Newsletter

Atsumi & Sakai

JAPANESE NEW RISK RETENTION RULES FOR SECURITIZATIONS

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TOKYO | LONDON | FRANKFURT
www.aplaw.jp/en

March 2019

March 2019
No. A&S (EN)_005

Japanese New Risk Retention Rules for Securitizations

On March 15, 2019, the Financial Services Agency of Japan ("FSA") published the partial amendments to notices on the capital ratio requirements (Pillar I, Pillar III) etc. and the results of the public comments[1]. These amendments include the new risk retention rules which will be introduced from March 31, 2019. The new risk retention rules require banks and certain other financial institutions (collectively, "Affected Financial Institutions")[2] which make investments in interests in securitizations to apply higher risk weighting to a securitization exposure unless such Affected Financial Institutions satisfy certain risk retention requirements. In this newsletter, we outline the new risk retention rules.

1. What's Risk Retention?

Risk retention means, in the context of securitization transactions, an originator and other relevant parties retain some portions of risks in original assets being securitized.

In cases where an originator transfers its assets to a securitization vehicle for the purpose of obtaining funding, the originator may pass credit risks in the original assets to investors without carefully analyzing the quality of such assets. The risk retention rules are designed to increase the originator's incentive to form appropriate assets being securitized by mandating that the originator retains some portions of risks in the original assets.

2. Comprehensive Guidelines for Supervision of Major Banks, etc.

After 2009, based on the international financial crisis triggered by the subprime loan problem in the United States, the risk retention rules have been globally discussed, which includes the Declaration of the G20 London Summit (2009)[3] and Recommendation to Strengthen Oversight and Regulation of Shadow Banking published by the Financial Stability Board (FSB) (2011)[4]. In November 2012, the International Organization of Securities Commissions (IOSCO) issued a final report entitled "Global Developments in Securitisation Regulation"[5] and recommended that regulators and policy makers implement risk retention regulations. On April 30, 2015, based on the recommendation, the FSA introduced the

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[1] FSA , "Regarding the publication of the partial amendments to notices on the capital ratio requirements (Pillar I, Pillar III) etc. and the results of the public comments"
(https://www.fsa.go.jp/news/30/ginkou/20190315-1.html)

[2] The Financial Institutions subject to the new risk retention rules include banks and other depositary institutions, bank holding companies, ultimate parent companies of large securities companies designated by the FSA.

[3] G20 London Summit, April 2, 2009, "Declaration on Strengthening the Financial System"
(https://www.mofa.go.jp/policy/economy/g20_summit/2009-1/annex2.html)

[4] FSB, "Recommendations to Strengthen Oversight and Regulation of Shadow Banking"
(http://www.fsb.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/)

[5] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf

current risk retention rules by amending the supervisory guidelines[6] applicable to banks, insurance companies, securities companies ("Supervisory Guidelines for Financial Institutions").

The Supervisory Guidelines for Financial Institutions require banks and other certain financial institutions to do the following actions when they make investments in interests in securitization products[7]:

- to check if an originator continuously retains parts of risks in the related securitization product; and

- in cases where the originator doesn't retain such risks, to deeply analyze the originator's involvement in the formation of original assets and the quality of the original assets.

Under the current rules, the originator does not have any direct obligation to retain the credit risks in the relevant securitization. Therefore, in this regulatory regime, it can be allowed that the originator form the origination of the original assets and that investors make investments in securitization products, even though the originator does not hold some portions of risks in the relevant securitization transactions.

3. The Partial Amendments to the FSA Notices on the Capital Ratio Requirements (Pillar I)

(1) Outline of the New Risk Retention Rules

The FSA introduces the new risk retention rules by amending the FSA Notices on the Capital Ratio Requirements (Pillar I)[8]. Under the new rules, the Affected Financial Institutions must:

(i) confirm if the originator of the related securitization transaction retains a securitization exposure equal to not less than 5% of the total of original assets being securitized; and

(ii) as a general rule, apply triple risk weighting (capped at 1,250%) to the related securitization exposure in cases where the Affected Financial Institutions cannot confirm the compliance of the 5% risk retention requirements[9].

