

Minutes of the Third Meeting of the Working Group on Distributions of Securitized Products

1. Date

April 23, 2008 (Wednesday) 15:00 to 17:00

2. Place

JSDA Conference Room

3. Participants

As stated in Appendix 1

4. Agenda

(1) Financial Stability Forum Report (FSA)

(2) Definition and scope of details of underlying assets and risks

- Information needed by investors to do risk/return analysis (Presentation by securitization analysts)
- Information items that rating agencies consider important in determining ratings (Presentation by rating agencies)

(3) “On Auditing the Evaluation, etc., of Securitized Products” by the Japanese Institute of Certified Public Accountants (JICPA)

- Presentation by representative of JICPA (Deputy President Komiyama)

5. Summary of Proceedings

At the start of the meeting, the WG Chair gave explanations on the following three points.

A. The Unified Information Disclosure Format Initiative Team (Appendix 4)

- The responsibility to lead the team was delegated to Mr. Egawa of Deutsche Securities.
- With the exception of the final meeting, the WG Chair and deputy chairs will not participate in the meetings of the Unified Information Disclosure Format Initiative Team (hereinafter called the “initiative team”).
- the purpose for setting up the initiative team was to consult a small group of experts regarding the determination of individual items for the unified information disclosure format because it would not be efficient to examine them in the WG given its large number of members.
- The main tasks of the initiative team are to update the model format for information disclosure by the Workshop on Securitization by adding or eliminating items and to indicate a direction for deciding which items should be regarded as important.
- Starting in the fall, the WG will be listening to the opinions of originators and others in a different venue. However, for now the initiative team will be asked only to conduct free discussions led mainly by analysts. Through that discussion, the initiative team will list up necessary information items from the point of view of investors referring to ratings but also carrying out an efficient credit analysis of investment products.
- The schedule for the initiative team included as Appendix 4 is only tentative; the actual schedule will be the responsibility of the team leader. The points that they will be asked to respect are to proceed with discussions on an asset type basis, such as RMBS, CLO, ABS, and CMBS; to receive a report on CMBS from the CMSA Standardization Sub-Committee; and to make a report to the WG on their working draft for a unified information disclosure format, bringing their work back into the 6th meeting of the WG on June 5.

B. Roadmap for creating a unified information disclosure format (Appendix 5)

- The WG will receive a report from the initiative team on their working draft for a unified information disclosure format at its 6th meeting on June 5. Following deliberations, at the 7th meeting on June 24, the WG will discuss about the provisional version of the unified information disclosure format to be included in the interim report.
- After the interim report in July, the WG will start establishing a group of committees in September, gathering together various stakeholders for each asset type. Continuing to move

forward with the direction given in the interim report, the WG will make its final proposal for a provisional unified information disclosure format.

- Then the WG will issue a public comment paper on its final proposal. Based on the results, the WG will decide on a final version of the unified information disclosure format.
- C. Establishing internal procedures for collecting and communicating information
- Currently, the secretariat is conducting hearings on establishing internal procedures at relatively large-scale securities companies, mainly those of the WG Chair and deputy chairs. The three main points being addressed in these hearings are 1) what is the current state of the internal control system? 2) What issues does the company have regarding the internal control system? And 3) how will the internal procedure change as progress in and standardization of information disclosure proceeds? What will be specifically done with the results is as yet undecided. However some form of presentation will be made in the fourth or fifth meeting, which the WG hopes will be a useful reference for individual companies as they proceed with establishing their own internal procedures in future.

Initiative team leader Mr. Egawa asked if he was correct in understanding that discussions on what type of investor the integrated information disclosure format would be for and whether it would be made obligatory or be a recommended or cooperative standard would be carried out in the WG. In addition, he asked if he was correct in understanding that the initiative team was to come up with something that could be used as a unified information disclosure standard without regard to the previously mentioned ongoing discussions on in the WG. The WG Chair replied to the effect that he was correct in his reasoning.

(1) Financial Stability Forum Report (FSA)

The FSA gave an explanation of the report based on the document included as Appendix 6.

