SFJ

Securitization Forum of Japan

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Comments on the Capital treatment for "simple, transparent and comparable" securitisations

Securitization Forum of Japan

I. Introduction

1. The Securitization Forum of Japan (SFJ) [1] welcomes the opportunity to comment on the proposals published by the Basel Committee on Banking Supervision (BCBS) in the Consultative Document *Capital treatment for "simple, transparent and comparable" securitisations*, dated November 2015. The members of SFJ include banks and other market participants such as non-bank finance companies, insurance companies and securities firms, as well as major law firms, accounting firms, and credit rating agencies. We provide our comments below, which are based on feedback received from member organisations.

II. General comments

1. The final regulatory framework on the capital requirement for securitisations issued by BCBS in November 2014 defined the three approaches (SEC-IRBA、SEC-ERBA and SEC-SA) to calculating capital requirements for "simple, transparent and comparable (STC)" securitisations.

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

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The hierarchy of approaches was also set forth in the final framework.

2. Of the three approaches mentioned above, the formulae under SEC-IRBA and SEC-SA tend to generate substantially higher capital requirement for securitisation tranches with relatively high attachment points compared to the formula used under the current Supervisory Formula Approach (originally introduced as part of the Basel II package). We understand that the aim of such modification is to ensure that tranches with relatively high attachment points attract a higher capital requirement in order to reduce the "cliff effect". As such, the framework takes a conservative approach to the treatment of tranches with relatively high attachment points. Also, we presume that the look-up table for SEC-ERBA is calibrated using cumulative default data reported by a US-based rating agency for the 25-year period between 1987~2011 or longer. This would include the period (2007~2010) during which US RMBS and CDOs performed poorly[2]. If such is the case, capital requirements under the SEC-ERBA would partially reflect the extremely poor performance reported by certain securitised products in the US during a specific period. Hence, we believe that the treatment of securitisation under the final framework of November 2014 is excessively conservative.

3. In addition, the final framework issued in 2014 introduced a risk weight floor of 15% for securitisation exposures. We understand that the floor aims to address model risk.

4. If our above understanding is reasonable, then the final framework issued in 2014 should already be biased towards a conservative (or relatively high) capital requirement for securitisation exposures.

5. We believe that BCBS should hold a discussion at some point in the future as to whether such conservativeness is appropriate or not. Moreover, such discussion should not be limited to securitisations that are eligible under the STC criteria. The regulatory capital framework should not treat securitisation favourably or unfavourably to exposures to the corporate and banking sectors. Overly conservative or optimistic capital requirements will detract from the meaning of a bank's regulatory capital ratio in its practical use.

[2] Basel Committee on Banking Supervision, *The Proposed Revised Ratings-Based Approach*, BCBS Working Paper No. 23, January 2013, http://www.bis.org/publ/bcbs_wp23.htm. See footnote 12 on page 9

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III. Response to specific questions

Question 1: Do responders agree with the rationale for introducing STC criteria into the capital framework? Are there any other aspects that the committee should consider before introducing STC criteria into the capital framework that are not already reflected in the rationale above?

1.1 We generally agree with BCBS's proposal.

1.2 We agree with the approach to applying a lighter (or less conservative) capital requirement than that calculated under the final framework issued in 2014 to securitisations that present less uncertainty in their analysis. However, we question whether the treatment should apply only to securitisations that comply with all of the 17 proposed STC criteria. It is also our impression that there are too many STC criteria and that they are too complicated. Furthermore, in light of the fact that legislative frameworks and business practices differ by country, the treatment of securitisations should be fair and balanced from an international standpoint. If the criteria are to be binding, then the main text should address general topics that are observed commonly across all countries and jurisdictions. We hence suggest keeping the criteria stipulated by BCBS at a minimum, and to allow for each regulator to establish detailed rules at its discretion.

