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AMT/Milbank CLO Client Alert: Increasing the Reach of Risk Retention: The Japanese Regulator's Proposal

BACKGROUND

Anderson Mori & Tomotsune ("**AMT**") and Milbank have been discussing the ramifications of the recent proposal[1] by the Japanese Financial Services Agency (the "**JFSA**") to introduce a risk retention rule as part of the regulatory capital regulation of certain categories of Japanese investors seeking to invest in securitisation transactions (the "**JRR Proposal**")[2]. The JRR Proposal bears a number of similarities to existing risk retention legislation in the US and Europe and may result in some Japanese investors being disincentivised from purchasing securitisation positions where an appropriate entity has not committed to hold a 5% retention piece in the transaction.

The below discussion is of general application to the global securitisation industry; however, mindful that Japanese investors make an important and valuable contribution to the US and European CLO markets[3] and with one source[4] estimating that Japanese banks may be buying between 50-75% of AAA-rated CLO tranches, any regulatory change that impacts Japanese investment in CLOs could have a dramatic effect on the market. Accordingly, this Q&A concentrates on the CLO sector in particular.

[1] https://www.fsa.go.jp/news/30/ginkou/20181228_3.html
https://www.fsa.go.jp/news/30/ginkou/20190109_1.html

[2] The JRR Proposal was published on 28 December 2018 as an amendment to the multiple JFSA public notices setting forth the details of the regulatory capital requirements applicable to banks and certain other financial institutions licensed in Japan (the "**first proposal**"). A further notification regarding the JRR Proposal was published on 9 January 2019 (the "**second proposal**"). For simplicity, this Client Alert focusses on Japanese banks and the amendment to the "Criteria for Evaluating Whether the Conditions of Capital Adequacy are Appropriate in light of Assets and Others Held by Banks Pursuant to the Provisions of the Article 14-2 of the Banking Act" (as amended by the JRR Proposal, the "**Bank Capital Adequacy Criteria**").

[3] Per the Bank of England's Financial Stability Report of November 2018 (Issue No. 44), Japanese banks are estimated to account for approximately 10% of the US$750 billion global CLO market.

[4] https://www.japantimes.co.jp/news/2018/12/16/business/fate-1-trillion-risky-u-s-loans-may-japans-hands/#.XDkBdsKWy8o

Q1. WHAT IS REQUIRED BY THE JRR PROPOSAL?

The JRR Proposal provides that certain types of Japanese financial institutions should apply an increased regulatory capital risk weighting to a securitisation exposure unless such institution has established that the "originator" of the transaction retains a "securitisation exposure[5]" in the transaction equal to not less than 5% of the total underlying assets (the "**Retention Amount**") by[6]:

1) holding equal portions of each tranche (vertical retention);

2) holding all or part of the most junior tranche, equal to at least 5% of the total underlying assets (horizontal retention); or

3) if the most junior tranche is less than 5%, holding both the entirety of such most junior tranche, and equal portions of each of the more senior tranches (combination 'L-shaped' retention),

the "**Japanese Retention Requirement**". The amount to be retained and the means of retention (excluding L-shaped retentions which are not permitted under the European legislation) is similar to the approach taken in both the US and Europe.

In addition, the JRR Proposal indicates that the Japanese Retention Requirement may be met by the originator retaining an alternative exposure to the securitisation, provided that the credit risk borne by the originator for the life of the transaction is at least equal to the Retention Amount[7].

As with the existing US and European risk retention regimes, the Japanese Retention Requirement is driven by the Basel III international regulatory framework for banks[8].

For the purpose of the Japanese Retention Requirement, a "securitisation transaction" is any transaction "*in which the risk associated with an underlying exposure or underlying pool of exposures is tranched into two or more senior/subordinated exposures and all or part of such tranched exposures are transferred to a third party or parties (except for exempted instruments such as certain loans for project finance, object finance, commodities finance or commercial real estate finance)*"[9]. This

[5] This phrase used in the legislative text is analogous to the "material net economic interest" concept which is familiar to European investors.
[6] Article 248. Paragraph 3, Items 1, 2 and 3 of the Bank Capital Adequacy Criteria.
[7] Article 248. Paragraph 3, Item 4 of the Bank Capital Adequacy Criteria.
[8] See in particular "Revisions to the securitisation framework" issued by the Basel Committee on Banking Supervision in December 2014 and "Revisions to the securitisation framework (amended to include the alternative capital treatment for "simple, transparent and comparable" securitisations)" published by the Basel Committee on Banking Supervision in July 2016.
[9] Article 1. Items 2, 16, and 47 of the Bank Capital Adequacy Criteria.

seemingly captures most CLOs and many other securitisation transactions, save where very specific asset classes are concerned.

