

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

1. Date

May 15, 2008 (Thursday) 15:00 to 17:00

2. Place

Empire Building No. 1 Conference Room

3. Participants

As stated in Appendix 1

4. Agenda

- (1) The role of information vendors in securitized product information disclosure
 - Presentations by information vendors
- (2) The role of rating agencies in the securitization market—spotlight on current global information provision
 - Presentation by a rating agency
- (3) Independent inspections of securitized product information disclosure
 - Presentation by a Certified Public Accountant
- (4) Establishing procedures for collecting and reporting on details and risks of underlying assets
 - Establishing procedures
 - Presentations by major securities companies
 - Counterparties in information reporting

5. Summary of Proceedings

At the start of the meeting, the WG Chair said that at the general meeting and reception of the Association for Real Estate Securitization held today, following comment on the activity of this WG was made.

The main issue facing us for the future is creating securitized real estate products with a higher degree of transparency that will be competitive globally. In that sense, we have high expectations for the work the JSDA WG is doing to ensure traceability of securitized products and to promote information disclosure. We're hoping they'll give their work full efforts.

Carrying on, the WG Chair gave the following explanations of the agenda.

(Regarding Item 1)

- One major discussion point concerning disclosure for securitized products is to what extent distributors are able to directly provide information in actual practice. Thinking that information vendors could have an important role in this point, we have asked two information vendor companies today to give us presentations on what types of roles they can play in promoting information disclosure in Japan, including some actual examples from the United States market.

(Regarding Item 2)

- In overseas markets, the role and business of rating agencies are not only to simply designate a rating, but have expanded to providing information on the risk analysis

on which the ratings are based. Today we will have a presentation by a rating agency on that trend.

(Regarding Item 3)

- Another major discussion point concerning the disclosure advancement regarding securitized products is deciding on who is going to guarantee the accuracy of the information and in what way. As one source of information on that point, today we're going to hear the views of a certified public accountant on Agreed Upon Procedures (AUP).

(Regarding Item 4)

- We will hear presentations by representatives of major securities companies on the current status of their efforts to establish information disclosure procedures and the issues involved.

(Item 1) The role of information vendors in securitized product information disclosure

A representative of Bloomberg gave the following presentation based on the presentation materials included as Appendix 4.

- Of all the Japanese securitized products issued since April 2007 (Japanese collateralized asset base, on a yen basis), 46 products are registered on Bloomberg's "Mortgage Sector." And out of these products, 34 provide projected cash flow (CF). In addition, 15 products are private placement issues and have restricted access to the information.
- Among securitized products, at the wish of the seller, some products have been registered in the "Corporate Sector" rather than the "Mortgage Sector". Because in technical terms multiple CF scenarios cannot be done in "Corporate Sector," there is no way of doing early redemption trigger analysis for defaults.
- We only provide asset performance data in Excel format for the RMBS of housing loan institutions. The rest are in PDF format, and have to be converted to Excel files for users to make use of them. In the United States, however, asset performance data is stored as digital data within Bloomberg's analysis tools, allowing users to change the data format without any problems. This makes it possible to do many varieties of credit analysis using the analysis tools. Since this WG is considering a unified information disclosure format, we are hoping to be able to load asset performance data as digital data and provide analysis tools in Japan just as we do in the United States.
- In the United States, users have access to a "Super YT Function" that allows them to calculate yields and duration based on their own assumptions about the underlying assets.
- For CMBS products in the United States, the information even includes mortgaged property data. In Japan, however, we don't do this because information disclosure for CMBS is not really sufficient. For J-REIT products, on the other hand, information disclosure is improving, and we started providing mortgage property data in March of this year.

The WG Chair said, "it is explained in the presentation that the information provided by information vendors in the United States is extremely advanced and useful for risk analysis by investors. But how is this point consistent with the fact that U.S. securitized products have been fingered internationally for having traceability problem?" The Bloomberg representative gave the following answer.

- Even in the United States, the majority of disclosed information is for interest risk analysis for fixed rate RMBS. The need for disclosure of data regarding the quality of underlying assets only began to emerge three or four years before the subprime loan problem happened. In fact, the Super YT Function mentioned previously was just introduced three months ago.
- The CDO that have been pointed out among U.S. securitized products as having a particular problem with traceability are premised on nondisclosure, and true to their nature there is no information available even in the United States. Among secondary securitized products, the trend in United States in dealing with traceability is to expect solid disclosure of the primary securitized products and to carefully scrutinize those that seem to have a problem with the underlying assets.

A representative of QUICK gave the following presentation based on the presentation materials included as Appendix 5.

