

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

1. Date

September 18, 2008 (Thursday) 15:00 to 17:30

2. Place

JSDA Conference Room

3. Participants

As stated in Appendix 1

4. Agenda

- (1) Establishing procedures for evaluating, calculating, and communicating theoretical prices
- (2) Scope of securitized products

5. Summary of Proceedings

At the start of the meeting, the WG Chair made the following explanation of the WG's discussions schedule.

- The discussion of the Unified Information Disclosure Format (provisional name) would be divided into two sessions over the tenth and eleventh meetings.
- Establishing procedures for collecting and communicating details and risks of underlying assets would be discussed again in the eleventh meeting.

(1) Establishing procedures for evaluating, calculating, and communicating theoretical prices (continued)

The Secretariat announced the following proposal about what content should be included in the interpretations of the discrepancies between the expressions used in the Supervision Guidelines and the JSDA guidelines, a continuing topic from the last meeting, and where to put the interpretation text.

- The terms "securities companies" and "members" in the JSDA guidelines would be interpreted as meaning "association members" and the term "market price" in the JSDA guidelines would be interpreted as meaning "theoretical price" when market price was difficult to specify.
- The "interpretations" would not be included in the self-regulatory rules, but in the final report of the Working Group.

The Deputy WG Chair gave the following supplemental explanation on the proposal.

- In actual application to the business practice of securitized products, there are several patterns used for determining market price: A. there is a market price; B. there is no market price for the product, but a market price can be calculated rationally by making adjustments to the market prices of similar products; C. there is no market price for the product or equivalent products, but a market price can be calculated rationally using the market prices of the underlying assets; and D. there is no market price for the product or underlying assets, but a market price can be calculated rationally using the financial performance or other data of the underlying assets. The Practical Guidelines for Accounting for Financial Instruments contain instructions that when there is no market price, a market price shall be determined by "calculating a price in a rational manner." The proposal of the Secretariat is based on considering that prices calculated rationally in cases B. to D. (Theoretical price in the Supervision Guidelines) are to be considered market price.

A WG member asked where there is any difference in putting the interpretations in the self-regulatory rules or in the final report. The Secretariat answered by saying that putting the interpretations in the self-regulatory rules would give them a stronger regulatory tinge that would

detract from the instructions that the interpretations be based as much as possible on practical application.

The Secretariat's proposal was approved by the WG.

(2) Scope of securitized products

Note: As indicated in the Interim Report, since almost all securitized products are covered by the Supervision Guidelines, the scope of securitized products covers all securitized products with the exception of the products where there is no problem with traceability as noted in (1) to (5) in 4-(3)- "Scope of securitized products covered by the Supervision Guidelines"

A. The overall definition and scope of securitized products

First, the WG discussed the overall definition and scope of securitized products prior to the exclusion of securitized products from the scope where there is no problem with traceability (in other words, without considering whether the products are covered by the Supervision Guidelines or not). The WG members had the following opinions.

- Within the text of the definition of securitized products there probably should be a statement that "credit risk has been structured using subordination, over-collateralization or other schemes." By including this statement, we should be able to eliminate so-called "funds", products that are securitized capital financing loans of life insurance companies, and others from the definition.
- Nevertheless, there are some products that are commonly thought of as securitized products that do not use subordination, over-collateralization or other schemes.
- It would probably be better to start with a broad scope for securitized products and then eliminate the products for which there is no problem with traceability.
- If we limit the term "risk" in "the main purpose being the transfer of risk of specific assets" in the proposed definition of the WG Chair and Deputy Chair to "credit risk," we would be able to eliminate so-called structured bonds or notes, but on the other hand, we will not be able to include securitized products for which the main purpose is the transfer of risk other than credit risk.
- Can CDOs structured with credit derivatives which the precise risk of the product cannot be identified, such as total return swaps, be recognized as "securitized products" though these are credit-linked notes?
- Before considering the issue of whether credit-linked notes fall under the Supervision Guidelines or not, it is extremely difficult to determine whether they should be included in the scope of securitized products. To my mind, there is no clear border between credit-linked notes and CDOs. Conversely, even if credit-linked notes were included in the scope of securitized products, they could afterward be treated as being outside the scope of the Supervision Guidelines because they are products for which there is clearly no problem with traceability.