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[6] FSA, "Regarding the publications of the partial amendments to the supervisory guidelines in relation to the securitization risk retention rules" (https://www.fsa.go.jp/news/26/20150430-5.html). The supervisory guidelines mean guidelines for administrative employees who are in charge of supervising financial institutions such as banks.

[7] With respect to banks, Comprehensive Guidelines for Supervision of Major Banks, etc. III-2-3-3-2(3)②二 (https://www.fsa.go.jp/common/law/guide/city/03b.html)

[8] Partial Amendments of the FSA Notices on the Capital Ratio Requirements (Pillar I) (https://www.fsa.go.jp/news/30/ginkou/20190315-1.html)

[9] With respect to banks, Chapter VIII, Section I, Article 248, paragraph 3 of the FSA Notice on "the Standards for a Bank to Determine the Sufficiency of Equity Capital in Light of the Assets Etc. Held Pursuant to Article 14-2 of the Bank Act (FSA Notice No.19, 2006) ("Notices on the Capital Ratio Requirements") (https://www.fsa.go.jp/news/30/ginkou/20190315-1/09.pdf)

As with the current rules, the new rules do not impose direct obligations on the originator to comply with risk retention requirements. In addition, the new rules require the Affected Financial Institutions to secure an adequate level of capital in consideration of the risk retention status of the originator and any other relevant parties, though the current rules do not set out the status and the adequate levels of credit risks held by the originator. In this regard, the new rules are additional regulations to the current rules.

(2) The 5% Risk Retention Requirements

In the risk retention rules, it sets out four types as a method for the 5 % risk retentions held by the originator[10].

(i) Vertical Type
The credit risks can be held vertically, meaning that an equal potion of all tranches held, and the total amount of the securitization exposure is 5% or more of the aggregate exposure of the original assets for the related securitization transaction (See Example 1 in the Exhibit).

(ii) Horizontal Type
The credit risks can be held horizontally, meaning that all or parts of the most junior tranche held, which is 5% or more of the aggregate exposure of the original assets for the related securitization transaction (See Example 2 in the Exhibit).

(iii) L-shaped Type
If the most junior tranche is less than 5% of the aggregate exposure of the original assets, the credit risks can be held as combination of vertical and horizontal, meaning that all of the most junior tranche together with an equal potion of other tranches held, and the total amount of the securitization exposure is 5 % or more of the aggregate exposure of the original assets for the related securitization transaction (See Example 3 in the Exhibit).

(iv) Other Type
The credit risks can be held if they are considered to be equal to or not less than each of the foregoing items (i) through (iii). The status of the credit risks held by the originator must be judged specifically in each individual case. However, Q&A of the FSA Notices on the Capital Ratio Requirements[11] provides the following cases as examples of this category[12].

(a) the originator holds 5% or more of each tranche (See Example 6 in the Exhibit);

(b) the portion of the most junior tranche held or the aggregation of subordinated tranches in order of subordination held is less than 5%, and the originator holds all these

[10] With respect to banks, Chapter VIII, Section I, Article 248, paragraph 3, item (i) through (iv) of the Notices on the Capital Ratio Requirements,

[11] FSA, "Q&A of the FSA Notices on the Capital Ratio Requirements" in relation to "Partial amendments to the FSA Notice regarding Capital Ratio Requirements (Pillar I, Pillar III)" etc. (review of the capital charges framework of securitization products) ("Q&A") （https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf）

[12] Q&A, <Standards for judging the status of credit risks held by the originator>, Article 248-Q4

tranches together with subordinated tranches to these tranches in order of subordination, and the sum of these tranches held is 5% or more of the total (See Example 5-1 and 5-2 in the Exhibit); and

(c) the portion of the most junior tranche held or the aggregation of subordinated tranches in order of subordination held is less than 5%, and the originator holds all these tranches, and holds each of the tranches other than the foregoing tranches equally, etc., and the sum of these tranches held is 5% or more of the total (See Example 6 in the Exhibit).