- The Financial Stability Forum (FSF) Report was submitted to the recent G7 meeting, and its findings are being addressed individually by each country.
- The portion most relevant to the WG is “III. Enhancing transparency and valuation.” In this section, recommendations aimed directly at securities companies fall into two pillars: 1) how arrangers and distributors can contribute to improving transparency within the securitization process and 2) how to deal with disclosure when holding a proprietary position in securitized products.
- The content of Recommendation III.10 in “4. Transparency in securitization processes and markets,” agrees with the direction indicated by the FSA in the Guidelines. In addition, the report states that efforts by the WG to establish distributors’ rules and a standardized format of disclosure of securitized products are welcome.
- Deciding how to interpret the “system” stated in Recommendation III.13 will require some examination. However, the FSA’s feeling at this point is that following the completion of the unified information disclosure format currently under study in this WG, what will likely be important is to what degree the format can be applied.
- Recommendation III.1 regarding “1. Risk disclosures by market participants” strongly recommends that in their mid-year 2008 reports major financial institutions make disclosures in accordance with the framework included as Annex B for specific risk exposures they are holding. Basically, the recommendation is regarding semi-annual business results and because the financial year-end of most financial institutions in Japan is in March, that would mean the September semiannual results. On the other hand, these recommendations are expected to be implemented within 100 days of the G-7 communiqué. Therefore, no matter when they are done during the period from April to June, at the very least, Japan will have to avoid being inconsistent in its response. The details of what types of disclosure items are going to be required in Japan will be communicated to financial institutions as soon as the FSA finishes drawing them up. The FSA would like the discussions in this WG to be based on what type of disclosure investors want to have.

(2) Definition and scope of details of underlying assets and risks

A. Information needed by investors to do risk/return analysis

(Securitization of monetary claims)

Securitization analyst Mr. Tomohiro Miyasaka of Credit Suisse gave an explanation of what information was necessary for investors to make their own risk/return analysis using the presentation included as Appendix 7.

- As a necessary information for credit risk analysis when investing, the “Level 1” and “Level 2” items in “1. Disclosure at point of issuance” in the model format for information disclosure by the Workshop on Securitization are extremely important. There are almost no items that can be omitted.
- Out of the total value (about ¥7.7 trillion) of securitized product issuance in Japan in FY 2008/3, RMBS accounted for 43%, of which about 84% had fixed interest rate coupons. In other words the interest rate risk of originators has been transferred to investors on a substantial scale. Information in “1. Disclosure at point of issuance” in the model format does not necessarily cover enough necessary information for making interest risk analysis when investing. The repayment history data of the Japan Housing Finance Agency would be a reference for the specific disclosure items required.
- The necessary information for making return analysis when investing is covered to a certain degree by “1. Disclosure at point of issuance” in the model format (expected cash flow included payments made before maturity is not covered). In addition, there is a lack of information about multiple existing issues of the same type that could be used for comparison.
- As necessary information for monitoring credit risk after an investment, the “Level 1” information in “2. Disclosure following issuance” is extremely important. On the other hand, there is room for paring down items in “Level 2.” In addition, because it is possible that the necessary information could change depending on changes in market conditions, etc., there should be some flexibility to enable revisions in the format.
- The necessary information for monitoring interest rate risk and calculating return is market price.

(Real Estate securitization)

Securitization analyst Mr. Hidetoshi Ohashi of Morgan Stanley gave an explanation of what information was necessary for investors to make their own risk/return analysis using the presentation included as Appendix 8.

- In the United States and Europe, a typical CMBS includes about 100 properties. In this case, investors do not necessarily look at the details of each property. One way of looking at the investment is checking the main properties only based on the degree of diversification. Ratings are also being used in conjunction with the information provided by originators and others to make the investment decisions. This, of course, is based on receiving information from the rating agency on what information was used in making the rating and what assumptions were used. Taking these views into consideration, he examined what information items would be necessary.
- The minimum necessary items and points for evaluating individual properties, loans, bonds and trust beneficiary rights levels are shown on Page 3. In the case of multiple asset issues, in addition to these points it is necessary to look at the effectiveness of the overall portfolio and what type of special characteristics it might have. The minimum information items necessary when putting a deal together are given on Page 5.
- The information items necessary during the term of the product are related to the cash flow of the property and the changes in the asset pool of the portfolio. Specifics are given on page 7.
- As a conclusion, most items in the draft disclosure format presented by CMSA at the second meeting can be used as it is now. Specifically, the part on how to determine LTV during the life of the product and the sales value if property is sold need further consideration. But these

points could be addressed based on the WG discussions about whom the information is being disclosed to.

