JAPANESE FINANCIAL SERVICES AGENCY ISSUES GUIDANCE ON CAPITAL REQUIREMENTS FOR SECURITISATION INVESTORS

Key issues

- No absolute requirement to incorporate risk retention
- Japanese Institutional Investors will be required to establish and maintain a Risk Assessment System for their investments in Securitisation Transactions
- Helpful guidance provided by the JFSA on what may constitute "appropriate origination"

Japanese investors have become increasingly active in the US, European and Australian securitisation markets in recent years, particularly with respect to CLO and RMBS transactions. The significant investments they make mean arrangers and issuers listen attentively to their requirements. The introduction by the Japanese Financial Services Agency (the "JFSA") of new due diligence rules (the "JDDRs") for Japanese investors therefore commands attention in all the major securitisation markets. The JDDRs are set out in the Financial Services Agency Notices (the "Notices") provided for each category of financial institutions (e.g. in respect of banks, the JDDRs are set out in Article 248 of the "Criteria for Judging Whether A Financial Institution's Own Capital Is Sufficient in Light of the Assets Held, etc. under the Provision of Article 14-2 of the Banking Law" (Notification No. 19 of 2006, the Financial Services Agency)). They bear similarities to due diligence and risk retention rules found in the EU and the US, though they diverge in a number of ways, therefore requiring an assessment to be undertaken on a case-by-case basis. The JDDRs will become applicable to banks upon the Notices taking effect on 31 March 2019. On 15 March 2019, the JFSA released some guidelines and its views on questions made by market participants with respect to the application of the Notices (the "Notice Guidelines"), which alleviates earlier concerns that the JDDRs would exclude Japanese investors from many European and US securitisation transactions by providing that (i) if an investor considers them equivalent on the facts of the relevant rules, compliance with the US rules and/or EU rules will suffice for the purposes of the JDDRs and (ii) certain US securitisation transactions, such as open market CLOs, may not require risk retention for the purposes of the JDDRs. However, many of these deals will need to display triple compliance – with the US rules, the EU rules and, now, the Japanese rules too.

APPLICABILITY TO JAPANESE INVESTORS

The JDDRs apply to Japanese investors which fall into certain categories (the Japanese Institutional Investors). Among others, the JDDRs apply to all Japanese banks, all Japanese credit unions and credit co-operatives, the Norinchukin Bank, the Shoko Chukin Bank and ultimate parent companies of large securities companies. Given this scope, the JDDRs will be relevant to most of the regular Japanese investors in US, European and Australian securitisations.

As the JDDRs apply to investors, they have only an indirect effect on transactions - issuers, originators and arrangers have no obligation to comply, but if their transactions fail to meet the requirements then Japanese Institutional Investors are expected to avoid them. Any issuers or arrangers seeking to access the Japanese capital markets should consequently ensure their transactions comply with the JDDRs.

THE JAPANESE DUE DILIGENCE RULES

The key definitions

Definition	Component elements
Securitisation Transaction	• credit risk on Underlying Asset • stratification of credit risk into two or more senior/subordinated tranches • some or all credit risk transferred to a third party • *not* Specified Loan Receivables
Specified Loan Receivables	Project Finance, Object Finance, Commodity Finance and Business Real Estate Lending
Originator	Either • directly or indirectly involved in the formation of the Underlying Asset • sponsor of an asset-backed commercial paper conduit or equivalent programme
Underlying Asset	Either • any one or more assets transferred by the Originator or any other parties to a securitisation SPV in respect of an Asset-transfer-type Securitisation Transaction • any one or more reference obligations and guaranteed receivables in respect of a Synthetic Securitisation Transaction

Relevance of timing

The JDDRs apply at the moment in time at which a Japanese Institutional Investor makes their investment in a Securitisation Transaction and, on an ongoing basis, each time the Japanese Institutional Investor is required to re-measure the amount of capital it is holding. This differs from the EU and US rules, which generally look at the date an exposure is created rather than the date it is acquired by an investor.

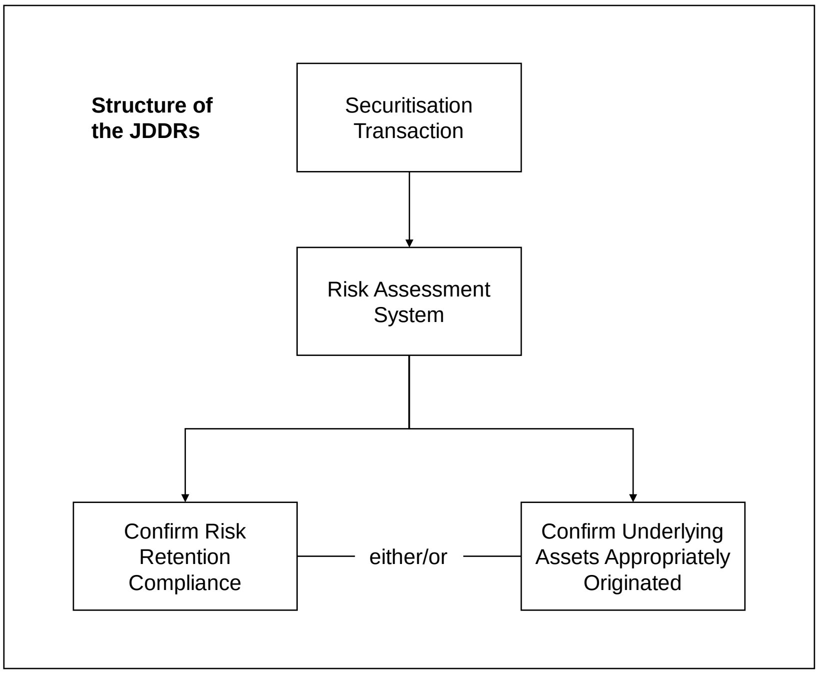
The JDDRs will, therefore, be relevant to Securitisation Transactions which closed prior to 31 March 2019 if a Japanese Institutional Investor looks to acquire an exposure to it after 31 March 2019.

