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Securitisation

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Amendment to Japanese Risk Retention Rules for Securitisation Products

On 15 March 2019, the Japanese Financial Services Agency (JFSA) published certain amendments to its notices on the capital requirements for banks and certain other financial institutions; these became effective as of 31 March 2019. Such amendments overhauled the methods of calculating risk-weighted assets in the case of financial institutions holding securitisation products. In particular, in the event that a financial institution holds securitisation products but is unable to confirm that the originator holds 5% or more exposure concerning such securitisation products, a higher risk weight than normal (ie, triple risk weight, up to 1,250% – which means full capital deduction) shall be applicable in calculating such financial institution's risk-weighted assets unless certain exemption requirements are satisfied.

Such risk retention itself was already required by the JFSA's supervisory guidelines for financial institutions even before the above amendments were made, but, before these amendments, financial institutions were required only to check (i) whether or not the originator retains part of the exposure of the securitisation products, and, if not, (ii) whether or not the originator's involvement in the underlying assets or the quality of the underlying assets is analysed in depth.

However, after the above amendments, more specific requirements, such as quantitative criteria and sanctions in case of a violation of such rules (ie, application of higher risk weight) were additionally introduced. In substance, similarly to the USA or the EU, the originator or sponsor is required to hold 5% or more exposure of the securitisation products in Japan. It should be noted that, differently from the USA or the EU (after January 2019), Japanese risk retention rules do not directly require the originator or sponsor to hold certain amount of exposure of securitisation products and only indirectly requires such risk retention by stipulating that financial institutions shall apply a higher risk weight to the securitisation assets for which the risk retention rules are not complied with. Such amendments will be applicable in respect of securitisation products acquired by financial institutions on or after 1 April 2019 and will not be applicable to securitisation products held by financial institutions on 31 March 2019.

To meet the risk retention requirements, in general, the originator must hold 5% or more of the aggregate amount of exposure of the underlying assets of the relevant securitisation. It should be noted that the portion of the exposure substantially not borne by the originator, due to hedging such exposure with guarantees or CDSs, is to be excluded from the percentage of the exposure held by the originator. More specifically, the originator shall hold:

- (i) an equal portion of all tranches, the total amount of which is at least 5% of the aggregate exposure of the underlying assets of the relevant securitisation;
- (ii) all or part of the most junior tranche, the total amount of which is at least 5% of the aggregate exposure of the underlying assets of the relevant securitisation;
- (iii) if the most junior tranche is less than 5% of the aggregate exposure of the underlying assets of the relevant securitisation, all of such tranche and part of other tranches, the total amount of which is at least 5% of the aggregate exposure of the underlying assets of the relevant securitisation; or
- (iv) an exposure that is equal to or greater than the exposure required to be held by the originator under the above three methods.

As an exception to the above general rule, even when a financial institution cannot confirm that the originator holds 5% or more of the aggregate exposure of the underlying assets of the relevant securitisation, if such financial institution can determine that the underlying assets were not inappropriately originated, taking into consideration the relevant circumstances such as the originator's involvement in the underlying assets or the quality of the underlying assets, etc, then the financial institution will not be required to apply a higher risk weight in calculating its securitisation exposure. More specifically:

- when it can be confirmed that the originator, etc, holds an exposure equal to or greater than the exposure required to be held under requirements (i) through (iv) above, such as;
  - (a) when the originator's parent company, the arranger or any other entity who was deeply involved in the structuring of the relevant securitisation holds the exposure;
  - (b) when the originator provides credit enhancement to the subordinated portion; or
- when so-called "random selection" was conducted (eg, when the underlying assets were randomly selected from an underlying asset pool that included a large number of receivables, etc, and the originator continues to hold all of such receivables, etc, of the underlying asset pool other than

the above selected assets, the exposure of which amounts to 5% or more of the aggregate exposure of the underlying asset pool);
- when the quality of the underlying assets was analysed in depth and it can be determined that the underlying assets have not been originated inappropriately. For example, (x) when it can be determined that the underlying assets were not originated inappropriately, relying upon objective materials, etc, by which investors may determine the quality of the underlying assets (eg, where the underlying assets of the securitisation are real estate and appropriate appraisal documents and engineering reports were made for the origination of such securitisation); or (y) when the originator originated the securitisation products by purchasing the underlying assets from the market (like open market CLOs in the USA) and it can be determined, by relying upon objective materials, etc, that the quality of the securitisation products procured in the market is not inappropriate; or
- when requirements (i) through (iv) above are no longer met due to changes in the factors surrounding the securitisation products after their acquisition, but it can be determined that the originator continues to hold the relevant exposure (eg, when the total amount of the exposure held by the originator becomes less than the required amount of exposure due to default or prepayment of the underlying assets during the securitisation period).