- Information vendors aggregate, average and otherwise process information that their customers need, distributing it through specialized terminals or over the Internet. The basic conditions for disclosing information are 1) many investors that need the information will use the service (our customer base for securitized products is about 1,200 companies), 2) the information complies with the constraints or disclosure requirements of users, and 3) understand the needs of customers using the information and reflect those needs in the information or analysis tools provided.
- The information we disclose is the basic items at the time of issue, rating information, price, prospectus, investment scheme, etc. For the RMBS of Japan Housing Finance Agency (JHFA), we add CF data for entrusted assets, rescheduling factors, and historical data in a downloadable Excel format.
- The RMBS of the JHFA have the following special features: 1) as originator, the JHFA directly provides the vendor with timely data when pools are being made up and on an ongoing basis, 2) detailed prospectuses and schemes are made public, 3) its prices are used in trading reference statistics and quoted by many securities companies, and 4) a certain level of standardization is carried out for the information items they provide, which has helped vendors in building information screens for their system.
- We provide evaluation tools for the RMBS of the JHFA. When we asked customers (wide range of customers covering major institutional investors to regional financial institutions) what they thought of these tools, their response was generally favorable. Most major institutional investors have their own evaluation tools; therefore, they have an interest in our tools for management purposes. For trading, particularly for launches, they also find them useful in discussions with the securities companies selling the product based on the use of a common OAS. Of course, customers who do not have their own evaluation tools use our tools not only for sales but also for management.
- We have had requests from our customers to provide these tools for not only the JHFA RMBS, but also RMBS of private-sector financial institutions. We believe this would be difficult because private-sector financial institutions do not disclose information on their RMBS in a standard or continuous way. Conversely, if a wide range of securitized products started to make standardized and continuous information disclosure, the scope of use of our evaluation tools will broaden and improve convenience for customers.

The WG Chair commented that it was likely that setting up benchmark issues and providing disclosure information to vendors on a sustained basis or the creation of a bond index would be of benefit to the development of the market in the future. For example, the recently securitized fiscal loans have already been included in the Nomura BPI. It was asked what the background to this was, to which the Ministry of Finance representative answered that it was probably the result of the index company being briefed before the issuance, and the understanding that the Ministry planned to continue to issue information.

(Item 2) The role of rating agencies in the securitization market—spotlight on current global information provision

A representative of Moody's Japan commented that as they understood it, the purpose of the WG was to build an infrastructure to enable the securitization market to fulfill its national economic function. Amid the rapid increase in issuance of the securitized products since May, they recognized that the work being done by the WG was extremely timely and necessary for the securitization market.

Following that comment, a representative of Moody's Japan gave the following presentation based on the presentation materials included as Appendix 6.

- The reason the debate in the United States over whether or not there is a traceability problem with secondary securitized products relates to the fact that there is a very large number of managed CDO. And even with the ABCP and SIV, given the turnover of managers within the scope of the covenants, investors have no way of seeing what's behind the screen.
- A recent major theme in ratings is the opinion that ratings of securitized products should be separate from that of business enterprises. In the April report of the Financial Stability Forum, it recommended the use of different ratings for structure products or additional symbols. In February of this year, Moody's conducted a survey of global investors (on a total issuance basis, about US\$9 trillion). The results were announced on May 14 in the United States. Three quarters of the investors who responded to the survey said they did not want separate rating symbols. However, just because investors answered in this way does not mean that they were necessarily satisfied with the service of rating agencies. What they wanted was additional information from rating agencies. Looking at other opinions, Fitch Ratings said in an April 29 press release that in their dialogue with the market they found that the majority was on the side of not changing rating symbols. A May 6 press release by S&P also stressed that the general opinion was in favor of rating agencies ensuring that securitized products could be compared with other instruments, and S&P thought that rating agencies should meet those expectations.
- In March, IOSCO announced its revised Code of Conduct Fundamentals for Credit Rating Agencies in which it particularly stressed the two points of 1) strict measures to prevent companies from so-called "shopping for credit ratings" and 2) ensuring the quality of the data used for the assumptions the ratings are built on. We believe that the latter point is especially important. One Japanese investor gave the opinion that there was only a small possibility that any slight deterioration in the performance of an underlying asset of an AAA securitized product could lead directly to losses. Instead, the investor thought that daily governance was defective and that the data was reliable were more important. In fact, there are many securitized products scattered throughout Japan's market that are considered a little

suspicious, and I think the important point in ensuring traceability is how we cast our net. In the U.S. subprime problem, they found that false data was mixed with the good, and how we take advantage of that lesson is important.

