CLO Group

Client Alert

Japanese Risk Retention – The Final Rule; CLO Market Implications

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Background

Following December and January's proposal (the "**JRR Proposal**")[1] by the Japanese Financial Services Agency (the "**JFSA**") to enhance its existing Supervisory Guidelines[2] by introducing a risk retention rule with respect to investments in securitisations by certain Japanese investors, the JFSA published the final risk retention rule (the "**Final Rule**")[3] on 15 March 2019, which comes into effect on 31 March 2019. The publication of the Final Rule was accompanied by both (i) a detailed "Q&A" document[4] (the "**Q&A**") and (ii) a table[5] of comments received on the JRR Proposal along with the JFSA's responses (the "**Commentary & Analysis**"), both of which are instructive for industry participants in understanding and interpreting the Final Rule[6][7]. Anderson Mori & Tomotsune and Milbank have been discussing the

[1] For further background and information on the JRR Proposal, see the Anderson Mori & Tomotsune and Milbank Joint Client Alert of 14 January 2019 (https://www.milbank.com/en/news/amtmilbank-clo-client-alert-increasing-the-reach-of-risk-retention-the-japanese-regulators-proposal.html and https://www.amt-law.com/publications/detail/publication_0019674_ja_001).
[2] https://www.fsa.go.jp/news/26/20150430-5.html.
[3] https://www.fsa.go.jp/news/30/ginkou/20190315-1/09.pdf – The Final Rule was introduced by way of 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 (JFSA Public Notice No. 19 of 2006, as amended, the "**Bank Capital Adequacy Criteria**") and certain other JFSA public notices setting forth the details of the regulatory capital requirements applicable to affected Japanese investors. For simplicity, this alert focusses on Japanese banks and the amendment to the Bank Capital Adequacy Criteria.
[4] https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf – Questions 1 through 5 regarding Article 248 of the Q&A are of most relevance and assistance to the CLO industry.
[5] https://www.fsa.go.jp/news/30/ginkou/20190315-1/02.pdf - "*The JFSA's point of view in response to the public comments overview and comments in response to the partial revision to the notice related to the capital ratio regulation (pillar 1 and pillar 3)*". Comments 41, 42 and 44 of the Commentary & Analysis will be of most relevance and assistance to the CLO community.
[6] Although these documents are in Japanese, LSTA members can access translations helpfully prepared by the LSTA and available on their website at https://www.lsta.org/news-and-resources/news/japanes-risk-retention-capital-rules-published.
[7] As a transitional measure, securitisation positions which are held on 31 March 2019 will be "grandfathered" and, accordingly, investors subject to the Final Rule may continue to hold such investments regardless of whether they are compliant with the

Final Rule, together with the Q&A and the Commentary & Analysis, with a view to understanding how the US and European CLO markets might be affected and, more importantly, how transactions might adapt to accommodate and assist Japanese investors complying with the Final Rule.

The Effect of the Final Rule

The Final Rule, which is substantially identical to the draft legislation set out in the JRR Proposal, imposes a punitive regulatory capital risk weighting[8] on certain Japanese financial institutions where they acquire securitisation positions in relation to which an appropriate entity has not committed to hold at least a 5% retention piece in the transaction in any of the methods specified in the Final Rule (the "**Retention Requirement**")[9], unless investors can determine that the original assets were not "*inappropriately formed*"[10].

The JRR Proposal anticipated that the Retention Requirement could be met only by an "*originator*" and with respect to the "*original assets*"[11] of a securitisation, raising a number of questions from industry participants as to who and what might constitute an "*originator*" and an "*original asset*". Particular clarification was sought in the context of CLO transactions, where assets are often not acquired from an originator's balance sheet, but typically sourced in the open market and managed by a CLO manager. Although largely unchanged, the Final Rule amends the JRR Proposal to make clear that "*original assets*" include those transferred to the issuer by any person[12].

The universe of Japanese investors that will be required to comply with the Final Rule also remains unchanged from the JRR Proposal, and includes 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 certain large securities companies and certain other financial institutions regulated in Japan. It is therefore the case that Japanese investors in CLO transactions will, to the extent they do not do so already[13], need to conduct appropriate due diligence and analysis to either establish compliance with the Retention Requirement or with the principle-based criteria (as discussed below).