1.3 We also believe that some exposures that fall under BCBS's definition of "resecuritisation" deserve to be treated as STC-eligible. For example in Japan, there are transactions which issue senior and subordinated tranches out of a single pool of multiple (10 or less) senior tranches of RMBS (each of which is backed by a single pool of residential loans). In other words, not all "resecuritisations" as defined by BCBS are securitised products known as "ABS CDO" or "CDO-squared". We therefore believe that the STC criteria should be expanded to include resecuritisations.

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Question 2: Do responders agree that, for the purpose of alternative capital treatment, additional criteria are required? What are respondents' views regarding the additional criteria presented in Annex 1?

2.1 We generally agree.

2.2 The language used in the STC criteria is abstract on the whole, and certain sections are rather vague. We therefore welcome the additional guidance provided to assist with the interpretation of the criteria. Having said that, BCBS should clarify that the criteria allows for flexible interpretation, in order to avoid "adverse effects" created by the additional guidance that could inhibit interpretation of the criteria based on actual transactions. In other words, additional guidance should primarily be intended to provide examples to address ambiguities in the main text of the criteria. Hence, we would like for BCBS to clarify that the additional guidance is not binding, unlike the main text.

Question 3: What are responders' views on the compliance mechanism and the supervision of compliance presented in this consultative document?

3.1 The BCBS proposes that "both the originator/sponsor and investor must assert that a securitisation/tranche is compliant with the STC criteria for regulatory capital purposes". In our view, BCBS should allow the regulator in each country to define "originator/sponsor" based on market practices. In Japan, the "originator" is usually an entity that simply transfers its assets to a securitisation vehicle (and in most cases, serves as the initial servicer). Therefore, in Japanese securitisations, the "originator" (excluding certain entities such as major banks) would typically lack the necessary expertise and information to assess a transaction's compliance with each of the STC criteria, including "Structural Risk" as prescribed in Section B of Annex I. On the other hand, financial institutions (banks, trusts banks, securities companies, etc.) that play a key role in the Japanese securitisations are known as the "arranger". The "arranger" is responsible for the structuring and marketing of securitisation

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transactions, and facilitates communication between the parties involved (including the "originator", credit rating agencies, law firms and/or auditors). Hence, it is the "arranger", and not the "originator", that has sufficient expertise and information to appropriately assess a transaction's compliance with the STC criteria. We believe that in Japan, the "arranger" should fall under the definition of "originator/sponsor" as the entity to assert a transaction's compliance with the STC criteria.

3.2 Furthermore, we propose for BCBS to allow for the regulator in each country to decide that it would be sufficient for any of (and not all of) the "originator/sponsors" to assert a transaction's compliance with the STC criteria. In Japan, some "originators" are unregulated entities (such as manufacturing companies, including SMEs) that are unable to fully understand all of the STC criteria, which have become increasingly detailed and complicated even for the most sophisticated financial market participants. If BCBS imposes the responsibility to assert or attest a transaction's compliance with the STC criteria on these "originators" who lack deep expertise on structured finance, such originators may shy away from such transactions, causing an adverse effect on the Japanese securitisation market.

3.3 We would also like to confirm that the "originator/sponsor" can rely on analyses, opinions and/or information provided by credit rating agencies, law firms, and/or auditors in asserting a transaction's compliance with the STC criteria, on its own responsibility.

3.4 BCBS should also allow the regulator in each country to define "originator/sponsor" based on market practices as it pertains to "the transaction and the securitising party(ies), solely in its/their role in originating and/or sponsoring the STC securities issuance, must be subject to oversight by a regulatory authority". For example, in Japan, the "arranger" should be subject to oversight by a competent authority, and such oversight should be sufficient and appropriate for the following reasons.

(1) Most "arrangers" in Japan are supervised by the Financial Service Agency of Japan. They play a key role in Japanese securitisations, and hold sufficient information to assert a transaction's compliance with the STC criteria, as described above. In our view, the arranger would be the most appropriate entity to be supervised for the assessment of the compliance with the STC criteria.