- Three rating agencies have announced that they're going to provide additional information related ratings. Fitch revealed on April 29 that they were considering adding (1) Loss Given Default (LGD) Ratings, (2) Transition/Stability Ratings, (3) Collateral Ratings as three pieces of additional information. S&P said on May 6 that they were "exploring to cover more dimension of creditworthiness or risks, including recovery or LGD, volatility, liquidity and the correlation of defaults and rating transition." Moody's announced today that they would include (1) Assumption Volatility Score and (2) Loss Sensitivity as additional rating-related information. The Assumption Volatility Score will assess potential rating volatility based on the uncertainty of rating model assumptions. It will be derived from the four factors of historical performance, data adequacy, the complexity and market value sensitivity of the transaction, and governance. Loss Sensitivity will capture a rating's sensitivity to changes in the expected loss rate on the collateral pool backing the security (measures the number of likely rating notch downgrades for a security should the loss rate on a transaction's underlying collateral pool increase to a highly stressed level (for example, when it rises to a stress level of 95 percentile or greater).
- Instead of the simple provision of information, our group has recently been emphasizing contributing to investors' credit and price decisions by providing them with simulation models. For example, we are asking ourselves if it would be a benefit to investors if we provided tools that an investor can use when he/she thinks that a rating agency's rating for an issue is a little lax to determine whether the rating looks reasonable by revising the correlations and factors. Tools to simulate expected losses if the underlying asset pool factors or excess spread decline over time are also being considered.

(Item 3) Independent inspections of securitized product information disclosure

A CPA gave the following presentation based on the presentation materials included as Appendix 7.

- Looking at the disclosure items audited by CPAs, on the surface the items related to securitized products can be roughly divided into 1) checks of external vouchers and disclosure items and 2) checks of information creation processes. Out of the two, 1) is relatively easy to do, while 2) it is difficult because the reliability of the internal documentation cannot be guaranteed.
- The types of audits done by CPAs in inspecting these disclosure items can be roughly divided into 3 types 1) reviewing the accuracy of disclosure documentation, 2) following Agreed Upon Procedures related to the accuracy of disclosure documentation, and 3) auditing the establishment and operation of the internal control system related to the process of producing the information for disclosure documentation (SAS 70 administration, auditing of internal control systems based on Auditing Standards Committee Statement No. 18).
- In 1), a specific standard is applied to determine whether there are any matters that could be considered inappropriate in the information disclosure, and the results are reported (limited guarantee). Although this method has the advantage of receiving an opinion on the accuracy of the disclosure documentation by the auditor, it has the disadvantages of requiring the setting of implementation standards appropriate

for information disclosure of securitized products and generally higher costs than Agreed Upon Procedures (AUP). Because of this, this method is almost not used at all.

- For 2), the auditors implement procedures agreed upon with the client business, and report on the results. The audit report is only on the AUP and the CPAs do not make any conclusions. The company requesting the procedure takes responsibility for deriving any conclusions from the implemented procedure and results. In addition to the setting of a standard, the advantage here is generally lower costs compared with a review. The disadvantages are that the auditor gives no opinion on the accuracy of the disclosure documentation and the report is not made widely available for public inspection because it is reported only to the client.
- In 3), the CPA audits the structure and operation of the internal control system and makes a report. Employees preparing the disclosure information prepare a written statement on the structure of the internal control system on which the audit is then based. The advantage here is that the auditors give an opinion on the structure of the internal control system. The disadvantages are that employees preparing disclosure information must prepare a statement on the structure and operation of information creation processes under the internal control system and the cost is generally higher than either a review or AUP inspection.

(Item 4) Establishing procedures to collect and report on details and risks of underlying assets

Establishing procedures

The WG Chair stated that the WG Chair and deputy Chairs had collected opinions among themselves on the procedures that sellers/distributors must set up to collect and report on information regarding details and risks of underlying assets, and produced a memo on “Internal Procedures” The WG Chair gave an explanation of “Internal Procedures” based on the memo included as Appendix 8.

A detailed discussion of Appendix 8 was not undertaken at the meeting, but postponed to the next meeting.

A WG member asked whether or not they would have another chance to discuss Appendix 8 after the sixth meeting and before the interim report or whether their opportunity to question and debate the content of Appendix 8 would end following the report on information disclosure items, on which Appendix 8 is based, which is scheduled for the sixth meeting. The WG Chair replied that the direction of the information disclosure items had been set by previous meetings and it had been agreed that the Initiative Team would proceed along those lines. In that sense, they did not consider that holding a discussion of setting up procedures at the fifth meeting was a problem, but would make sure to provide members with another opportunity to discuss it before compiling the intermediate report.

Presentations by major securities companies

A representative of Morgan Stanley Japan Securities gave the following presentation on internal procedures of collecting and reporting on information regarding details and risks of underlying assets based on the presentation materials included as Appendix 9.

