context, we suppose that, prior to the introduction of post-trade transparency, it is still prerequisite to establish a practice pursuant to ABS Disclosure Principles in Japan which comply with the Financial Instruments and Exchange Act (Act No. 25 of 1948, "FIEA") together with education programs aiming at enhancing the ability of investors to do fundamental analyses of SFPs. A post-trade transparency regime, if it inadequately discloses market prices, would distort investors' fundamental research in investing in the SFPs. In the long-run, this will reduce the investors' ability to analyze SFPs, leading to a decrease in prudent market players as well as the SFP market size.

G. Another basic concern pertains to the usability of the prices under post-trade transparency. In fact, investors rarely have an incentive or chance to substitute their portfolio in the course of the investment period. This is due in part to the fact that the market does not always provide investors with abundant securities suitable for substitution. In this case, investors do not necessarily need the market prices publicized in the market. In particular, they have little need for a price that is artificially derived from a model-based approach.

H. On the other hand, we should admit that investors always have a strong incentive to collect their invested proceeds in a full and timely manner, just as they do in other investment sectors. Therefore, it is true that existing low marketability and little availability of price information with regard to the SFPs is a hurdle for efficient secondary trade and substitution. Although we notice that investors enter the SFP market knowing that it has limited liquidity and post-trade information, we should continue to consider how we could develop the market in terms of post-trade transparency in accordance basically with the approach proposed in the Report (pp. 23-24).

III. Comments on 3.3 Existing pricing mechanisms (pp. 13-14)

A. Whether SFPs are publicly offered or offered via private placement depends upon the individual financing situation on the part of originators/sponsors. In general, SFPs in Japan are usually offered via private placement. This is because most of the SFPs arranged in Japan are usually used as an alternative fund-raising tool for bank loans. Just as bankers would lend money without disclosing any clientele information at all, originators/sponsors of SFPs tend to make up the financing scheme on a private placement basis.

B. From the viewpoint of pricing mentioned in the Report (pp. 13-14), the situation that SFPs are usually issued primarily on a private placement basis means that it is generally difficult to quote fair market price in a timely manner; thus, we would heavily depend on a theoretical model-based price with many assumptions under a mandatory post-trade transparency regime. We suppose that this dependence on model-based pricing would raise at least two serious problems. The first problem pertains to the questionable usability of the publicized prices as a benchmark when investors perform their mark-to-market. Secondly, model-based pricing would not be so reliable compared to prices based on actual trading conditions in the market. In other words, model-based pricing could not reflect both the real performance of the underlying asset and the substantial non-public information unrevealed in the market, failing to improve price discovery or reduce information asymmetries stated in the Report (p. 15).

C. Based on the observation above, we suppose that we should first examine what form of post-trade transparency should be considered to ensure the appropriateness of market price. At a minimum, we could say that, where investors to the transaction are all sophisticated institutional professionals, a mandatory post-trade transparency regime based on model-based prices would seem to be too mechanical. Although investors usually adopt a "buy-and-hold" strategy, they are not allowed to mechanically adopt the publicized model-based prices which indicate only a theoretical price. In this case, these professionals' self-responsibility instead of mandatory post-trade transparency would be more suitable. A mere rigid and standardized post-trade transparency regime by authorities, and its uniform application to all types of securitized products, would lack the accuracy required to mark-to-market on the part of investors, leading to market stagnation. In addition, over-reliance on model-based prices would bring about another problem just as we have experienced in the Subprime crisis.

D. A fair market price which reflects the real economic condition surrounding the respective transaction could only be useful as an adequate number for investors in determining whether they should trade out of the position and whether their invested SFPs are substantially overstated on their balance sheet.

IV. Comments on 4. Enhancing post-trade transparency (pp. 15-18)

A. As for potential drawbacks, we should consider the practical side of the post-trade transparency regime so that we could avoid overly rigid and expensive practices. In addition, it is essential to adapt the post-trade transparency regime to the Japanese market based not only on the consideration of the potential benefits and drawbacks as the Report points out, but also on the degree of investors' sophistication.