As mentioned above, the Japanese risk retention rules do not directly require that the originator or sponsor hold a certain amount of exposure and only indirectly requires the same by making a rule that a higher risk weight shall be applied when financial institutions acquire securitisation products that do not comply with the risk retention rules. Therefore, practically speaking, investors in securitisation products (many of which are financial institutions) should establish a due diligence framework and confirm compliance with the Japanese risk retention rules not only at the time of acquisition of the securitisation products but also at each time they are required to calculate the risk weighting of its assets for capital adequacy purposes. In addition, financial institutions should request of the originator the insertion of the following language in the relevant documents to confirm the compliance with the Japanese risk retention rules:

- the originator shall continue to hold the subordinated exposure constituting 5% or more of the total exposure of the underlying assets;
- the originator shall continue to hold the subordinated exposure substantially and may not hedge such exposure by way of third-party guarantees, risk participation or otherwise;
- the originator may not transfer the subordinated exposure or may only transfer it if one of requirements (i) through (iv) above will continue to be met after the transfer; and
- if the originator violates any of the above requirements, the originator shall indemnify the investors for damages or repurchase the subject receivables or be imposed other sanctions.

An information memorandum on securitisation products usually sets forth certain disclaimers such that financial institutions as investors shall calculate their own risk weights and that the amount of credit risk assets may increase due to future possible amendments by the JFSA to its notices and such amendments may have an adverse effect on the liquidity of the relevant securitisation.

These amendments to the Japanese risk retention rules are relatively new and we have to keep a close eye on the future application of and further amendment to these rules.

Implementation of STC Criteria under the Basel III Securitisation Framework

In July 2016, the Basel Committee on Banking Supervision (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 financial institutions. On 15 March 2019, the JFSA incorporated such Basel III securitisation framework into Japanese regulations by amending its notices on the capital requirements for banks and certain other financial institutions and Q&As clarifying the interpretations thereof. The amended notices were implemented on 31 March 2019.

The new framework essentially requires a larger amount of regulatory capital, especially for financial institutions holding highly rated securitisations, as the risk weight (RW) applied to such securitisations is higher compared to the previous framework. At the same time, in an effort to improve its risk sensitivity, the new framework has introduced simple, transparent and comparable (STC) criteria and permits financial institutions to apply a lower RW to long-term securitisation products compliant with such criteria.

With respect to each component of the STC, "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. The STC criteria embodied by the amended notices are 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 recent insolvency proceedings, adverse credit history or contentious disputes. 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. The amended Q&As clarify practical ways for the originator to adhere to this criterion.

Taking the example of recent insolvency proceedings, the originator is deemed to have undertaken the required verification if the originator has no knowledge of such insolvency proceedings prior to the closing date, and if the originator is contractually obliged to repurchase relevant underlying receivables in case it later learns about such insolvency proceedings of any debtors.

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.

A further criterion requires the initial and ongoing availability of the underlying receivables data for the purpose of assisting investors' due diligence and monitoring. Loan-level data is required for a non-granular pool of assets while summary stratification data is sufficient for a granular pool. According to the amended Q&As, for providing a level of assurance about the accuracy of the underlying receivables data and the fulfilment of eligibility criteria, the initial portfolio must be reviewed by an appropriate legally accountable and independent third party such as an independent accounting practice or the calculation agent or management company for the securitisation. The amended Q&As require that the outcome of such review be disclosed to investors in the prospectus or other similar documents. The amended Q&As also clarify that the underlying receivables data must be updated at least on a quarterly basis.

