NEW JAPANESE SECURITIZATION RISK RETENTION RULE AND ITS IMPACT ON CLO INVESTORS IN JAPAN

Date: 22 May 2019

Investment Management Alert

By: Anthony R.G. Nolan, Yuki Sako

In December 2018, the Financial Services Agency of Japan (the "JFSA") proposed amendments to its regulations[1] under the Banking Act of Japan to introduce a new risk retention rule applicable to collateralized loan obligations ("CLOs"), along with other amendments that relate to bank capital related rules, and sought public comments. On March 15, 2019, after considering public comments submitted in response to the December proposal, the JFSA adopted the final rule (the "Rule"). As usual, the JFSA also published its views and guidance on certain issues raised in the public comments and updated Q&As regarding bank capital requirements, including guidance on an exception to the Rule. The Rule became effective March 31, 2019, for securitization exposures acquired after that date. The Rule applies to all securitizations, but it predominantly affects the CLO market because of the importance of Japanese banks as investors in US and European CLOs. This note focuses on the application of the Rule to investments in CLOs.

By way of background, given the extremely low interest rate environment in Japan, senior tranches of CLOs have been popular among certain Japanese banks. There are several reasons for this, but the key driver is that CLOs provide slightly higher returns than domestic products, particularly as cross-currency hedging spreads have widened in recent months. However, there have been concerns about the risk that CLOs and other securitizations may pose to financial stability, which led the Basel Committee on Banking Supervision to publish standards on capital treatment of securitization exposures, most recently in the so-called Basel III regulations implemented in all major economies.[2] In response, the JFSA introduced the Rule to require the originators or arrangers of CLOs and other securitizations in which Japanese banks invest to have "skin in the game" because of concern that financial stability of the Japanese banking system could be threatened if large banks suffer damage to their CLO investments.

Prior to the Rule, the JFSA supervisory guidelines instructed Japanese institutions to review whether an originator of a securitized product retains a portion of the risks associated with the respective CLO, and if not, to thoroughly review the nature/level of the originator's involvements with the original assets and the quality of the original assets. However, there was no "regulation" that mandated risk retention on the part of originators of securitized products.

The Rule is similar to the European risk retention regime in that it places a due diligence obligation on Japanese bank investors in CLOs and penalizes them directly for investments in CLOs that do not comply with the risk retention requirements of the Rule.[3] This is very different from the originator being the only party penalized for non-compliance with risk retention requirements and banks being simply prohibited from holding ownership interests in non-compliant CLOs.

Establishing a Due Diligence System

Under the Rule, banks are required to establish systems and processes to, in essence, (i) continuously collect information on the comprehensive risk characteristics of its securitization exposures; (ii) collect, in a timely basis, information on the comprehensive risk characteristics and performance of the underlying assets in the securitizations; (iii) identify structural characteristics of the securitization transactions related to the securitization exposure held by them; and (iv) establish and implement internal policies and procedures reflecting these systems and processes.[4]

5% Risk Retention

In addition, the Rule effectively requires banks to treble the weighted securitization exposure risks unless they can confirm that the originator or arranger retains credit risk equivalent to 5% or more of risk exposures of original assets, whether in a vertical, horizontal or L-shaped form, or unless the transaction benefits from the exception described below.[5]

Exception to the 5% Risk Retention Requirement

An exception to the 5% risk retention requirement exists if a bank determines, based on "the situations in which the originator is involved with the original assets, the quality of the original assets and other facts and circumstances,"[6] that "no improper original assets are structured." (futekisetsuna genshisan no sosei ga nasareteinai)[7] While these terms require careful interpretation and application, as noted above, both the JFSA's response to the public comments and the Q&As provide some guidance for interpreting the requirements to rely on this exception including various examples. This is analogized by some to the exclusion of open-market CLOs from risk retention in the U.S., following a United States Court of Appeals decision in February 2018 which held that the U.S. risk retention requirements do not apply to CLOs backed by broadly syndicated loans acquired in the open market if the asset manager does not own or make the loans to collateralize the CLO.[8]

On the other hand, the JFSA made it clear in its response to public comments and Q&As that, while a bank may determine that certain open market CLO satisfies the exception that "no improper original assets are structured", such decision should be made based on objective evidence, which (a) cannot be its independent credit rating, pricing at the market, and short-term performance alone, but, however, should also (b) include review and analysis of, for example, the appropriateness of credit review standards applied to underlying loans, loan covenants, and collaterals thereunder, claim collection ability of the originator or servicers. In light of such required review and analysis, the JFSA noted in the Q&As that, if review and analysis of each of the individual loans is difficult, for example, the bank should review whether objective and reasonable standards for the acquisition and replacement of loans are implemented by the CLO manager (namely, whether the CLO manager is not granted the broad discretion in selecting underlying loans), and confirm that loans are acquired and replaced as underlying assets in accordance with such standards by way of reviewing sample assets. The JFSA also noted that it recommends risk analysis that potentially involves stress tests.