Note that, unlike in the US and Europe (but arguably of most relevance to balance sheet securitisations and "open market" CLOs), the Japanese Retention Requirement would not apply where an investor is able to judge that the origination of the underlying assets is appropriately conducted, based on various factors such as the originator's involvement in the underlying assets and the quality of the underlying assets or other relevant circumstances[10]. Such originator involvement may be a factor in exempting middle-market CLOs and the generic catch-all for "other relevant circumstances" offers a potential route to exemption for "open market" CLOs.

Lastly, and as is the case under both the US and European risk retention regimes, the originator is not considered to hold its retention interest for the purpose of the Japanese Retention Requirement if the originator hedges or otherwise substantially mitigates its credit risk in respect of such retention interest[11].

Q2. WHO IS REQUIRED TO COMPLY WITH THE JAPANESE RETENTION REQUIREMENT?

The JRR Proposal mandates an 'indirect' compliance requirement, meaning that certain categories of Japanese investors will be required to apply higher risk weighting to securitisation exposures they hold unless the relevant originator's compliance with the Japanese Retention Requirement is confirmed. Originators of transactions will not have any direct obligation to comply with the Japanese Retention Requirement.

Under the JRR Proposal, the Japanese investors that will be required to confirm compliance with the Japanese Retention Requirement include banks, bank holding companies, credit unions (*shinyo kinko*), credit cooperatives (*shinyo kumiai*), labour credit unions (*rodo kinko*), agricultural credit cooperatives (*nogyo kyodo kumiai*), the Norinchukin Bank, the Shoko Chukin Bank, ultimate parent companies of large securities companies and certain other financial institutions regulated in Japan.

Q3. WHICH ENTITIES ARE ELIGIBLE TO HOLD THE RETENTION AMOUNT?

The Japanese Retention Requirement is predicated upon the "originator" holding at least a 5% (or equivalent) exposure to the relevant securitisation transaction. The term "originator" is defined as:

[10] Article 248. Paragraph 3 of the Bank Capital Adequacy Criteria.
[11] Article 248. Paragraph 3 of the Bank Capital Adequacy Criteria.

"*(i) a person who is involved in the origination of underlying assets directly or indirectly or (ii) a sponsor of an ABCP conduit or other similar program which acquires exposures from third parties*"[12].

The term "sponsor" included in limb (ii) of the "originator" definition is not defined in the JRR Proposal or the existing Bank Capital Adequacy Criteria, and it is currently unclear as to whether this would include the collateral manager of a CLO transaction as an eligible retainer for purposes of meeting the Japanese Retention Requirement. Given that both the existing US and European risk retention regimes offer a route to compliance by way of the collateral manager holding the required retention, Japanese investors would be unhelpfully and unduly restricted from investing in CLO transactions if a collateral manager is ineligible to qualify as an "originator" under the Japanese Retention Requirement. Moreover, even if the term "sponsor" is ultimately defined to include the collateral manager of a CLO, unless that term also allows certain affiliates of the collateral manager to satisfy the retention obligation (as is the case for "majority-owned affiliates" under the US rules), sponsors of US CLOs seeking to comply with the Japanese Retention Requirement will have fewer options than they have historically exercised when complying with the US rules, such as having an affiliate partially capitalised by third party investors hold the retention obligation.

The JFSA is expected to provide its responses to public comments received on the JRR Proposal when the final form legislation is published (the "**Final Rule**"). It is hoped that these responses will provide some clarification as to the scope of the "sponsor" reference in the "originator" definition.

Q4. WHAT ARE THE IMPLICATIONS OF NON-COMPLIANCE WITH THE JAPANESE RETENTION REQUIREMENT?

