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Japan: Trends & Developments
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Trends and Developments

Contributed by Nagashima Ohno & Tsunematsu

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Recent Issue of Covered Bonds by Japanese Banks
Under Japanese law there is no specific legislation for statutory covered bonds and traditionally only contractual (structured) covered bonds have been issued in Japan. However, one of the largest Japanese commercial banks (the Issuer) recently issued covered bonds (the Covered Bonds) that provide investors with recourse to the Issuer's assets held in its proprietary (banking) capacity as well as the cover pools (mortgage loans secured by residential properties in Japan) held in its trustee capacity (trust assets) by using a total return swap (TRS) that may be liquidated by a close-out netting under the Act on Close-out Netting of Specified Financial Transactions Conducted by Financial Institutions (the Netting Act).

The Covered Bonds are so-called trust bonds that are issued by the Issuer in its capacity as the trustee of a specified money trust. The Issuer, as trustee, executes the TRS agreement with itself in its proprietary (banking) capacity as the counterparty (the TRS Counterparty). The relationship between the Issuer, as trustee, and the TRS Counterparty unfolds as follows.

- Under the TRS agreement, the Issuer will initially transfer the net issue proceeds of the Covered Bonds to the TRS Counterparty in exchange for Japanese law-governed senior trust certificates (RMBS).
- During the term of the TRS transactions, the Issuer will pay the TRS Counterparty all net interest, principal and any other payments that a hypothetical holder of each RMBS would have actually received in exchange for fixed or floating payments to be made by the TRS Counterparty to the Issuer, which effectively match the Issuer's payment obligations under the Covered Bonds. The TRS Counterparty may add, remove or substitute the RMBS unless it defaults.
- The TRS agreement shall terminate upon the early or final full redemption of the Covered Bonds. Upon such termination, the TRS Counterparty will pay the Issuer an amount equivalent to the relevant portion of the net issue proceeds of the Covered Bonds, which was exchanged at the commencement of the TRS transaction, and the interest under the TRS transaction. In exchange, the Issuer may pay the market value of the RMBS or transfer the RMBS to the TRS Counterparty as a physical settlement option.

In short, the ability of the Issuer to meet its payment obligations under the Covered Bonds primarily depends upon the TRS Counterparty's performance of its obligations under the TRS agreement. Additionally, the holders of the Covered Bonds benefit from the cover pool (trust asset) held by the Issuer in its trustee capacity, which consists mainly of the RMBS originated by the Issuer in its proprietary (banking) capacity. Therefore, if the TRS Counterparty defaults, the Issuer will have access to the proceeds from the RMBS to fulfil its obligations under the Covered Bonds.

In a typical securitisation transaction, if the originator continues to owe a debt obligation, the assignment of the cover pool from the originator to the special purpose corporation or the trust may be recharacterised as the creation of collateral to secure the originator's debt obligation, the payment of which will be subject to insolvency, particularly in corporate reorganisation, proceedings. While still under discussion, the above TRS arrangement may mitigate such recharacterisation risk since the TRS arrangement will be statutorily exempted from insolvency proceedings so long as it may be liquidated by a close-out netting under the Netting Act.

The Covered Bonds are secured by a pledge over the cover pool (trust asset) held by the Issuer in its trustee capacity. However, secured bonds are rarely issued in Japan since, according to one prominent interpretation, the issuance of secured bonds by Japanese companies, within or outside Japan, will be subject to the onerous rules and burdensome procedures under the Secured Bond Trust Act. These rules and procedures include the mandatory entrustment of collateral and the mandatory holding of a bondholders' meeting for the disposition or replacement of collateral. However, according to another prominent interpretation, the Secured Bond Trust Act will only be applicable to bonds governed by Japanese law. Accordingly, the Secured Bond Trust Act will not be applicable to secured Euro bonds issued by Japanese companies so long as such bonds are governed by the law of England and Wales or another non-Japanese law jurisdiction.

Amendment to the Civil Code – New Rules for Assignment of Receivables with a Non-assignment Covenant
The provisions of the Civil Code of Japan regarding claims and contracts were amended (the Amendment) to respond to social and economic changes that occurred in about 120 years after the Civil Code was enacted. The Amendment, enacted on 26 May 2017, will enter into force on 1 April 2020 (the Effective Date). The Amendment introduces new rules for the assignment of receivables with a contractual provision that prohibits or restricts a transfer of a right, receivable or claims (a Non-assignment Covenant and receivables with a Non-assignment Covenant shall be referred to as Non-assignable Receivables). The purpose of the new rules is to promote securitisation and collateralisation of Non-assignable Receivables. The new rules shall apply to the assignment of receivables for which the assignment agreement is concluded after the Effective Date, regardless of the timing of the occurrence of receivables or the time of conclusion of a Non-assignment Covenant.