Rule-based Criteria (Retention Requirement)

According to the Final Rule, an affected Japanese investor must apply a punitive regulatory capital risk weighting to the securitisation exposure (i.e. an exposure to the securitisation transaction) held by it, unless it can confirm that the "originator" of the transaction retains a "securitisation exposure" in the transaction equal to not less than 5% of the total exposure of the original assets (the "**Retention Amount**") by any of the following methods[14] (or unless the below described principle-based criteria are satisfied):

1. holding equal portions of each tranche (vertical retention);
2. holding all or part of the most subordinated tranche, equal to at least 5% of the total exposure of original assets (horizontal retention); or
3. if the most subordinated tranche is less than 5%, holding both the entirety of such most subordinated tranche, and equal portions of each of the more senior tranches ('L-shaped' retention).

Retention Requirement and with no risk of an increased regulatory capital charge being applied. However, a subsequent acquirer will lose the benefit of this grandfathering; a refinanced or upsized position will similarly be subject to the Retention Requirement.

[8] Being three times that applied to a compliant securitisation exposure, up to a maximum of 1250%.

[9] Such retention requirement, as is the case in Europe and the United States, cannot be subject to hedging or other credit risk mitigation.

[10] See Article 248(3).

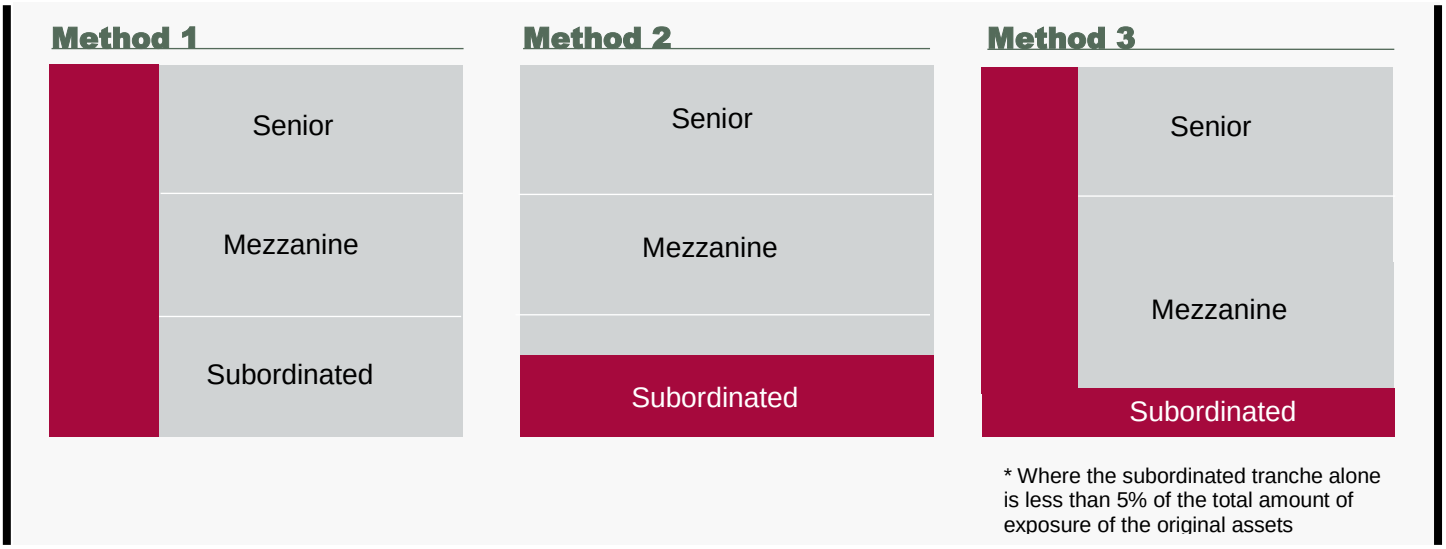
[11] Being described as those "*transferred to the [issuer] by the originator or any other person in an asset transfer transaction*".

[12] Article 1, Item 22 of the Bank Capital Adequacy Criteria and comment 44 and response in the Commentary & Analysis. For better or worse, this also had the effect of removing any doubt that CLOs might be exempt from the Retention Requirement.

[13] Anecdotally, we understand from our discussion with CLO managers and arrangers that several of the largest Japanese investors already have well-established and very extensive due diligence investigations and modelling tests that are routinely applied as a pre-condition to investment in accordance with the existing Supervisory Guidelines. We further understand that such investors will likely need to augment such investigations and modelling tests in light of the Final Rule.

[14] Article 248. Paragraph 3, Items 1, 2 and 3 of the Bank Capital Adequacy Criteria.