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(2) In Japan, "originators" include a wide range of entities belonging to different types of industries, and some are not subject to oversight by a supervisory authority. If BCBS requires all "originators" in Japan to be placed under the oversight of a regulator body solely in their role in originating and/or sponsoring a STC-eligible securitisation, some "originators" may hesitate to consider securitisation as a financing option. This would have negative consequences on the Japanese securitisation market, as well as the diversification of funding at these companies.

3.5 Regarding legal liabilities or regulatory action due to material misrepresentations or omissions regarding a transaction's satisfaction of the STC criteria, we request for BCBS to allow for discretion in each country. Given that legal systems differ by country, the regulator in each country should be allowed to decide whether to prescribe new regulations or to handle such issues within the framework and interpretation of current provisions in existing laws and regulations.

Question 4 : What are respondents' views on the alternative capital requirements for STC securitisation presented in this consultative document?

4.1 The risk weight floor should be reduced to 7% for senior traches.

4.2 Under the SEC-IRBA formula, x is proposed as a factor "in the range between 0.6 to 0.8" (Paragraph 115, Annex 2). We propose 0.5.

4.3 We also propose 0.5 for the "supervisory parameter p" under the SEC-SA formula (Paragraph 118, Annex 2).

4.4 The risk weight floor is intended to provide a conservative safety buffer (margin of error) to address model risk. Hence, securitisations that comply with the STC criteria, which are relatively easy to analyse, should attract lower safety buffers. We propose to adopt the Basel II risk weight floor of 7% for securitisations that comply with the STC criteria.

4.5 Neutrality of the capital treatment for securitised products can only be achieved by setting "the supervisory parameter p" at 0.5 or lower and by abolishing the risk weight floor. If

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parameter p = 1 is applied to securitisation exposures that do not comply with the STC criteria, then 0.5 should be sufficient for those that are STC-compliant.

IV. Comments on the proposed criteria

A.1. Nature of the assets

A1.1 In our view, the language in the additional guidance for A1 is overly prescriptive, and may inhibit flexible interpretation of the criteria. We would therefore propose to eliminate the prescriptive language and to keep the additional guidance to a minimum.

A1.2 More specifically, the subsentence beginning with "loans that have level monthly payments that fully amortise the amount financed over its original term…" should be deleted in its entirety.

(1) In Japan, consumer loans (including auto loans and residential loans) are often repaid in monthly instalments with "bonus payments".

(2) A "bonus payment" scheme typically allows the borrower to select two months of the year (for example, January and July), in which he/she repays a larger amount than the other months.

(3) It is common practice in Japan, in both the private and public sectors, to pay employees (executives and full-time employees) a bonus twice a year (typically June and December), in addition to the monthly salary. The repayment schemes offered by Japanese banks and non-bank finance companies for consumer loans are therefore designed to accommodate the standard salary/bonus payment schedule in Japan.

A1.3 The additional guidance lists "collateral mix of auto loans with corporate/floorplan/dealer assets" as an example of a "non-homogeneous" pool. We propose to delete this subsentence in its entirety.

(1) We understand that this aims to address concerns regarding the difficulty in analysing auto loan pools that comprise instalment loans to consumers and loans to corporates (loans that finance inventories at auto dealers in particular), and therefore the lack of simplicity. We would agree that asset pools that include both loans to retail customers and loans to corporates in a specific sector (such as auto dealers) are rather difficult to assess. However,

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auto loan pools that include loans to consumers and to small businesses are sufficiently homogeneous, and are not difficult to analyse. From the perspective of monitoring and evaluating retail exposures, it does not matter whether the borrower is an individual or a corporate. Even if a loan contract is under the name of an individual, the individual may be self-employed, and the vehicle may be used for business purposes. On the other hand, an owner of a small business may purchase a vehicle for personal use under the name of his/her company. Combining retail loans to individuals and corporates should not damage the "homogeneity" of a pool.

A1.4 The additional guidance lists "collateral mix of auto loans with auto leases" as an example of a "non-homogeneous" pool. We propose to delete this subsentence.