The purpose for which a creditor and a debtor agreed on the prohibition of the assignment of receivables is, in general, to secure the debtor's interests by fixing the person to whom the receivables are to be paid. In other words, the purpose is to (i) avoid burdensome clerical work for the debtor, (ii) avoid the risk of the debtor's erroneous payment and (iii) secure opportunities for the debtor to offset against its counterclaims. Since debtors of Non-assignable Receivables often have high creditworthiness, securitisation and collateralisation of Non-assignable Receivables would be effective methods for creditors' fund-raising transactions. Under the current Civil Code, however, an assignment of receivables that violates a Non-assignment Covenant shall be null and void. Therefore, under the current rule, when creditors raise funds using Non-assignable Receivables, it is necessary to use methods without assignment of receivables, such as declaration of trusts and loan participation. The current rule was considered as a major obstacle to fund-raising transactions using assignment of Non-assignable Receivables. Accordingly, the amendment made the assignment of Non-assignable Receivables always valid. However, in order to ensure the debtor's interests protected by a Non-assignment Covenant, the amended Civil Code allows the debtor to continue to make repayment to the assignor of the receivables and allows the debtor to assert its defence against the assignor of the receivables. In an ordinary securitisation transaction, the assignor of the receivables is appointed as a servicer and continues to collect the receivables from the debtor. Accordingly, allowing the debtor to continue to make repayment to the assignor of the receivables does not immediately make it impossible to securitise such receivables. Therefore, it is expected that the amendment will enable financing by the assignment of Non-assignable Receivables to some extent.

However, even in an ordinary securitisation transaction, the assignor of the receivables may be removed from the servicer and another person may be designated to collect the receivables in the following circumstances. If the debtor can still make repayment to the assignor of the Non-assignable Receivable in such circumstances, the amendment has an obstacle to financing by the assignment of Non-assignable Receivables.

First, a special servicer, as a collection agent of the assignee, may be designated to collect defaulted receivables. The amended Civil Code provides that if a debtor fails to perform its obligation, the assignee may demand the debtor to pay the assignor within a reasonable period and if the debtor fails to make payment to the assignor within such period, the debtor may no longer refuse to perform its obligations to the assignee. The provision allows the special servicer to collect the defaulted Non-assignable Receivables.

Second, in the event that the assignor's credit standing deteriorates in an ordinary securitisation transaction, the assignor may be removed from the servicer and a new back-up servicer may be appointed to collect the receivables. If the assignor continues to collect the receivables, there is a risk that the assignee's claim for delivery of the collected money is performed pari passu with other claims and the entire amount will not be recoverable (in other words, 'commingling risk' exists). With respect to the money to be collected after the commencement of insolvency proceedings – such as a bankruptcy proceeding, a civil rehabilitation proceeding and a corporate reorganisation proceeding – against the assignor, the risk is limited. As for bankruptcy proceedings, the amended Civil Code provides that the perfected assignee of Non-assignable Receivables may request the debtor to make a deposit with an official depository and only the assignee may make a request for a refund of the deposit. The burden of the deposit procedure under such provision allows the assignee to incentivise the debtor to accept the collection of the receivables by the back-up servicer and even if the debtor does not accept the collection by the back-up servicer, the back-up servicer may request the refund of the deposit as an agent of the assignee after the debtor makes the deposit. As for other insolvency proceedings, such as civil rehabilitation proceedings and corporate reorganisation proceedings, such provision under the amended Civil Code does not apply. However, the assignee may request the assignor to provide the money that the assignor collected after the commencement of insolvency proceedings and the claim shall be protected from the commingling risk to the extent that it, as a common benefit claim, shall be performed preferentially to other claims. With respect to the money that the assignor, as the servicer, collected but did not deliver to the assignee prior to the filing of the petitions for commencement of insolvency proceedings including bankruptcy proceedings, the claim shall not be protected from the commingling risk. Since the assignor cannot be removed from the servicer and the assignee cannot request the debtor to make a deposit with an official depository until the commencement of bankruptcy proceedings against the assignor, the commingling risk in the assignment of Non-assignable Receivables is relatively higher than that of assignment of receivables without a Non-assignment Covenant. If the assignee is a bank and the assignor accepts to open its bank account, as a servicing account, in the assignee, and to demand the debtor to pay into that bank account, the assignee can avoid the commingling risk by offsetting the assignee's claim for the collected money from Non-assignable Receivables against the assignor's counterclaim.

In separation from the new rules, there are other risks in the securitisation and collateralisation of Non-assignable Receivables. For example, if the assignor assigns Non-assignable Receivables without the debtor's consent, there is a risk that, even if the assignment of the Non-assignable Receivables itself is effective under the new rules, it may constitute a breach of the agreement between the assignor and the debtor, which leads to remedies under the agreement. However, since the amended Civil Code protects the debtor's interest by fixing the person to whom the receivables are to be repaid to a certain extent, it is possible to construe that the assignment of the Non-assignable Receivables does not necessarily breach the agreement between the assignor and the debtor. Since this issue is a matter of interpretation of individual agreements, it is necessary to make judgment on a case-by-case basis.