The following diagram[15] illustrates the permitted retention methods (1) to (3) above:



Methods (1) and (2) are very similar to the approach typically taken by retainers complying with EU risk retention requirements[16]. However, under the Final Rule, the 5% threshold must be calculated with reference to the securitisation exposure held by the originator against the total exposure of original assets under the Retention Requirement.

Furthermore, the Retention Requirement can be met by the originator retaining a securitisation exposure to the securitisation transaction, provided that the credit risk borne by the originator for the life of the transaction is at least equal to the Retention Amount. The Q&A[17] indicates that such requirement may be met by, for example, the originator holding equal to or greater than 5% of each tranche[18].

According to the Q&A[19], each Japanese investor must confirm the originator's retention of the securitisation exposure at each time that it calculates the risk weight to the securitisation exposure that it holds and at the time of the acquisition of the securitisation exposure. In this context, currently it is not entirely clear as to how the exposures for purposes of the Retention Requirement should be calculated. Of potential relevance to this issue, the Commentary & Analysis[20] mentions that the total exposure that must be held by the originator shall be calculated based on the amount of the outstanding principal balance as of the date of the calculation by the Japanese investors[21].

Principle-based Criteria (Original Assets Not Inappropriately Formed)

Even if the originator does not meet the rule-based Retention Requirement, there is an alternative option available under the Final Rule for securitisation transactions where the Japanese investor can show that the origination of the original assets is "not inappropriately conducted" based on various factors, including the originator's involvement in the origination of the original assets and the quality of the original assets or other relevant circumstances (the "principle-based criteria").

As elaborated below, the Q&A and Commentary & Analysis provide some helpful colour on the circumstances where the original assets are considered as "not inappropriately formed" and the Retention Requirement is inapplicable or can be deemed to be met:

[15] English translation of the chart extracted from the Q&A.
[16] See Article 6(3)(a) and (d) of Regulation (EU) 2017/2402 (the "**EU Securitisation Regulation**").
[17] See question 4 regarding Article 248 of the Q&A which provides three specific examples.
[18] As distinct from method (1) discussed above, the originator need not retain "equal" portions of each tranche in the case of this particular example.
[19] See question 5 regarding Article 248 of the Q&A.
[20] See No. 40 of the Commentary & Analysis.
[21] According to paragraph (3) of question 2 regarding Article 248 of the Q&A, the Retention Requirement is inapplicable or can be deemed to be met if (i) the originator complied with the Retention Requirement at the time when the affected Japanese investor acquired the securitisation exposure and (ii) the originator continued to hold such securitisation exposure, but (iii) the total exposure held by the originator had become less than the level of the Retention Requirement as a result of a default of the original assets.

1. Equivalent risk retention by the originator and/or other relevant persons

The Q&A[22] and Commentary & Analysis[23] provide that the principle-based criteria would be met, where it can be confirmed that the originator or other relevant persons bear the credit risk which is equal to or more than the level of Retention Requirement.

One example case falling under this category is where a relevant party other than the originator (e.g., (i) the parent company of the originator, or (ii) the arranger or another person who was deeply involved with the formation of the securitised product) bears the credit risk and the total amount of credit risk retained by such person (and the originator) is equal to or greater than the level of the Retention Requirement.

For the European CLO market, this example case raises the prospect that investors may conclude that original assets were not "inappropriately formed". Whilst, as noted above, the Final Rule refers only to the Retention Requirement being met by an 'originator', the additional Q&A commentary is encouraging for European CLO transactions where the CLO manager, as a party heavily involved in structuring the transaction, acts as the retainer for purposes of compliance with the EU risk retention rules. However, on a note of caution, the Q&A only contemplates (a) the parent company of the originator or (b) the 'arranger' or another person who was deeply involved with the formation of the securitised product as qualifying for the purposes of the criteria. Therefore, there remains some uncertainty in respect of whether the credit risk borne by other affiliates of the originator that are not involved with the formation of the securitised product would also meet the criteria[24].

2. In-depth analysis of the quality of the original asset

Helpfully for the US CLO market, the Q&A and Commentary & Analysis[25] also provide that Japanese investors can form a view that "*the original assets were not inappropriately formed*" (meaning that the Retention Requirement becomes inapplicable) through an "*in-depth analysis of the quality of the original asset*"[26]. Although the Commentary & Analysis is clear that, in contrast to the "open market CLO" exemption[27], the general characteristics of CLO transactions are insufficient for such conclusion to be drawn, the Q&A does set out examples of the "*objective criteria*" that investors may use to determine that the underlying portfolio of a transaction[28] does not include "*inappropriately formed*" assets.