In summary, the Rule requires that Japanese banks hold excess capital against all securitization exposures unless the "originator" (including a CLO manager) retains, on a continuous basis and without hedging the credit risk, at least 5% of the exposure of the securitization in horizontal, vertical, or "L-shaped" form or unless it is determined through due diligence that "no improper original assets are structured."

In response to the Rule, Japanese bank investors are expected to conduct even more extensive due diligence than they would traditionally have done before. While there is anecdotal evidence that Japanese bank investors have begun to adapt to the new due diligence requirements, Japanese bank investors and CLO managers seeking their investments will continue to grapple with a series of open issues in establishing a basis for making a determination that the "no improper original assets are structured" in a CLO. This determination could be difficult because it requires judgement based on specific facts and circumstances. Other substantive issues may include the use of so-called "covenant-lite" loans, what constitutes adequate collateral, underwriting standards, and "claims collection ability." Among the procedural issues, with respect to a manner of determination, the JFSA noted that, while, generally, written statements issued by the originator are preferred, if it is practically difficult, it is permissible to use other reasonable methods such as diligence interviews of the originator or manager.

The Rule also includes various transition measures. For example, the Rule does not cover investments in CLOs held by a Japanese bank on March 31, 2019, as long as those "grandfathered" investments continue to be held by the bank. Thus, the Rule only applies to new transactions with Japanese bank investors.
As a practical matter, the compliance tasks for Japanese banks under the Rule may depend heavily on the type of CLO investment under consideration and where the investment is sourced. In the case of investments in open market CLOs originated in the U.S., the focus of a Japanese bank investor will be on confirming that "no improper original assets are structured" in the CLO, as those CLOs are excluded from the risk retention requirements of both Japanese and US law. In the case of US middle market CLOs and European CLOs the due diligence task may involve a more straightforward analysis of whether the sponsor has properly retained 5% risk under applicable law. In the case of European CLOs, if the Japanese bank is an "institutional investor" that is established or located in the EU for purposes of the EU Securitisation Regulation, it may be subject to separate due diligence requirements under European law. In that case it would be important to ensure that the bank's processes for conducting due diligence under the Rule are coordinated with those required by Article 5 of the EU Securitisation Regulation.

Notes:

[1] Standards for a Bank to Determine Whether Circumstances of Enhancement of its Capital is Appropriate in Light of the Assets, etc. the Bank Holds, Pursuant to Article 14-2 of the Banking Act of Japan (Public Notice of Financial Services Agency of Japan, No. 19 of 2006, as amended) (the "FSA Capital Public Notice").

[2] *See* "Basel III: Finalising post-crisis reforms," Basel Committee on Banking Supervision (December 2017).

[3] *See* Article 248 of the FSA Capital Public Notice. For the EU risk retention requirements, see Regulation (EU) 2017/2402 (the "EU Securitisation Regulation"). Article 5 of the EU Securitisation Regulation imposes due diligence obligations on "institutional investors" as defined therein.

[4] Article 248(1) of the FSA Capital Public Notice.

[5] Article 248(3)(i)-(iv) of the FSA Capital Public Notice. To satisfy the risk retention requirement under the Rule, credit risks can be retained by holding, either, (i) the least senior tranche(s) horizontally, which amount to 5% of exposure of the total amount of original assets (horizontal form), (ii) 5% or more of every tranche vertically, which collectively amount to 5% of exposure of the total amount of original assets (vertical form), or (iii) tranches in the combination of horizontal and vertical forms which collectively amount to 5% of exposure of the total amount of original assets (L-shaped form). Note the Q&As provide examples for each category.

[6] Article 248(3) of the FSA Capital Public Notice.

[7] *Id.*

[8] For the US rule, see 12 C.F.R. Part 244 (Regulation RR). For the appellate court decision, see *Loan Syndications and Trading Ass'n v. Securities and Exchange Commission et al*, Case No. 17-5004, (DC Cir. February 9, 2018).

KEY CONTACTS

ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

YUKI SAKO
COUNSEL

WASHINGTON DC, TOKYO
+1.202.778.9061
YUKI.SAKO@KLGATES.COM