The WG Chair proposed the following overall definition for securitized products, which was approved by the WG.

- (a) The statement "credit risk has been structured using subordination, overcollateralization or other schemes" will not be included.
- (b) The "risk" in the WG Chair and Deputy Chair proposal will not be limited to "credit risk."
- (c) In addition to the above, if a product falls outside the definition of securitized products and this treatment is considered to be inappropriate, said product would be added to the definition on an individual basis.
- (d) The term "issues" in the WG Chair and Deputy Chair proposal will be revised to "issues (issued)."

B. Products removed from the scope of “the securitized products covered by the Supervision Guidelines”

Next, within the overall group of securitized products, the WG discussed the bounds of products removed from the scope of the securitized products covered by the Supervision Guidelines as products that have no problem with traceability.

“ Products that do not transfer all or part of the credit risk associated with specific assets to another party”

The WG members expressed the following opinions on the above issue.

- Because it is difficult to see exactly what the WG Chair and Deputy Chair are getting at, I think it would be useful to include a statement saying “can be seen in practical terms as being the same as an actual transfer of the specific asset to another party.” In addition, to maintain consistency with the content of the previous discussion of the overall definition and scope of securitized products, it should be made clear that “risk” is not limited to credit risk.
- The risk being targeted by the Supervision Guidelines is clearly credit risk.
- However, I don’t think that products should be automatically included in the scope of the Supervision Guidelines just because credit risk has been transferred to another party. For example, in first-to-default (FTD) swap products involving listed companies, because the location of the risk is clear, these transactions could be removed from the scope of the Supervision Guidelines even if they do fall within the definition of securitized products. Moreover, whether products are included or excluded in the scope of the Supervision Guidelines will differ even with identical products—for example, identical CPDOs—depending on the difficulty of tracing risk.

The WG Chair made the following proposal, which was approved by the WG.

- (a) The statement “can be seen in practical terms as being identical as an actual transfer of the specific asset to another party” will be included.
- (b) The term “credit risk” in the proposal will be revised to “risk.”

“Products for which risk is clearly located”

The WG members expressed the following opinions on the above issue.

- With ABCP that have 100% credit enhancement by bank, rather than the underlying assets of the ABCP, the focus of whether the location of risk is clearly on the bank’s credit enhancement. Therefore, we should include a statement indicating “products for which the location of the risk regarding the product is clearly located.”
- Should the CDOs with CDSs that involve credit risk of listed companies be included in the scope of securitized products (within scope of Supervision Guidelines)? If judged by whether or not the underlying assets are traceable, even though there are a great many companies involved, when the credit risk of each company is visible, these products could be left outside the scope of securitized products (the Supervision Guidelines) without a problem because of the traceability of the underlying assets.

A WG member brought up the issue of how securitized products that have guarantees should be treated when prepayment risk exists. In reply, the WG Chair said that products would not be excluded because of the risk of changes in the repayment schedule, including the existence of prepayment risk. In addition, the Deputy Chair said that there was not necessarily a clear risk in all cases of securitized products with guarantees and it would be better to look at the actual conditions and determine whether there was any risk on a case by case basis.

Another WG member asked how repackaged bonds or notes should be treated. In response, the Deputy Chair said that it would probably be best to judge each repackaged bond or note from the point of view of traceability.

Yet another WG member questioned whether CMBSSs comprising one-property split into equity and a single tranche should be outside the scope of the Supervision Guidelines because the risk was clearly located. The WG Chair replied that treatment might be different for single property products that were 100% performance linked, but regular CMBSSs would not be excluded because of the involvement of risk related to multiple loan tranches and the composition of maturities.

Several WG members said that the clauses of the self-regulatory rules related to the scope of the Supervision Guidelines would have to be simple. However, if to a certain extent there were not concrete indications of what products the guidelines applied to, it would cause difficulties in practical terms. Therefore, the WG members felt that it would be good to include specific examples in the final report.

The WG Chair announced the following intentions.