(1) In Japan, "auto loans" (including instalment sales) and "auto lease" are subject to different treatment under accounting and tax standards. However, there is no major difference between the two in terms of credit risk analysis (which focuses the ability of the borrower to pay, regardless of whether the obligation is an instalment payment on a loan or a rental payment under a lease contract) and cash flow analysis. Hence, we do not agree with the view that a mix of the two will result in a "non-homogeneous" pool.

A.2. Asset performance history

A2.1 We do not agree with the statement "This performance history should ideally cover at least one complete economic cycle but must, in any case, be no shorter than a period of seven years for non-retail exposures. For retail exposures, the minimum performance history is five years" as mentioned in the additional guidance. The minimum performance history, as a general rule, should be five years for both retail and non-retail exposures.

A.3. Payment status

A3.1 The sentence in the additional guidance that begins with "Additionally, at the time of their inclusion in the pool, at least one payment should have been made on the underlying exposures, except in the case of revolving asset trust structures…" should be deleted in its entirety.

A3.2 It would be unfair to allow for the inclusion of credit card and dealer floorplan receivables in underlying pools immediately as of the ownership transfer/purchase date, while requiring

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consumer loans (such as auto loans) to present a track record of at least one payment for STC-complaint securitisations.

A3.3 The risk associated with an underlying consumer loan from when the securitisation vehicle acquires the loan to the first payment date (such as dilution risk resulting from cancellations) can be assessed using historical performance data. In Japan, some auto loan and residential loan securitisations adopt schemes that transfer receivables to the trustee (the securisation vehicle) as of the ownership transfer date (i.e. a loan is included in the underlying pool as of the date when funds are extended to the borrower). This is similar to the master trust scheme for credit card and residential mortgage securitisations in other jurisdictions. We find no reason to treat such auto loan/residential loan securitisations as STC non-compliant, while treating similar credit card and dealer floorplan securitisations as STC-compliant.

A.6. Initial and ongoing data

A6.1 Depending on the number of receivables and the types of receivables that comprise the underlying pool, information on the risk characteristics of the underlying pool as of the cut-off date should be sufficient to conduct appropriate analysis on the performance of a securitisation, even if such data on the seasoned pool (whose outstanding amount is lower) is not available. For example, the geographical or obligor age distribution of an auto loan pool, whose outstanding size may be half of the initial pool after two years, should not have changed significantly (although it is clear that the borrowers would be two years older). Meanwhile, the default track record of the pool, which would not have been available at cut-off, would be available after two years. In other words, information provided as of the cut-off date for “new offerings” and information that should be provided regularly to assist investors and potential investors are not necessarily the same. For this reason, we would like for BCBS to provide additional guidance on this criteria. More specifically, we propose to add that “timely loan-level data in accordance with applicable laws or granular pool stratification data on the risk characteristics of the underlying pool”, as mentioned in paragraph 2 of the additional guidance for A6, may differ (e.g. items that represent the characteristics of the underlying pool) from the “sufficient loan-level data…” required for “new offerings” as mentioned in paragraph 1.

A6.2 Furthermore, we would like BCBS to clarify that it would be acceptable to provide “timely loan-level data in accordance with applicable laws or granular pool stratification data”, as

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mentioned in paragraph 2 of the additional guidance for A6, at the request of investors or potential investors.

A6.3 As for the interpretation of the last sentence in A6 ("Cut-off dates of the loan-level or granular pool stratification data should be aligned with those used for investor reporting."), we propose to clarify that "loan-level data" and "granular pool stratification data" would not require updating as frequently as investor reporting, which is required "at least quarterly".

D.15. Credit risk of underlying exposures

D15.1 We propose to delete D15 in its entirety. "A2: Asset Performance History" sets forth the requirement to provide historical performance data on underlying assets. Investors can use this data to assess the credit risk of the underlying pool. Moreover, the credit quality of a securitisation tranche is not the same as that of the underlying pool. Hence, there is no need to impose a pro-forma standard pertaining to the credit risk of the underlying assets.