These "*objective criteria*" include whether:

i. the originator's loan review criteria were appropriate;
ii. the specifics of the covenants of the loan agreements are conducive to investor protection;
iii. the extent and terms of the collateral of such loan are appropriate; and
iv. the debt collection abilities of the originator, the servicer and any other relevant party are adequate.

The Q&A also provides that where it is impracticable for investors to verify individual assets (as would be the case for a CLO transaction), they should verify that objective and reasonable standards with respect to the items of (i) to (iv) above and other relevant items have been established for investment and reinvestment (including whether excessive discretion is afforded to any party) and that such standards have in fact been adhered to (e.g. by way of a sample check of the portfolio)[29].

While the details of certain of these principle-based criteria remain ambiguous and unclear in some aspects, we expect that consensus will emerge as a result of ongoing dialogue between Japanese investors, CLO managers and the JFSA.

Process of Due Diligence

Of additional assistance to the European CLO industry is the guidance provided in the Q&A that due diligence as to satisfaction of the Retention Requirement may be conducted:

[22] See paragraph (1) of question 2 regarding Article 248 of the Q&A.
[23] See No. 38 of the Commentary & Analysis.
[24] The Q&A (see paragraph (2) of question 2 regarding Article 248) and the Commentary & Analysis (see No. 29) have clarified that the following is also an example of the cases where the originator and/or other relevant persons bear the credit risk which is equal to or more than the case of Retention Requirement:
(i) original assets of the securitisation product are randomly selected from an asset pool consisting of a large number of claims or other assets that are not securitisation products; and
(ii) the originator assumes credit risks that are 5% or more of the total exposure by continuing to hold either: (x) all such claims or other assets included in the asset pool except for those constituting the original assets; or (y) such claims or other assets selected randomly from the asset pool at the time when the selection of the original assets are made.
[25] See No. 30 of the Commentary & Analysis.
[26] See paragraph (2) of question 2 regarding Article 248 of the Q&A.
[27] Being generally relied upon by broadly syndicated CLO transactions with respect to the US risk retention rules.
[28] Question 2 regarding Article 248 of the Q&A specifically refers to the "*objective criteria*" being applied to transactions where "*the person forming a securitisation product does so not by using the assets such person holds as the original assets but by purchasing debts on the market to form the original assets*" (such as a typical CLO).
[29] See paragraph (2) of question 2 regarding Article 248 of the Q&A.

1. by the investor receiving confirmation (written or through hearing from related parties such as the originator) of the originator's intention to hold the requisite retention piece, which would be deemed to be fundamentally adequate as a method of determining whether the notification requirement is satisfied; or
2. through "*situations* where *the originator or equivalent persons ("**Originators etc**") may be directly obligated to retain the same amount of credit risk as [the Retention Requirement] depending on the jurisdiction of formation*"[30], unless there are special circumstances where there is reasonable suspicion of the credit risk retention circumstances relating to the originator (the "**Alternative Procedure**").

Arguably, the Alternative Procedure could be utilised where EU risk retention rules impose risk retention obligations on the originator, sponsor or original lender of a securitisation transaction. However, it is unclear as to whether the Alternative Procedure may be utilised by a retainer complying indirectly with the EU risk retention rules[31] where they are established *outside* of the EU, as the prevailing market view is that the *direct* obligation to retain applies only where the originator, sponsor or original lender is established in the EU[32]. On a conservative view, this may mean that transactions involving non-EU retainers may not utilise the Alternative Procedure. Nonetheless, it may be able to rely upon the principle-based criteria relating to a retaining entity having been "*deeply involved*" in the formation of the securitised product as discussed above in the "Principle-based Criteria (Original Assets Not Inappropriately Formed)" section.

US CLOs which are unable to rely on the "open market CLO" exemption for purposes of the US risk retention rules (e.g. certain middle-market deals) may also be able to rely on the Alternative Procedure on the basis of the 5% retention requirement imposed as a matter of law upon the sponsors of such transactions.

Where compliance with the EU or US risk retention rules is intended and use of the Alternative Procedure is contemplated, it should be noted this appears only to be possible where the 5% material net economic interest held in compliance with the EU or US rules is equal to or in excess of that required by the Retention Requirement[33].

The Practical Impact of the Final Rule on European and US CLO Transactions

We expect that a market consensus will develop in the coming months, but in the meantime the table below analyses the most common European and US CLO transaction structures, with our initial predictions[34] as to how the Final Rule can be accommodated within existing transaction frameworks.

