

10 March 2008

Securities Business Division
Supervisory Bureau
Financial Services Agency
Government of Japan
3-2-1 Kasumigaseki, Chiyoda-ku
Tokyo 100-8967 Japan

Via e-mail to: shouken@fsa.go.jp

Re: Public Consultation on the partial amendment of the Guidelines for Financial Instruments Business Supervision

Sirs:

The CFA Institute Centre for Financial Market Integrity¹ (the “Centre”) and CFA Society of Japan² (“CFAJ”) thank the Financial Services Authority for the opportunity to comment on the new proposed rules on the *Guidelines for Financial Instruments Business Supervision*, issued on 06 February 2008 (the “Proposal”). With headquarters in New York, USA, the Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

The Centre and CFAJ commend the FSA for taking the initiative to introduce regulatory solutions to some of the problems that led to the subprime crisis and the subsequent difficulties, such as the dislocation in capital markets, which have collectively imposed significant challenges in financial markets and systems worldwide. The Proposal, which follows the *First Report of the Financial Markets Strategy Team* in November 2007, demonstrates that the FSA understands not only the global ramifications of the current situation but also its urgency, and that the FSA is prepared to apply the lessons from the current crisis through proactive regulation. This bodes well for Japanese government’s effort to internationalize its capital markets.

¹ The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 91,500 financial analysts, portfolio managers, and other investment professionals in 134 countries of which more than 78,200 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute membership also includes 134 Member Societies and Chapters in 55 countries and territories.

² Based in Tokyo, the CFA Society of Japan is a professional society comprised of 900 members who are mostly practitioners in the investment and fund management industry in Japan. Its mission is to promote global best practice in the areas of financial analysis, investment decision making, and ethical and professional conduct to contribute to the further improvement of capital market integrity and the investment profession in Japan.

The FSA is correct in identifying that among the main factors that led to the subprime crisis are the lack of communication of underlying risk among the players, the insufficient risk-awareness of investors with regards to securitized instruments, and the independence and transparency of the credit rating process for subprime and securitized credit products. As the FSA has identified in one of its proposals, one of the biggest puzzles in the financial sector today is putting a market value on the subprime securities still outstanding. We believe this is an inevitable result of the information asymmetry that existed between the entities involved in their creation – from the borrowers and originators of mortgage loans, to the arrangers and distributors of the securitized products, to the credit rating agencies and investors.

With this as the background, the CFA Institute Centre and CFAJ would like to comment on the item in the Proposal that is most relevant to our work in capital markets policy, namely, on **ensuring the traceability of securitized products.**

1. Prior to sales, carry out internal analysis of the underlying assets' contents and risk to enable the provision of appropriate information when required.

The Centre and CFAJ are very much in support of the principle of this proposal. In its representation to regulators in the United States, the Centre has stood by its view that originators and arrangers of asset-backed securities should make available all relevant information about the pool of assets used in (or the contents of) a securitized product, the structure of the product, and the servicer³ of the product prior to its issuance. The Centre has also advocated that credit quality and performance information about the underlying assets behind the securities be made available on an ongoing basis.

The challenge of the proposal is identifying the relevant information that should be internally analyzed and subsequently made available to the chain of players involved in the sale of the securitized products, including the ultimate investors. While originators and arrangers should be able to analyze the contents of the underlying assets with great level of detail, it may be impractical to expect credit rating agencies and distributors of securitized products – the party with the most direct interface with investors – to inspect and value every asset included in a securitization pool. The Centre and CFAJ therefore believe that guidance is needed with regards to the pieces of information that should be reasonably shared among the key players involved in the securitization market.

For this purpose, the Centre and CFAJ believe that the following are some of the relevant pieces of information: 1) average balance; 2) loan-to-value ratios; 3) percentage of the portfolio with full documentation; 4) geographic concentrations; 5) deal structure; 6) percentages of the portfolio suffering from 30-, 60-, and 90-day delinquencies; 7) defaults; 8) prepayments; 9) real-

³ Typically the entity that receives payments from borrowers and pays interest and principal to investors in asset-backed securities (ABS), known as the “Servicer,” is the same company whose activities gave rise to the issuance of the ABS. ABS investors need relevant information about the Servicer to understand the long- and short-term risks associated with receiving their principal and interest payments when due. An exemption from reporting on these corporate events would put ABS investors at a disadvantage to both the company and to investors in other securities issued by the company.

estate owned; and 10) remaining balances. Furthermore, items 6 through 10 above should be analyzed and made available for disclosure **on an ongoing basis**.