- The main points that we follow in our business operations from the perspective of ensuring traceability are ensuring independence, clarifying job responsibility, and making sure checks and balances are in place. To that effect, our procedures remove the possibility of intentional manipulation of information and avoid and manage conflicts of interest.
- Keeping the origination and distributions of CMBS in mind, when securities companies use assets bought on proprietary accounts as the underlying assets in securitized products, they not only have to fulfill their responsibility as a market intermediate, but also a so-called arranger responsibility by considering whether or not the project will damage their reputation with investors. First, the product undergoes a strict credit examination as if the company had borrowed the funds itself. At this point, some proposed products are dropped because of credit problems in holding them as proprietary positions, but the inspection does not just stop at this kind of risk management, it goes on to consider the product from the point of view of whether the outlay of funds is appropriate considering the securitization process. In other words, it looks at the product from the point of view of risk management by the investor. In addition, at the creation and distributions stages, we provide proper disclosure and detailed explanations to investors regarding the details of the underlying assets and the securitized product structure. The important thing at this point is avoiding conflicts of interest. It is important to have a system that ensures the fairness of the process. At Morgan Stanley, the collection and close scrutiny of information is done by departments that have a certain degree of independence from the distributions promotion sections. At the disclosure stage as well, to prevent the information from being intentionally manipulated to the detriment of the investors' interests, the legal and compliance departments are included in the process along with the distributions promotion sections to effect checks and balances.
- We recognize that the concept of arranger responsibility has— whether great or small—a certain degree of similarity with underwriter responsibility, which has mainly been discussed concerning equities. In actual fact, in the June 2006 report of the discussion points by the Roundtable On The Market Intermediary Function of Securities Companies, it was pointed out that “in this way, against the backdrop of the growing diversity and sophistication of the businesses of securities companies as market players, the business of securities companies...III) securities companies (group companies) create securitized products using underlying assets in which they made the principal investment and sell them to other investors without proper explanation (risk transfer), and IV) in an environment where cases that pose (potential) conflict of interest, etc. problems are increasing, such as using SPCs and other vehicles for the purposes of manipulating accounting, proposing or trying securitization structures suspect of being for the purpose of tax evasion, and other cases.” Based on this, as a securities firm that creates and sells securitized products, Morgan Stanley has built and operates an internal control system capable of ensuring the protection of the public interest and investors.
- Of course, there is no need to introduce the idea of underwriter responsibility exactly as is into the business of the origination and distributions of securitized products. However, considering the social responsibility of securities companies that sell securitized products to a wide range of investors, we think the concept of underwriter responsibility, which has been well debated and tabulated in the equities markets, should be taken into account in the “Establishing procedures” given the similarities, great or small.

A representative of Mizuho Securities gave the following presentation on establishing procedures to create and sell securitized products based on the presentation materials included as Appendix 10.

- In establishing procedures, in addition to the organizational aspect of establishing an inappropriate organization and the allocation of people, it is important to ensuring their effectiveness.
- Besides already including destructive risk, procedures have to be revised even after they have been implemented to respond to changes in the market environment.
- Points (potential risks) to be considered when thinking about establishing procedures to create and sell securitized products include 1) because expertise is required, it is not always easy to implement checks by third parties, 2) because the products often use complicated risk structures, it is not always easy to determine risk, 3) because of the use of SPVs and other vehicles, the originator or arranger is not the central player, 4) a lot of different entities are involved, 5) even distributions of the product require expertise, 6) and even after distributions, it is essential to provide information disclosure and market prices. Even in the past, securities companies have been careful when it comes to establishing procedures to deal with these types of special features and risks of securitized products. Specifically, when creating these products they use checklists to visualize the details and processes of the proposed deal; establish procedures organizationally, such as establishing departments specializing in inspection; increase the effectiveness of checks by allocating the job to people with experience creating securitized products; or keep a proper record of the inspection paper trail. In addition, detailed responses are also offered at the point of distributions, such as bringing along a securitized product specialist team to explain in detail the risks to investors, providing follow-up services after distributions by supplying information on the performance of the underlying assets, and developing products that incorporate the needs of investors.
- To make further improvements in the procedures for creating and selling securitized products, this WG should not be satisfied with the current procedures. For example, we would like to propose the following. Improve the risk analysis inspection function in the procedure used to monitor product development. Improve the inspection function for the supply of information and market prices after distributions. In addition, raise the bar on the in-house inspection function at securities companies. We believe these are the steps that should be taken to improve transparency of securitized products and information disclosure.

Counterparties in information reporting

The WG Chair stated that the WG Chair and deputy Chairs had collected opinions among themselves on the counterparties in information reporting regarding details and risks of underlying assets and produced a memo on “Counterparties In Information Reporting.” The WG Chair gave an explanation of “Counterparties In Information Reporting” based on the memo included as Appendix 11. A detailed discussion of Appendix 11 was not undertaken at the meeting, but postponed to the next meeting.

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