D15.2 If D15 is not deleted, BCBS should clarify that the criteria will apply only to securitisations originated/sponsored by a bank, and that securitisations originated/sponsored by other entities (e.g. non-bank finance companies) will be excluded. It would be challenging for originators/sponsors that are not subject to bank regulatory capital requirements to determine risk weights of underling exposures under the Standardized Approach.

D15.3 If D15 is not deleted, then the criteria should be streamlined to apply a 100% maximum risk weight requirement to the value-weighted average of the underling exposures across all asset types. There is no need to impose a more stringent standard on residential mortgages than unsecured retail exposures, and the same is true for unsecured retail exposures and unsecured large corporate exposures.

D15.4 If D15 is not deleted, then the criteria regarding residential mortgages should be eliminated and merged with those for retail exposures. In this case, the 85% maximum risk weight requirement should be applied on a value-weighted average basis, and not on an individual exposure basis.

D15.5 If D15 is not deleted, and the criteria for residential mortgages are to be defined separately from those for retail exposures, we propose setting the maximum risk weight requirement

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for residential mortgages at 75%, as opposed to the proposed 40%. We find no reason to exclude residential loans (secured by a mortgage) that attract 75% or 100% risk weight (due to the fact that the loan is not fully covered or has an LTV of above 100%) from the eligibility criteria, while setting the eligibility criteria for unsecured retail exposures at a maximum risk weight of 75% or 85%.

D.16. Granularity of the pool

D16.1 We propose to delete D16 in its entirety. The effectiveness of setting a 1% limit on obligor concentration is not clear to us.

D16.2 As regards to obligor concentration (granularity), a requirement to provide information that will allow investors to assess the level of concentration and impact on performance for portfolios with more than 1% obligor concentration should be sufficient. This requirement is stipulated in A6: Initial and ongoing data. Hence, there is no need for D16.

D16.3 If D16 is not deleted, we would propose to set the limit on obligor concentration (granularity) at 4% or N (effective number of exposures) of 25. The N (effective number of exposures) is defined in Paragraph 633 of the Basel II text (originally issued in June 2004).

D16.4 Assuming that resecuritisations are made eligible under the STC criteria, the fact that resecuritisations with fewer underlying assets are simpler and easier to analyse should be taken into consideration. Therefore, the criteria regarding concentration for resecuritisations should be based on the number of assets in the underlying portfolio. We would propose setting the limit at 12 (the number of months in a year).

D.17. Relationship between the originator and the servicer of the securitised assets

D17.1 We propose to delete the section in its entirety. We are of the view that the shareholding relationship between the originator and the servicer does not directly affect the simplicity, transparency nor comparability of securitisations. We also question why the exception “where it is common practice to employ a third party servicer” applies only to residential loans. The issue of servicer motivation is appropriately addressed in the last paragraph of C13.

D17.2 At the least, entities that demonstrate expertise in servicing, such as those that are engaged

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in the same or a similar business as the originator (such as industry peers), those that have received approval from the Minister of Justice under the Act on Special Measures Concerning Claim Management and Collection Businesses, and those that engage in trust banking operations in Japan, should be considered eligible as servicers, even if there is no capital relationship or affiliation with the originator.

End of document.

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ANNEX

Description of Securitization Forum of Japan

The **Securitization Forum of Japan (SFJ)** was founded as a voluntary association in 2005 and established as a corporation in 2007. SFJ aims to contribute to the sound development of the asset securitisation market and carry out the following operations: (1) research and study associated with asset securitisation; (2) exchanges and cooperation with internal and external organisations concerned, etc. associated with asset securitisation; (3) diffusion and enlightenment of asset securitisation; (4) policy recommendations concerning asset securitisation; and (5) any other operations incidental or relevant to operations of the above items. SFJ operates Experts Committees on a steady basis to discuss issues on securitisation, 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 securitisation such as Basel III securitisation framework. SFJ also deliver high-quality educational system to members, providing opportunities to attend seminars on securitisation or to take professional development programs.
Association's web site: http://www.sfj.gr.jp/e/index.html.