It is also noteworthy that, for compliance with the STC criteria, the originator is also required to hold a part of the securitisation exposure in an appropriate manner. The amended Q&As clarify that this criterion can be met by complying with the risk-retention requirements by the originator holding 5% or more of the aggregate amount of exposure of the underlying assets of the relevant securitisation (please see "Amendment to Japanese Risk Retention Rules for Securitisation Products", above).

The majority of the criteria appear unlikely to raise any serious practical issues, but further clarification from the financial institutions' 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.

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. In that context, the STC criteria is being implemented with sufficient clarity and in a manner that is compatible with current securitisation practices in Japan. STC-compliant securitisation will also enhance transaction parties' thorough risk and return analyses across similar securitisation products.

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 will be amended to reflect socio-economic changes that have occurred in the approximately 120 years since the enactment of the Civil Code. The amendment, enacted on 26 May 2017, will enter into force on 1 April 2020 (ie, the effective date). This amendment will introduce 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; receivables with a non-assignment covenant will 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 will apply to the assignment of receivables for which the assignment agreement is concluded after the effective date, regardless of when the receivables were accrued or when the non-assignment covenant was concluded.

The purpose for which creditors and debtors agree on the prohibition of the assignment of receivables is, in general, to safeguard debtors' interests by fixing the person to whom the receivables are to be paid. In other words, the purpose is to (i) eliminate or reduce burdensome clerical work for debtors, (ii) eliminate the risk of debtors making erroneous payments, and (iii) secure opportunities for debtors to offset against their 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 is null and void. Therefore, under the current rule, when creditors raise funds using non-assignable receivables, they must do so using methods other than the assignment of receivables, such as declaration of trusts or loan participation. The current rule is considered as a major obstacle to fund-raising transactions using assignment of non-assignable receivables. Accordingly, the amendment will make the assignment of non-assignable receivables a viable option. However, in order to safeguard debtors' interests protected by a non-assignment covenant, the amended Civil Code will allow debtors to (i) continue making repayments to the assignor of the receivables, and (ii) assert their 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 repayments 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 as servicer, and another person may be designated to collect the receivables in the two circumstances outlined below. If the debtor can still make repayment to the assignor of the non-assignable receivables in such circumstances, the amendment would be 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, if the assignor's credit standing deteriorates in an ordinary securitisation transaction, the assignor may be removed as the servicer, and a new back-up servicer may be appointed to collect the receivables. If the assignor continues to collect the receivables, the risk may arise that the assignee's claim for delivery of the collected money could rank 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 will be protected from the commingling risk to the extent that it, as a common benefit claim, will be ranked 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 for such money will not be protected from the commingling risk.

Since the assignor cannot be removed as 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 in the assignment of receivables without a non-assignment covenant. If the assignee is a bank and the assignor agrees 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 against the non-assignable receivables against the assignor's counterclaim.

Separate from the new rules, other risks in the securitisation and collateralisation of non-assignable receivables exist. For example, if the assignor were to assign non-assignable receivables without the debtor's consent, the risk could arise 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 could lead to remedial actions being taken pursuant to 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 may be construed 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, its determination must be made on a case-by-case basis.

In addition, the amended Civil Code stipulates the judicial doctrine that future receivables (receivables accruing 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 (ie, electric power, air transport, water supply, and similar infrastructure businesses).

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Nagashima Ohno & Tsunematsu has a structured finance and derivatives team of more than 50 lawyers (including approximately 15 partners) who have extensive experience dealing with a wide variety of structures in Japanese and cross-border transactions, including – in addition to the traditional methods of structured finance – WBS (whole business securitisation), CMBS (commercial mortgage-backed securities), CDO (collateralised debt obligations), BIS finance (dealing with financial institutions capital adequacy requirements under the Basel Accord) and other transactions involving derivatives. NO&T provides exceptional advice in all aspects of structured finance and derivatives transactions – for example, structure development, risk analysis, SPC or trust formation, documentation, negotiation, research and rendering of legal opinions. NO&T expertly represents clients that serve various functions in the structured finance and derivatives market, from arrangers, originators, fiduciaries (trust banks), and special purpose companies, to parties supplying supplementary financing and/or credit-enhancement (financial institutions), credit-rating agencies and investors.

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