It should be noted that although the originator retains 5% and more securitization exposure, it can be judged that the originator does not retain credit risks in effect in cases of hedging such credit risks by a guarantee or purchasing CDS etc.[13]. As a method to confirm whether the originator has hedged credit risks etc. or not, it can be confirmed by requesting the arranger to disclose information or requesting the originator to submit a written confirmation, etc.

(3) Timing and Method of Confirming the Status of Credit Risks Held by the Originator

As a rule, whether the 5 % risk retention requirements are satisfied needs to be judged on a continuing basis, not only at the time of acquisition of securitization products but also each time of measurement of risk assets by establishing a system for due diligence[14].

Also, whether the 5 % risk retention requirements are satisfied can be confirmed by obtaining a written confirmation from the originator. In addition, if it is difficult to confirm in writing, it would be permissible to confirm by any other reasonable means such as an oral confirmation from the parties related to the originator, etc. instead of a written confirmation[15].

(4) Exceptions of the 5 % Risk Retention Requirements

The Affected Financial Institutions do not have to apply higher risk weighting to a securitization exposure in cases where it is judged that the original assets have not been inappropriately formed based on various factors such as the status of the originator's involvement in the formation of the original assets, the quality of the original assets or any other circumstances. What cases fall under the exceptions will be discussed in section 5 in this newsletter.

[13] Q&A, <Standards for judging the status of credit risks held by the originator>, Article 248-Q3

[14] Q&A, <Timing and method of confirming the status of credit risks held by the originator >, Article 248-Q5

[15] Q&A, <Timing and method of confirming the status of credit risks held by the originator >, Article 248-Q5, and No. 26 of the FSA's response to the public comments.
(https://www.fsa.go.jp/news/30/ginkou/20190315-1/02.pdf)

(5) Effective Date

The new risk retention rules will be effective on March 31, 2019 ("Effective Date")[16]. However, with respect to securitization products held by the Affected Financial Institutions on the Effective Date, the rules are not applicable to such Affected Financial Institutions which continuously hold such securitization products[17].

It should be noted that the new rules do apply to existing securitization products on the Effective Date, meaning that the rules apply to securitization products which the Affected Financial Institutions purchase after the Effective Date, even though such securitization products are formed prior to the Effective Date.

4. How to Deal with CLOs

While Japanese financial institutions invested significantly in U.S. CLOs most of which are AAA Open Market CLOs, in early January overseas media alerted that the U.S. CLO market may be at risk from the Japanese rule change as it could make it more difficult for such investors to continue said investment. The Loan Syndications and Trading Association (LSTA) had been discussed with the FSA regarding the treatment of Open Market CLOs and submitted their comment letter[18] under the public consultation process to the effect that investors in Open Market CLOs should be excluded from higher capital charges.

However, we have not been aware of such a risk as the media reported as far as we have been involved in U.S. Open Market CLOs. In response to the comments to the effect that Article 248, paragraph 3 should be removed[19], the FSA considered the dialogue with investors, etc. that have been conducted so far and is trying to clarify by Q&A the cases where it can be judged that "the original assets have not been inappropriately formed " so that it would avoid unintended excessive consequences that could be caused by the introduction of this rules[20]. As a practical matter, as is often the case with Open Market CLOs the focus of discussion is now on how to conduct due diligence in order to judge that the original assets have not been inappropriately formed pursuant to Q&A.