The WG Chair requested that CMSA-Japan make their report on the IRP study to the initiative team a little ahead of the original schedule to contribute to their discussions on the unified information disclosure format.

B. Information items that rating agencies consider important in determining ratings

(Securitization of money claims)

Mr. Kitahara of Rating and Investment Information, Inc. (R&I) gave an explanation of information items that rating agencies consider important in determining ratings using the presentation included as Appendix 9.

(Real estate securitization)

Using the presentation included as Appendix 10, Mr. Yamamoto of Standard & Poor's gave an explanation of information items that rating agencies consider important in determining ratings. Afterward, he also explained the role played by ratings as follows.

- Ratings act as a common language for credit risk. Whether or not an investor evaluates credit risk using his own independent in-house evaluation standards or not, the fact that different investors use different standards means that the credit risk of the same product cannot be simply compared. This becomes even more difficult when investors come from different countries. By acting as a common language for credit risk, ratings make it easy for investors to compare credit risk assessments, contributing to improved market efficiency. Conversely, without using ratings as a common language, the secondary market for securitized products would face a much higher hurdle for development.
- It could be said that, in general, rating agencies have access to a larger volume of information than investors. All the information previously received for rating individual products and the accumulated knowledge from our due diligence process are reflected in the rating analysis of individual securitized products. There are probably even cases where, depending on the type of information, originators provide rating agencies information that they would prefer not to disclose to investors. For example, when considering distribution of any securitized product, there may be cases where the investor buying the product is a potential business competitor of the originator (However, it is difficult to conceive of the rating agency being a business competitor).
- Investors have various types of personnel organizations, and some investors may require more efficient investment inspections. In receiving information on analysis method or assumptions from the rating agency, it is possible that there may be some rationalization of resources necessary for making the investment decision and for monitoring the product.
- Rating agencies do not just deliver a rating, they provide the criteria for rating analysis to investors. Whether or not a product has a rating tells an investor what criteria the product has met or not met. Hypothetically, if there wasn't a rating, the investor would have to examine individually a large number of items, which would result in enormous costs and work for the investor and the originator.
- Using the performance information by asset type and research report provided by the rating agency, the investor can acquire information on the average movement of products in the same product class as the securitized product they are holding. In addition, the rating agency researches changes in legal systems that could affect the securitized product as well as current topics, and announces its views to the market. If rating agencies were not rating securitized products, this type of information would not be available to investors, and they would have to research them independently. Therefore, Standard & Poor's thinks information from breaking companies contributes to the effective monitoring of products by investors.

- Since there is no disclosure of the analysis methods of individual investors, it is difficult to see in what way risk analysis would be done in the securitization market without rating agencies, and it is possible that the transparency of the market would decline.

The WG Chair asked about disclosure by rating agencies overseas to which the following answers were given regarding CMBS.

- In the United States, even investors investing in AAA rated products do not receive real estate assessment certificates or engineering reports. This is probably because multiple properties are included in each CMBS in the United States and it is not necessary to go that far in evaluating diversified pools of assets.
- Conversely, unlike Japan, there are almost no cases in the United States where the rating agencies' pre-sale report is not made public at the wish of the originator. Since in many cases in Japan we observe underlying asset is a single office building, we understand why originators are so sensitive about information disclosure to the public. However the fact that one of the special features of the market in Japan is the lack of progress in disclosure of pre-sale reports can be considered a factor blocking the expansion of the secondary market.

The WG Chair asked whether it would be possible for investors to monitor ratings for products if they followed specific information, receiving the following answer.

- If investors receive sufficient information from originators and if they analyze that information, they may react to the situation prior to the changes in the ratings. With the subprime loan problem in the United States, among analysts who were closely analyzing the data, there were people blowing the whistle from the end of about 2005. However, it was probably difficult to predict the timing of actual changes in ratings. While rating agencies are always factoring in the latest movement in the market, it is difficult to determine whether the changes occurring right in front of you are transient or indicative of real trends.