- The statement that “products for which the location of the risk regarding the product is clearly located” needs to be included.
- In the JSDA guidelines, we will state the basic principle. In addition, for the purposes of preventing unnecessary confusion in the market, we will give representative examples somewhere other than the self-regulatory rules, for example in the final report of the WG. Of course, these new self-regulatory rules must not become an obstacle to financial innovation. If the new self-regulatory rules become established in the market, when other highly individualistic or completely new products are developed, whether or not they are covered by the new self-regulatory rules will be decided based on whether market practitioners ensure traceability for investors at the points of origination or distribution. Moreover, because of the new self-regulatory rules, investors will likely require this type of feature. As the development of such products expands, it is possible that they will then be considered for coverage by the Unified Information Disclosure Format (provisional name) (UIDF) if it seems they are becoming commodity-type products.

“Structured bonds and notes”

The WG members expressed the following opinions on structured bonds or notes.

- Even if the number of companies involved is large, there isn’t a problem if the risk for each company is visible. Aren’t structured bonds and notes outside the definition of securitized products?
- The reason we proposed that the term “risk” in the overall definition of securitized products be limited to “credit risk” was to eliminate structured bonds and notes from securitized products. If risk is not limited to credit risk, then it will be necessary to provide a clear definition of structured bonds and notes.
- It would be good to provide an illustration of structured bonds and notes in the final report.
- There is a limit to what can be achieved with illustrations because new types of structured bonds and notes are constantly appearing.

Another WG member agreed with the previously mentioned idea that since the self-regulatory rules need to be simple, the supplemental and more detailed explanations should be given elsewhere. However, the WG member expressed the opinion that there would be a problem if these explanations were placed only in the final report of the WG, because they obviously cannot be revised and therefore would not be able to deal with new products that appear later. Therefore, it would be better to produce guidelines or a Q&A pamphlet that supplement the self-regulatory rules and could be revised as necessary.

In response, the Secretariat noted that while this also goes for illustrations and detailed explanations, it would not be possible to convey all the other interpretations decided in the WG only with the self-regulatory rules. Consequently, the Secretariat would produce a Q&A pamphlet to supplement the self-regulatory rules such as the one pointed out by the WG member.

“Securities stipulated in Article 2, Paragraph 1, Items 10 and 11 of the Financial Instruments and Exchange Act”

WG members expressed the following opinions on this subject.

- The proposal of the WG Chair and Deputy Chair on this topic limits its focus to investment trusts, which is a narrower focus than the interim report. The expressions should be restored to those used in the interim report.
- In the interpretation of “fund managers, etc.,” shouldn’t such trustees as those for Designated Money Trust with Stipulated Investment Targets be included as well as the operators of investment business defined by the FIEA?

For this proposal, it was decided to revert to the expressions of the interim report. In addition, it was decided to clarify the interpretation of “fund managers, etc.” in the Q&A pamphlet.

“Other products for with no traceability issue”

For “specified company bonds that have the capital financing notes or subordinated loans to life insurance companies as their specific assets,” it was decided to clarify to which products “products for which the location of the risk regarding the product is clearly located” applies in the Q&A pamphlet.

C. The scope of securitized products covered by the UIDF

The WG Chair made the following proposal, which was approved by the WG.

- (a) Only 4 types of products will be covered by the UIDF.
- (b) CBOs and CDOs will be handled as much as possible using the current CLO format.
- (c) Instructions for systematically determining whether newly emerging products should be covered by the UIDF will be included in the final report of the WG.

D. Securitized products not covered by the JSDA

The WG Chair made the following proposal, which was approved by the WG.

- (a) Whether companies are JSDA members or not, the WG will recommend in its final report that procedures with the same purpose be established by all parties regarding traceability when they distribute asset backed loans (ABLs) to others.
- (b) Provided that for the “part regarding theoretical price,” there will be no particular recommendation made.

A WG member gave the opinion that “deemed securities” seemed to be a field in which only real estate businesses were involved. Therefore, it also seemed to be unrealistic to make such broad-sweeping recommendations. The WG Chair explained that the recommendations were only trying to deal fairly with products of the same type and were not intended to create any obstacles to the operations of real estate businesses.

At the end of the meeting, the WG Chair made the following statements.

- Based on the discussion today, the WG Chair and Deputy Chair would revise the proposal on the scope of securitized products. The revised proposal will be sent to WG members by the Secretariat and would be finalized at the next meeting.
- During the period up until the putting together of the final report, the WG Chair asked WG members to submit their opinions on the examples of individual products to be given. The WG Chair planned to create an opportunity to discuss those opinions.

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