European CLO Structures	Description	Suggested approach for compliance with the Final Rule
Sponsor retainer	A bank or European investment firm[35] establishes and manages the CLO	The bank or European investment firm deeply involved with the formation of the securitised product may retain the Retention Amount. See section 1 under "Principle-based Criteria (Original Assets Not Inappropriately Formed)"[36]
5% originator manager retainer	An entity establishes and manages the CLO transaction, originates 5% of the assets on or prior to the closing date and retains a 5% material net economic interest	The 5% originator[37] deeply involved with the formation of the securitised product may retain the Retention Amount. See section 1 under "Principle-based Criteria (Original

[30] See question 5 regarding Article 248 of the Q&A. Note that compliance with the "open market CLO" exemption is specifically carved-out for these purposes.
[31] I.e. where European investors are only permitted to invest in compliant transactions.
[32] See prior Milbank client alert on the territoriality of the EU Securitisation Regulation (https://www.milbank.com/en/news/securitisation-regulation-application-of-disclosure-requirements-to-non-european-clos.html).
[33] See the final paragraph of "Rule-based Criteria (Retention Requirement)" above.
[34] Our suggestions in the table are illustrative and not comprehensive. In particular, we expect that other solutions may emerge as a result of ongoing dialogue between Japanese investors, CLO managers and the JFSA.
[35] The CLO market has long-awaited pronouncement from the European Commission as to whether a non-European investment firm can retain as "sponsor". Until such clarification is provided, the interpretation remains unclear, with the result that non-European investment firms typically retain as originators.
[36] Assuming that the 5% material net economic interest retained in compliance with the EU rules is sufficient to meet the Retention Requirement.
[37] Or, it may be arguable that the 5% (or more) originator should be able to retain the Retention Amount relying on the rule-based Retention Requirement.

		Assets Not Inappropriately Formed)"[38]
Majority (over 50%) originator retainer	An entity establishes the CLO transaction, originates over 50% of the assets on an ongoing basis and retains a 5% material net economic interest	The majority originator may retain the Retention Amount. See "Rule-based Criteria (Retention Requirement)"[39]
US CLO Structures[40]	Description	Suggested approach for compliance with the Final Rule
Open market CLO transaction (broadly syndicated)	No risk retention based upon the LSTA decision[41]	The approach of "in-depth analysis of the quality of the original asset" can be taken. See section 2 under "Principle-based Criteria (Original Assets Not Inappropriately Formed)"
Sponsor / majority owned affiliate (middle market CLO transaction)[42]	The collateral manager or a majority owner affiliate thereof retains 5% of the fair value of the CLO transaction horizontally through the equity tranche or vertically by retaining 5% of each class of securities issued	The collateral manager or a majority owner affiliate thereof, that was deeply involved with the formation of the securitised product may retain the Retention Amount. See section 1 under "Principle-based Criteria (Original Assets Not Inappropriately Formed)"[43]

Conclusion

It is very early days in yet another risk retention adventure for the CLO community. However, the initial sentiment and technical analysis of the Final Rule suggest that this latest regulatory intervention should not present insurmountable obstacles to the industry and that Japanese investors will be capable of retaining their position as valued and significant holders of CLO securities.

There will of course be increased scrutiny and analysis of deals to ensure the requirements of the Final Rule are complied with, but for now it does not appear that deal volumes and timing will be materially and adversely affected.

Our expectation is that Japanese investors, who have a record of providing significant input with respect to transaction structuring, will help by participating in a co-operative process in order to achieve compliance with the Final Rule.

Further, with the Final Rule, the Q&A and the Commentary & Analysis being open-ended (and subject to further guidance and direction from the JFSA), we expect that a market consensus will be established and develop on an iterative basis over the coming months.

[38] Assuming that the 5% material net economic interest retained in compliance with the EU risk retention requirements is sufficient to meet the Retention Requirement.
[39] Assuming that the 5% material net economic interest retained in compliance with the EU risk retention requirements is sufficient to meet the Retention Requirement.
[40] For US CLO transactions not marketed in Europe. US CLO transactions which are marketed to European investors can alternatively be categorised under one of the above European CLO transaction headings.
[41] See Milbank client alert on the LSTA open market CLO decision (https://www.milbank.com/en/news/dc-circuit-rules-managers-of-open-market-clos-are-not-required-to-have-skin-in-the-game.html).
[42] These transactions may also, in some circumstances, be able to rely upon the LSTA open market CLO decision.
[43] Assuming that the 5% material net economic interest retained in compliance with the EU risk retention requirements is sufficient to meet the Retention Requirement.

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