B. There may be alternatives which would be worth considering in the course of designing the post-trade transparency regime. Examples include YTM and some form of index which indicates the degree of disclosure level of each transaction in terms of data of underlying assets, relevant documentations, and periodic audit trails (p. 19). As mentioned before, the Japanese market has no mandatory disclosure system in operation. We support the idea that it is adequate to enhance the transparency of the underlying asset through ABS Disclosure Principles prior to mandatory post-trade transparency, which is mentioned in the Report (p. 18). This could safely avoid unnecessary implementation cost as well as inefficacy of the regime.

V. Comments on 5. Evaluating drawback and benefits (pp. 19-22)

A. We agree with the observation stated in the Report with regard to the cost efficiency of the post-trade transparency regime. In this context, however, we should keep in mind that it is not only the implementation and operational costs of the regime that should be considered; the financing cost on the part of originator/sponsor should also be considered (pp. 20-21). Under the post-trade transparency regime, originators or sponsors fairly expect that, thanks to the transparency, they could raise money at a lower cost than they can now. Unless a clear and reasonable effect in terms of financing costs is observed, market participants would feel such regime as being rather costly as well as ineffective to enhance market tradability and liquidity. We recommend adding financing costs on the part of originators/sponsors as the third category of potential costs suggested in the Report (p. 20).

B. With regard to the response from industry participants stated in the Report (p. 20), we strongly agree that transparency in terms of market price is important. On the other hand, however, investors seem to have a different viewpoint; they actually want to know not so much about the market price but rather sufficient information as to the transaction they intend to invest in which is in compliance with the FIEA. To be honest, we suppose that we need not artificially establish a mandatory post-trade transparency regime because sophisticated investors could specifically analyze the risk and find a fair price for the SFPs by themselves, provided that detailed information as to the transaction is adequately disclosed.

VI. Comments on 6. Proposed Approach (pp. 23-24)

A. As the Report mentions, it is recommended that each jurisdiction has discretion as to the time and manner for post-trade transparency. There may be cases in which some information other than prices would be rather meaningful information to stimulate secondary trades and improve accuracy of investors' mark-to-market. In particular, we totally agree that, in cases where the jurisdiction should introduce a post-trade transparency regime from scratch, a detailed survey should be required beforehand to decide the most cost-effective means to realize the purpose. This is true for both the prices indicated on a trade-by-trade basis and those on an aggregate trade basis (p. 23).

B. As has been mentioned before, the information derived from the model-based approach tends to be less realistic, often deviating upward from the actual fair market price. Such theoretical market prices could lead investors to misjudgment in their mark-to-market because the approach does not contribute to an efficient price discovery process. Since it could not reflect serious fraud and other wrongdoings relevant to the transaction, it would fail to implicitly provide any material adverse signal for the transaction. This means that investors feel that it is inconvenient to rely on that price as an adequate proxy for their investment decision and valuation. It is advisable that we recognize possible alternatives other than model-based prices; alternatives by which investors could better estimate the fair market price and perform valuation of their SFPs portfolio.

C. As the report on ABS Disclosure Principles proposed, it may be useful to disclose, instead of information derived from a model-based approach, statistical information such as the effect of prepayments on yield and weighted average life in order to better evaluate the market price of the SFPs.

VII. Concluding Remarks

A. With regard to post-trade transparency, we would like to stress again that, as the Report adequately mentions, rule-making based on the individual features of the SFPs and investors in each jurisdiction is essential. A mere rigid and standardized post-trade transparency regime by authorities would provide useless and inaccurate price information, only to result in placing unnecessary burdens on transaction participants, leading to market stagnation.

B. As the Report also points out, we should continue to examine cost-effective measures for the implementation of post-trade transparency. In jurisdictions with a relatively small market size, phasing in post-trade transparency in stages seems to be an acceptable approach. If the transaction volume were to increase considerably thanks to the approach, we could enter the next stage where we could derive market price based on an economically beneficial and statistically meaningful sample of actual quotes from diversified participants.

C. Without such due process of introducing a post-trade transparency regime, we are afraid that originators/sponsors would adopt fund-raising tools other than securitization to avoid any excessive burden for the regime, and investors would only make poor investment decisions due to the regime missing the point of the trading situation and the individual feature of the SFPs.

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