5. Cases Where It is Judged that " the original assets have not been inappropriately formed "

Q&A[21] cites the following cases as examples of cases where the original assets have not been inappropriately formed:

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[16] The FSA Notice regarding Capital Ratio Requirements, Supplementary Provisions, Article 1

[17] FSA Notice regarding Capital Ratio Requirements, Supplementary Provisions, Article 4

[18] https://www.lsta.org/news-and-resources/news/japanese-risk-retention-the-lsta-weighs-in

[19] For the comments of Japan Bankers Association,
https://www.zenginkyo.or.jp/fileadmin/res/abstract/opinion/opinion310125.pdf
For the comments of Securitization Forum of Japan,
http://www.sfj.gr.jp/opinion/data/public/190128.pdf

[20] No. 49 and No. 50 of the FSA's response to the public comments.

[21] Q&A, < Cases where it is judged that " the original assets have not been inappropriately formed " >, Article 248-Q2

(1) Examples of cases where it can be confirmed that the originator, etc. bears the credit risks equivalent to or not less than those listed in Article 248, paragraph 3:

- Even if it cannot be confirmed that the originator bears the credit risks in a manner that satisfies the conditions listed in Article 248, paragraph 3, the credit risks are borne by any related party other than the originator such as the originator's parent company or the so-called arranger deeply involved in the origination of the securitization product, and it can be confirmed that the total sum of such credit risks borne by these persons and the originator is equal to or not less than the amount of credit risks listed in Article 248, paragraph 3;

- Although the originator does not bear the risks by retaining securitization exposure, the originator has provided credit enhancement with respect to any subordinated portion, and it can be confirmed that such credit risks borne by these persons are equal to or not less than the credit risks listed in Article 248, paragraph 3;

- In a case where the receivables, etc. are randomly selected as the underlying assets from the pool of assets containing a large number of claims, etc. (excluding securitization products), it can be confirmed that the credit risks to be borne by the originator, etc. by continuously retaining all the receivables, etc. other than the original assets that become the underlying assets contained in such pool of assets (or by continuously retaining the receivables, etc. randomly selected from the pool of assets concurrently with the receivables that constitute the original assets), accounts for 5% or more of the total exposure of such pool of assets; and

- In a synthetic securitization transaction, it can be confirmed that the originator and investors share the losses incurred by the receivables that are the original assets and that the originator bears the credit risks equivalent to or not less than those listed in Article 248, paragraph 3.

(2) Example of cases where it is judged that the original assets have not been inappropriately formed by performing in-depth analysis on the quality of the original assets:

- As with such securitization products of which the underlying assets are real estate (including trust beneficial interest in real estate) for which an appropriate appraisal report or engineering report has been prepared, regardless of whether the originator bears risks, it can be judged from objective documents, etc. that the original assets have not been inappropriately formed;

- Where the person who originates a securitization product does not originate the same using the assets held by it as the original assets but originates a securitization product by purchasing receivables from the market as the original assets, it can be judged from objective documents, etc. that the quality of such receivables procured from the market is not inappropriate.

Q&A elaborates methods of judging "the quality of the original assets" as follows:

- When making investment in a securitization product, it is particularly important to perform in-depth analysis on the quality of the original assets from the perspective of credit risks, etc. For this reason, as a method of judging the quality of the original assets, it is considered insufficient to make a judgment only based on the external rating of such securitization product and the transaction price of the original assets in the market, or the short-term performance of the original assets (especially during a boom period).

- In addition to the above, for example, if the original assets are loan receivables, then it is required to confirm and verify from the perspective of whether the loan screening criteria used by the originator are appropriate, whether the loan contract covenants contribute to the protection of the rights of investors, whether the content and terms of the security for the loan receivables are appropriate, or whether there are any problems with the ability of the originator or the servicer, etc. to collect receivables.

