

Follow up on the "Act on Provisional Measures for the Facilitation of Financing to Small and Medium Sized Businesses" (the "Moratorium Act") including the effect on securitization transactions

The Bill on Provisional Measures for the Facilitation of Financing to Small and Medium Sized Businesses (the "Moratorium Bill") which we referred to in our News Letter of November 12, 2009 ("November 09 Newsletter") passed the Diet and was adopted, without amendments, as law, being promulgated as the "Act on Provisional Measures for the Facilitation of Financing to Small and Medium Sized Businesses"¹ (the "Moratorium Act"). In connection therewith, the relevant Cabinet and Ministerial Ordinances, the supervisory guidelines (the "Supervisory Guidelines") used by the Financial Services Agency (the "FSA") in supervising financial institutions and the inspection manuals (the "Inspection Manuals") used by the FSA for conducting inspections over financial institutions were amended. Of particular note, a "Checklist on the Chapter for Facilitation of Financing", which provides a detailed list of what inspectors should look for when conducting financial inspections, was newly introduced in the Inspection Manuals.

The above was implemented as of December 4, 2009; provided, however, that the legal obligations explained in 1(b) below and the amendments to the Supervisory Guidelines and Inspection Manuals related thereto shall be implemented as of February 1, 2010. This News Letter will summarize developments surrounding the Moratorium Act since our November 09 Newsletter.

1. Contents of the Moratorium Act

The Moratorium Act requires "Financial Institutions" to do the following:

- (a) As a "best efforts" requirement, (i) to endeavor to provide new credit to Small and Medium Sized Businesses and (ii) to endeavor to take steps to alleviate the burden of debt, upon receipt of a request for the postponement of repayment of debt by a Small and Medium Sized Business or a Borrower of Residential Housing Loan; and
- (b) As a "legal obligation", (iii) to establish a framework to give effect to the steps described in (ii) above, and (iv) to disclose and report to the authorities steps taken in connection with (ii) and (iii) above.

Please note that the Japanese branches of foreign banks, registered moneylenders² and insurance companies are not included in the definition of "Financial Institutions" and are not, consequently, required to adopt the measures referred to in (a) and (b) above. Moreover,

¹ or "Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs), etc." according to the translation of the name of the act in FSA press release: <http://www.fsa.go.jp/en/refer/diet/173/01.pdf>

² It appears that the FSA is of the position that the provisions of the Moratorium Act do not apply to registered moneylenders even if they are the subsidiaries of Financial Institutions. According to the FSA, some registered moneylenders are taking steps in line with the Moratorium Act on a voluntary basis, but, upon our inquiry on a no name basis, it appears that the FSA does not take the position of requesting such actions.

those parts of the Supervisory Guidelines which were amended and the Checklist on the Chapter for Facilitation of Financing, as shall be described below, will not be applied to Japanese branches of foreign banks, registered moneylenders or insurance companies.

For further details of the Moratorium Act, you are referred to Section 4 of the November 09 Newsletter.

2. Contents of the Amended Supervisory Guidelines

In the amended Supervisory Guidelines, various detailed points which Financial Institutions need to take note of when taking those steps referred to in (b)(iii) above are set forth.

Under the Banking Act and the Inspection Manuals, banks are required to make a self assessment of their bank loans, classify them as (a) performing loans (b) loans that require monitoring, (c) dangerous loans or (d) claims in bankruptcy, reorganization or like procedures, to prepare adequate reserves and disclose the same on a half yearly basis. Regarding "Loans with Loan Conditions Relaxed", which are a type of "loans that require monitoring", even if the bank has relaxed the loan conditions, if the borrower has prepared a drastic management rehabilitation plan with a high probability of success and a rehabilitation of management in accordance with such plan has commenced, then the bank may opt not to classify such loan as a "Loan with Loan Conditions Relaxed" and treat it as a performing loan. Pursuant to the current amendments to the Supervisory Guidelines, a loan to a small and medium-sized enterprise may be excluded (and classified as a performing loan) for up to one (1) year from the date of the relaxation of loan conditions thereof from classification as a "Loan with Loan Conditions Relaxed" if it is likely that a management rehabilitation plan will be implemented within one (1) year from the date of relaxation of loan conditions, even if a management rehabilitation plan is not currently implemented.

It seems that the purpose of this measure is to make it easier for banks to relax the loan conditions on their loans to small and medium-sized enterprises. It has, however, also been pointed out that this would have a negative effect on the balance sheet of the banks and banks may not disclose their loans appropriately.

3. Contents of the Amended Inspection Manual (the Checklist on the Chapter for Facilitation of Financing)

The amended Inspection Manual (the Checklist on the Chapter for Facilitation of Financing) requires Financial Institutions "under appropriate risk management, to take risks appropriately and actively perform their functions as financial mediators". It is expected that future financial inspections will be conducted with this stance in mind.

The amended Inspection Manuals also require Financial Institutions to adopt appropriate systems (by means of adopting and raising awareness on internal rules, appointing a person in charge, education, reports to the board of directors and statutory auditors, monitoring and internal audits on the status of implementation) to effect the provision of new loans,

amendments to loan conditions, providing management advice to borrowers and support and consulting to improve business.

If a Financial Institution rejects a request for a new loan or an amendment to loan conditions, requires the provision of additional security or guarantees, or effects collection of debt, enforcement of security or disposition of the loan, the action taken by the Financial Institution is required to be reasonable in view of the circumstances of each individual borrower and such reasonableness must be able to be examined post facto. In effect, this might curb banks' ability to refuse new loans, to require new security, to collect its loans, enforce security rights and dispose of the loans. This may result in banks accumulating more non-performing loans.

4. Other (effect on Securitization Transactions)

The Moratorium Act, the amended Supervisory Guidelines and the amended Inspection Manuals will be applied to trust banks.

As suggested in a public comment published by the FSA ("No.28 Regarding Cabinet Ordinances, etc."), if the borrowers of loans to Small and Medium Sized Businesses and Residential Housing Loans, which are held by trust banks as the trustee in connection with loan securitization transactions, make requests for the amendment of loan conditions, etc., to the trust bank as the trustee, then, as a general rule, the trust bank must respond in compliance with the Moratorium Act, the amended Supervisory Guidelines and the amended Inspection Manual.

Nevertheless, looking at this problem from the perspective of the investors, as it is unlikely that the trust bank would agree to an amendment of loan conditions, as a practical matter, the impact of this matter would be small. This is because in order to accept a request for the amendment of loan conditions, ultimately the consent of the beneficiaries is necessary. Public comment "No.2", points out that such loans, by their special nature, should not necessarily be treated similarly to other loans to Small and Medium Sized Businesses and Residential Housing Loans.

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