The WG Chair stated that whether or not it was impossible to forecast the actual timing, he would like to include a discussion of what information is necessary to enable investors to predict changes in ratings to a certain extent in the WG's work on promoting information disclosure. He asked whether the rating agency would cooperate with the WG in this. A representative of the rating agency said that they were bound by confidentiality agreements but would be happy to cooperate to the greatest extent possible.

The WG Chair commented that the initiative team was now listing up necessary information items for investors. However, among those listed information items there may be ones that for some reason cannot be disclosed. He would like to be able to promote efficient and defective information disclosure by using rating agencies to cover for those gaps.

A member of the WG gave the opinion that the information received from rating agencies was extremely important for investors in the secondary market, analysts, and others. Hence, the member would like to have representatives of the rating agencies included in the initiative team so that they could consider information items that could be provided by rating agencies. In response, the WG Chair commented that this was an extremely important discussion point and he wanted to include it as a future topic for consideration.

(3) "On Auditing the Evaluation, etc., of Securitized Products" by the Japanese Institute of Certified Public Accountants (JICPA)

JICPA Vice-Chairman Mr. Komiyama gave the following explanation using the memo to JICPA members included as Appendix 11.

- After putting out this memo, there were some reports in the mass media stating that this was an "unusual notification," but this really is not the case. As the fiscal year-end draws near, the JICPA regularly puts out a "heads up" to its members about certain current topics. This memo falls within the scope of that accepted practice.
- Rather than financial institutions, the focus of the current memo is a reminder about auditing general enterprises that are holding subprime loan related products. For financial institutions, the government authorities have conducted surveys concerning their holdings of subprime loan

related products and made aggregate data publicly available. But no such surveys have been conducted for general enterprises, so it is difficult to grasp the real situation.

- The JICPA has no authority to set accounting standards, therefore, it goes without saying that this memo is only a reminder to do a good job within the scope of current accounting standards.
- Under current accounting standards, “fair value” is the cash involved in the purchase or sale. We would like this amount (market value) to take reflect not only credit risk but also, depending on the situation, liquidity risk.
- When we say “Obtain market values quotes from multiple brokers,” we mean that when there is doubt about the assumptions used in calculations in prices submitted by certain broker, it is necessary to get quotes from other third parties, which in auditing language we call “Use of other experts.” It is not just a crude reasoning requiring obtaining quotes from multiple brokers and value the product using the lowest price.
- In principle, composite financial products that include credit-risk related derivatives must be accounted for separately. However, this sectionized treatment is not required for products that show no principal losses. Nevertheless, there are cases currently where the market values of these products have fallen substantially. While sometimes the original value is not clear, for products where it is clearly appropriate to judge that they have fallen below notional, we are indicating that, according to the rules, they should be accounted for separately.

A WG member said that after this memo was put out, there have been an increase in clients’ requests to calculate the market value of products bought from other firms, as well as more inquiries about whether the liquidity risk is included in the value of products sold by his firm. There are even requests asking to represent that liquidity risks are included in the product values, and internal discussions are being held to decide whether it is necessary to address such demands. When the WG was asked to raise their opinion on this issue, Vice-Chairman Mr. Komiyama replied, “for auditing purposes, it is necessary for investors to ask about the pricing methods of financial products that they purchased, so I would like to ask for your cooperation.”

Another member of the WG commented that fair market value was the amount that could be converted into cash and takes liquidity into consideration. However in the securitization market in Japan, the fact is that there is almost no secondary market. The member asked whether the liquidity of individual products should be determined based on an approximate range or whether it should be on an individual basis given the multiple influences of not only the disclosure information being discussed in the WG, but the scale of the secondary market operations (market making ability) of arrangers and distributors. Mr. Komiyama replied that there was no absolute answer currently as to how to include consideration for liquidity risk. The basic stance in actual practice for financial products is that liquidity risk should be included to some extent, and this has to be judged on a case-by-case basis.

An FSA representative explained that their focus on the accounting policies is that the calculation method shall not be arbitrary. The FSA does not have specific requirement on what aspects should be factored into prices. He said that with liquidity risk as well, they were not necessarily requiring it to be included in price—their goal was for the risk involved to be clearly explained.

The WG Chair commented that a consensus had not yet been reached in the market regarding the treatment of liquidity risk in calculating theoretical prices. He wanted to include it as a future topic for consideration, including the point of whether or not it is possible to bring together the views of related participants.

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