Structure of the JDDRs

The JDDRs affect the amount of capital a Japanese Institutional Investor must hold against a securitisation exposure and require a full capital deduction (i.e., a risk weight of 1,250%) unless the Japanese Institutional Investor appropriately establishes a risk assessment system (a Risk Assessment System) to be applied to the specific Securitisation Transaction.

Further, even where a Japanese Institutional Investor establishes a Risk Assessment System with respect to the Securitisation Transaction, it must still triple the risk weighting to be applied to its exposure to the Securitisation Transaction (capped at 1,250%) unless either:

- that Japanese Institutional Investor is able to confirm that the Originator of the Securitisation Transaction retains a 5% interest in an appropriate form; or
- that Japanese Institutional Investor is able to determine that the Underlying Assets are appropriately originated, considering the Originator's involvement with the Underlying Assets, the nature of the Underlying Assets or any other relevant circumstances.



The establishment of the Risk Assessment System is, and should remain, a matter for investors to implement. However, confirming 5% risk retention, or appropriate origination of the Underlying Assets, is a matter which can be facilitated by appropriate disclosure and information sharing by the issuer and arranger of a Securitisation Transaction.

Risk Assessment System

The due diligence obligation imposed by the JDDRs requires Japanese Institutional Investors to establish a Risk Assessment System in respect of each Securitisation Transaction. In respect of the Securitisation Transactions that a Japanese Institutional Investor invests in, its Risk Assessment System must involve, among others, a system which:

- can collect, on an ongoing basis, information on the comprehensive risk characteristics of the securitisation exposure of the Securitisation Transactions;
- can collect, in a timely fashion, information on the comprehensive risk characteristics and performance of the Underlying Assets of the Securitisation Transactions; and
- can identify the structural characteristics of the Securitisation Transactions.

The Japanese Institutional Investors must also prepare internal rules to ensure these systems are established and maintained.

The Notice Guidelines appreciate that investors may have systems which differ greatly from one another by reference to a number of factors (e.g., the detail of information collected, the frequency with which information is collected etc.) taking into account the proportion of the investor's portfolio consisting of Securitisation Transactions, the tenor of the Securitisation Transactions, the anticipated length the Securitisation Transaction will be held and risk. Consequently, it is expected that each institution's systems will mirror the risk profile and business model with respect to its investments in Securitisation Transactions. For instance, the systems of an institution which has almost no investments in Securitisation Transactions could be far less strict than the systems of an institution which holds investments in a large number of Securitisation Transactions.

Risk retention compliance or appropriate origination

Risk retention

The Notice Guidelines say that confirmation of compliance with the 5% risk retention requirement should be given by the Originator in writing. However, the Notice Guidelines appreciate that it may be difficult to obtain confirmation from the Originator in writing and, where that is the case, verbal confirmation of compliance may also be acceptable - for instance, on a management due diligence call or through an interview with the Originator or other related parties.

The Notice Guidelines recognise that where an overseas risk retention obligation is equivalent to the JDDRs, then Japanese Institutional Investors may treat the Securitisation Transaction as complying with the JDDRs if that Japanese Institutional Investor confirms that the overseas risk retention obligation is met. Furthermore, the Notice Guidelines state that where an Originator or any other party or parties equivalent to it (an Appropriate Risk Retainer) is directly under risk retention obligations in other jurisdictions where the Appropriate Risk Retainer is obliged to hold an equivalent level of credit risk as required under the JDDRs, then the Japanese Institutional Investors may assume that the JDDRs are met without receiving any information from the arrangers in respect of the risks retained by the Originators unless there is a reasonable doubt that the Appropriate Risk Retainer may not be in compliance with the applicable overseas risk retention rule.