Japanese investors that are subject to the Japanese Retention Requirement face an increased capital charge on their securitisation investments if they invest in securitisation transactions which are found to be non-compliant. The increased capital charge will be three times higher than that otherwise applied to compliant securitisation exposures, subject to a maximum weighting of 1,250%[13]. In addition, disciplinary action may be brought against investors on the basis of their failure to meet the JFSA's supervisory guidelines, which require Japanese financial institutions to conduct due diligence on risk retention concerning securitisation transactions. However, the JRR Proposal does not impose criminal sanctions in the event of non-compliance.

[12] Article 1. Item 68 of the Bank Capital Adequacy Criteria.
[13] Article 248. Paragraph 3 of the Bank Capital Adequacy Criteria.

There is no consequence for originators if the Japanese Retention Requirement is not met, although the price and liquidity of the relevant securities in the market may be adversely affected by a restricted Japanese market.

Q5. WHAT ARE THE NEXT STEPS AND WHEN IS THE JAPANESE RETENTION REQUIREMENT EXPECTED TO APPLY?

Public comments on the JRR Proposal must be submitted by midday (Tokyo time) on 28 January 2019 for the first proposal, and by midday (Tokyo time) on 8 February 2019 for the second proposal[14]. The Final Rule will be implemented on and effective from 31 March 2019[15] (the "**Effective Date**") and is expected to be published either on or just before this date.

The JFSA is expected to publish the public comments received on the JRR Proposal, together with its responses thereon, contemporaneously with publication of the Final Rule. The responses to such public comments will likely provide further insights to the application and interpretation of the Japanese Retention Requirement.

Q6. HOW ARE PRE-EXISTING SECURITISATION POSITIONS AFFECTED?

Securitisation positions which are held by Japanese investors on the Effective Date will be "grandfathered"[16] and, accordingly, investors subject to the Japanese Retention Requirement may continue to hold such investments regardless of whether they are compliant with the Final Rules and with no risk of an increased regulatory capital charge being applied. However, a subsequent purchaser will lose the benefit of this grand-fathering; a refinanced or upsized position will similarly be subject to the Japanese Retention Requirement.

Q7. WHAT DOES THIS MEAN FOR THE US AND EUROPEAN CLO MARKETS?

With the introduction of the EU Securitisation Regulation[17] on 1 January 2019 (and the plethora of risk retention legislation applicable in Europe prior to this), European CLOs are generally structured to include risk retention and disclosure obligations that are, in fact, more far-reaching than those posed by the Japanese Retention Requirement. Accordingly, subject to the final paragraph below, it is expected that CLO transactions structured to comply with European risk retention legislation should largely meet the Japanese Retention Requirement.

[14] https://www.fsa.go.jp/news/30/ginkou/20181228_3.html
https://www.fsa.go.jp/news/30/ginkou/20190109_1.html
[15] Article 1 of the Supplementary Provisions published as part of the JRR Proposal.
[16] Article 4 of the Supplementary Provisions published as part of the JRR Proposal.
[17] Regulation (EU) 2017/2402

Conversely, following the D.C. Circuit Court ruling that the US risk retention legislation does not apply to "open market" CLOs[18], compliance with the US risk retention rules now applies only to a small subset of US CLOs. The imposition of the Japanese Retention Requirement may therefore see a return to retention-compliant US CLO structures to the extent that such transactions are to be marketed in Japan, together with its consequent costs and complexities. This is, of course, unless the JFSA implements a similar "open market" CLO exemption, which we understand from various market sources has been raised as a possibility and is under consideration by the JFSA.

Meanwhile, as discussed in Q3 above and absent an "open market" exemption or an investor determining, based on certain factors (as discussed in Q1 above), that the Japanese Retention Requirement does not apply, if a CLO collateral manager does not qualify as a sponsor (and therefore is not an "originator" for purposes of the Japanese Retention Requirement), the increased regulatory capital cost could pose a significant barrier to future Japanese investment in CLOs. We are therefore hopeful that the JFSA provides some positive clarification on this point upon the publication of the Final Rule.

[18] Loan Syndications & Trading Ass'n v. SEC, No. 17-5004 (D.C. Cir. Feb. 9, 2018)

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