- When making the foregoing confirmation and verification, it is necessary to actually confirm and verify the loan receivables that are the original assets for the securitization product. As a method thereof, if it is difficult for the financial institution itself to do so, upon confirming whether the purpose and reasonable standards of acquisition and replacement of the loan receivables by the securitization vehicle have been established (whether excessive discretion has not been given to the persons involved in the origination of the securitization product with regard to selection of the original assets), it is possible to confirm and verify in a timely manner that the receivables that will become the original assets have been appropriately acquired and replaced in accordance with said criteria (e.g., confirm and verity, as necessary, by conducting a sample check of the original assets that have been actually acquired and replaced).

- Other than the above, it is also considered desirable to conduct a risk analysis of the securitization product as a whole by performing stress tests based on reasonable scenarios and periods, etc.

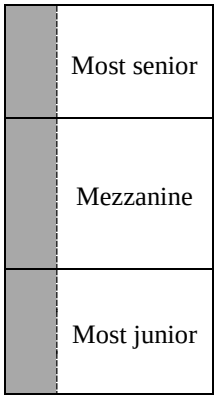
- Based on the results of the foregoing confirmation and verification, it is necessary that it can be judged that the original assets have not been formed inappropriately in light of the investment criteria provided by the financial institution.

(3) Example of cases where the requirements under Article 248, paragraph 3 cease to be satisfied due to changes in the situation after the acquisition of the securitization product but it can be judged that the risks have been continuously retained:

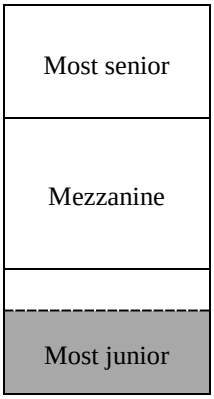
- The originator satisfies the conditions listed in Article 248, paragraph 3 at the time of the acquisition of the securitization product and in spite of the fact that the originator continues to hold such exposure, the total amount of exposure held by the originator has fallen below the requirements under Article 248, paragraph 3 due to a default of the original assets.

Exhibit

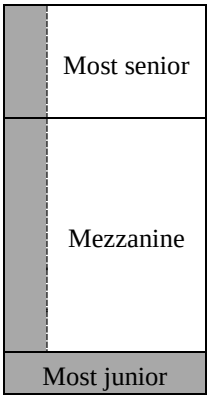
Example 1



Example 2

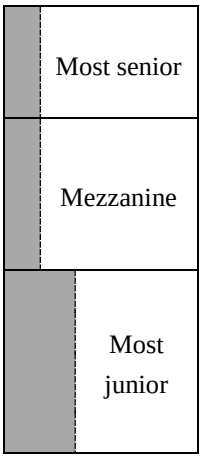


Example 3

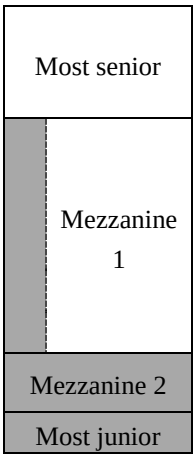


*The most junior tranche by itself does not reach 5% of the total amount of exposure of the original assets.

Example 4

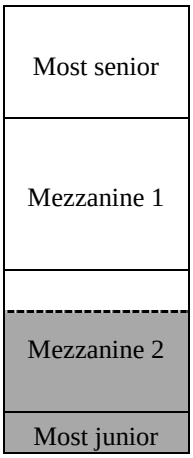


Example 5-1



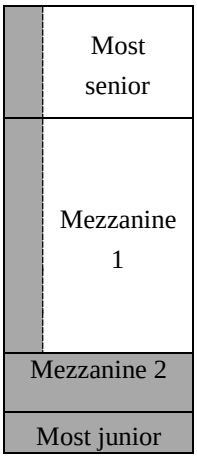
*The most junior and mezzanine 2 tranches by themselves do not reach 5% of the total amount of exposure of the original assets.

Example 5-2



*The most junior tranche by itself does not reach 5% of the total amount exposure of the original assets.

Example 6



*The most junior and mezzanine 2 tranches by themselves do not reach 5% of the total amount of exposure of the original assets.

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