The JDDRs provide for compliance with the risk retention option as follows:

Who must retain risk?	the "Originator"
How much risk must be retained?	5% of the Underlying Assets being securitised The JDDRs are clear that this is re-tested continuously, however, the 5% will be calculated by reference to the remaining principal balance of Underlying Assets when tested after closing of the relevant transaction
Are there different retention options?	Yes – horizontal, vertical and L-shaped Any other retention of credit risk by the Originator which is "equal to or higher" than one of these options would also be compliant. This may, for instance, include a case where the Originator holds all of the most junior tranche which is less than 5% of the total principal balance of Underlying Assets and a part of the second most junior tranche with the result that the aggregate portion of the tranches held by the Originator becomes equal to at least 5% of the total principal balance of Underlying Assets, but such compliance would need to be assessed on a case-by-case basis by the Japanese Institutional Investor
Can the retained risk be hedged?	No – the JDDRs and the Notice Guidelines are clear that risk that is hedged does not constitute "credit risk" on the Underlying Assets. The Notice Guidelines say the Japanese Institutional Investors should seek a confirmation that credit risk is not hedged

Appropriate origination

As an alternative to requiring the Originator to retain risk, a Japanese Institutional Investor can alternatively comply with the JDDRs if the Japanese Institutional Investor is able to determine that the Underlying Assets have been "appropriately originated". In construing this phrase, the JDDRs require each of the following matters to be taken into account:

- the involvement of the Originator in the origination of the Underlying Assets;
- the nature of the Underlying Assets; and/or
- other relevant circumstances.

The Notice Guidelines do explain further what these other relevant circumstances might be, along with some examples.

Case	**Suggested compliance options, as set out in the Notice Guidelines**
Retention of credit risk in another manner which is equal to or higher than the credit risk imposed by the JDDRs	Retention of at least 5% interest by parties (other than the Originator) who are deeply involved in the creation of the Securitisation Transaction (for instance, the Originator's parent company, an arranger or a CLO arranger). In the case where the Underlying Assets that are receivables are randomly selected from large pools of receivables, if the Originator retains credit risk which is equal to or exceeds 5% of the total exposures in the pool by continuously retaining all the receivables in that pool other than the Underlying Assets which are transferred to the Securitisation Transaction (or by continuously retaining particular receivables randomly selected from the asset pool).
A deep analysis of the quality (including the credit risk) of the Underlying Assets is made	Where the quality of the Underlying Assets that are real property is appropriately assessed in an appraisal report or engineering report. Where a Securitisation Transaction is created from receivables purchased in the market, the Japanese Institutional Investor is able to confirm, based on subjective documents, that the quality of the receivables forming part of the Underlying Assets are appropriate. In addition, for transactions involving loan receivables, it is necessary for each Japanese Institutional Investor to verify individual loan receivables based on: • appropriate replenishment criteria; • the provisions of the contract (e.g., covenants and collateral terms) creating the loan receivables protecting the investor; • security interests created in securing the loan receivables; and • the Originator or the servicer being able to service and collect the loan receivables.

Case	Suggested compliance options, as set out in the Notice Guidelines
Where it is difficult to verify individual loan receivables	Each of the following: • an objective and rational standard is established as a basis for the acquisition and replacement of loan receivables by the securitisation-purposed conduit (i.e., no excessive discretion for the selection of the Underlying Asset is given to those involved in the formation of securitised products); • verifying in a timely manner that the acquisition and/or disposal of loan receivables are made in accordance with such standard, for example, by way of conducting a sample check; and • conducting stress tests based on reasonable scenarios and terms.

CONCLUSIONS

The willingness between the JFSA and securitisation industry participants to consult and discuss the JDDRs has resulted in a framework, supported by the Notice Guidelines, which achieves several objectives:

- first, enhanced due diligence standards for Japanese Institutional Investors will provide greater financial stability as volumes of investments in Securitisation Transactions by those investors continue to increase;
- second, there will be no blanket ban on certain classes of transactions in which Japanese Institutional Investors invest in - for instance, open market US CLOs; and
- third, there is a high degree of overlap with EU and US rules, allowing relatively easy dual-or triple-compliance in many circumstances. For example, if an investor considers them equivalent on the facts of the relevant rules, compliance with the US rules and/or EU rules will suffice for the purposes of the JDDRs

While the JDDRs will require some additional work by Japanese Institutional Investors in instituting new systems and processes, the compliance with the rules should not require any significant adjustments to be made to the way securitisations are currently being structured in the market.

Open market US CLOs – open for business

One key concern in relation to the implementation of the JDDRs is the effect they may have on open market US CLOs. The concern related to the fact that such transactions are not required to comply with the US risk retention rules and, consequently, would be unlikely to comply with the Japanese rules.

Following a productive dialogue between the JFSA and various market participants, the Notice Guidelines include helpful context for structuring open market US CLOs in a manner which will comply with the JDDRs.

In particular, there will be no absolute requirement that a Securitisation Transaction incorporate risk retention in order for a Japanese Institutional Investor to invest, provided that investor is able to confirm that the Underlying Assets have been appropriately originated. For example, with open market US CLOs, risk retention may not be required for Japanese Institutional Investors to invest if the presence of already relatively common rights are confirmed and adequate information is provided to investors, to an extent that the investor is able to confirm that the Underlying Assets have been appropriately originated. Japanese Institutional Investors will need to determine if a Securitisation Transaction includes the transaction provisions needed to confirm this and, consequently, not require the Originator or arranger to retain risk.

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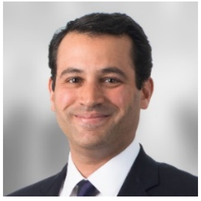

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