In addition, the amended Civil Code stipulates the judicial doctrine that future receivables (receivables occurring after the assignment agreement) can, in principle, be validly assigned and perfected at the time of the assignment agreement. The collateralisation of future receivables plays an important role in areas such as asset-based lending, acquisition financing and project financing. Furthermore, securitisation transactions of future receivables may be one of the useful schemes for raising funds for infrastructure businesses (electric power, air transport, water supply, etc).

STC Criteria under the Basel III Securitisation Framework

Following the global financial crisis, the Basel Committee of Banking Supervision (BCBS) revised the international framework for ensuring banks' capital adequacy with a view to providing the regulatory foundation for a more resilient banking system under an improved framework referred to as 'Basel III'. The treatment of securitisation transactions has been one of the most contentious areas of this undertaking. However, following a series of consultations among interested parties, in July 2016, the BCBS finalised the majority of Basel III's securitisation regulatory standards that adopt a more risk sensitive, prudent and simple approach to calculating the risk-weighted assets of securitisation exposures held by banks.

In Japan, the banking regulator (the Financial Services Agency of Japan) is in the process of incorporating the Basel III securitisation framework into Japanese banking regulations. Drafts of relevant rules were already published in late December 2018 and the regulator is soliciting comments from the public on such draft rules at this stage (late January 2019). After considering comments from the public, the regulator will prepare the final version of relevant rules, which are expected to come into effect at the end of March 2019. In accordance with the July 2016 BCBS publication, the new framework under such rules essentially requires a larger amount of regulatory capital, especially for banks holding highly rated securitisations, as the risk weight (RW) applied to such securitisations is higher compared to the previous framework.

One of the important components of this framework gathering attention from market players is the simple, transparent and comparable (STC) criteria for long-term securitisations. According to the July 2016 BCBS publication, there are 16 individual criteria that comprise the STC criteria as a whole. 'Simplicity' refers to homogenous underlying assets with simple characteristics and a simple transaction structure. 'Transparency' requires sufficient information on underlying assets, structure and relevant parties to be available to investors. 'Comparability' is meant to enable investors to undertake a more straightforward comparison across securitisation products within an asset class. If a bank confirms that a securitisation product meets all the STC criteria that embody the aforementioned basic concepts, the bank is permitted to apply a lower RW to the product, which results in less regulatory capital being required. This differentiated capital treatment of STC-compliant and non STC-compliant securitisations highlights the improved risk sensitivity of the new framework. What is more, STC-compliant securitisation enables transaction parties to conduct thorough risk and return analyses across similar securitisation products.

Since this favourable capital treatment is generally attractive to banks, originators and arrangers of securitisation transactions would likely seek to structure STC-compliant securitisations going forward; however, taking a closer look at each criterion, there may be a number of hurdles to structuring a securitisation product that satisfies each part of the criteria. The 16 criteria are fundamentally mapped to key types of risks in the securitisation process: (i) the asset risk, (ii) the structural risk and (iii) the fiduciary and servicer risks, which is where the asset risk-related criteria would require the most attention from a practical point of view. For example, one of the criteria requires the originator's verification that none of the debtors of the underlying receivables meets certain conditions indicative of credit risks, such as insolvency, adverse credit history or contentious proceedings. The important point here is that the assessment of such conditions should be carried out no earlier than 45 days prior to the closing date, not the portfolio cut-off date. Another criterion prohibits a single obligor's exposure from exceeding a certain ratio (in principle, 1%) of the aggregated exposures in the portfolio as of the portfolio cut-off date. In this case, depending on the types of underlying assets, compliance may not be practical or may at least require significant changes to the way assets are selected to constitute the portfolio. Another criterion regarding the initial and ongoing disclosure of the underlying receivables data may give rise to practical feasibility issues if loan-level data (as opposed to summary stratification data) is required for a non-granular pool of assets. The majority of the criteria appear unlikely to raise any serious practical issues, but further clarification from the banks' perspective, who are in the unique position of being required to assess the practical impact of STC compliance and the appropriateness of less regulatory capital for a specific securitisation, is required before any definite conclusions can be made.

In the Japanese post-crisis market, there have been efforts driven by the government and industry to reduce the uncertainty of the risks pertaining to securitisation products, including measures to enhance the 'traceability' of securitisation products. It is fair to say that the momentum towards adopting the underlying principles of the STC criteria has been growing in Japan in recent years and, in that context, it is expected that the STC criteria will be implemented with sufficient clarity and in a manner that is compatible with current securitisation practices in Japan.

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