The Centre and CFAJ believe that the new proposed supervisory checkpoint can be effective and enforceable as long as it provides guidance on the scope of the internal analysis necessary for communication; the analysis is done on a regular basis depending on the life of the product; and the outcome of the analysis is communicated to all entities involved, including the end-investors.

2. When selling securitised products, internal procedures and rules exist so that internal analysis of underlying assets' contents and risk, and liquidity risk not reflected in the rating is communicated internally. Merely depending on ratings is inappropriate when selling the product.

The Centre and CFAJ are very much in support of this proposal. We believe that the securitization market has reached a point where credit ratings have become a major, if not the most important, determinant of investment decisions. The Centre has recently proposed to IOSCO, in light of the organization's ongoing review of its *Code of Conduct Fundamentals for Credit Rating Agencies*, that credit rating agencies: 1) use a rating nomenclature that distinguishes structured products from both corporate and commercial paper ratings to help investors recognize the differences; 2) refine or otherwise eliminate the concept of "investment grade" wherever possible to reduce the incidence of misconception about the purpose of the CRA's ratings; and 3) refrain from rating new structured products until the statistical data are sufficiently robust to produce a defensible rating.

Absent these mechanisms, and in light of the current weaknesses in the credit rating process, the Centre and CFAJ believe it has become imperative for all entities involved in the creation and sale of securitized products – from the originators to the investors – to conduct their own due diligence on the contents and structure of these products to fully comprehend their inherent risks, especially where the underlying assets include subprime mortgages. One example of such due diligence is to perform stress-testing on the portfolio to visualize how its valuation and liquidity would perform in difficult situations, including a period of financial crisis.

We therefore support the FSA's initiative to require these entities to set up internal rules and procedures for continuously and regularly analyzing the underlying assets' inherent and liquidity risks, regardless of the rating already assigned by credit rating agencies to these instruments. For practical considerations, we further add that these rules and procedures must be determined at the company level, and subsequently reported to and validated by the FSA to ensure that they meet the standard of diligence that the FSA deems appropriate.

3. Ensuring that internal procedures and rules exist so as to enable information of the underlying assets' contents and risks to be available to customers/investors when requested.

The Centre and CFAJ believe that this is the crux of the Proposal for ensuring the traceability of securitized products. We fully support the FSA's view that entities involved in the creation and sale of these instruments must have rules and procedures ensuring transparency with regards to their inherent risks. Originators and arrangers must have the readiness and the ability to disclose to credit rating agencies, distributors and investors information about their most current analysis

of the credit quality and performance of the underlying securities. Equally important, a mechanism must be in place – such as in the prospectus or via a provision in the securities purchase agreement – to make sure that such information is indeed accessible to the securities distributors and investors without preconditions or prejudice. We believe that a formalized system of communicating risks is a necessary, if not sufficient, condition for the information asymmetry currently inherent in the securitization market to be eliminated or minimized at least.

4. Ensuring that even when the market value of the product is difficult to ascertain, procedures exist so as to enable smooth provision of information on the theoretical price and valuation when requested. Procedures should exist so that the valuation process is objective and appropriate.

The Centre and CFAJ agree with this proposal, and even go a step further by calling on underwriters or arranging institutions to create a transparent secondary trading market. The goal is to increase transparency in the pricing methods and methodology of mortgage structured products and their derivatives. These markets would include specialists or market makers who would step in and provide liquidity into the market for products and structures they have created.

The CFA Institute Centre for Financial Market Integrity and CFA Society of Japan laud the Financial Services Agency to take the initiative in finding solutions to the subprime crisis and subsequent difficulties it has imposed on global financial markets and systems. We appreciate your consideration of our comments. If you feel that we can provide additional information, please do not hesitate to contact Lee Kha Loon at +852.3103.9303 (khaloon.lee@cfainstitute.org) or Yasuhiro Oshima at +813.5549.5314 (yasuhiro.oshima@sgcib.com).

Yours sincerely,

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