Japanese Risk Retention: JFSA Favors Diligence Over Disruption

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March 2019

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The new Japanese Risk Retention Rules will lead to increased loan and collateral manager due diligence by Japanese investors but not wholesale changes to the CLO market.

Background

On March 15, 2019, the Japanese Financial Services Agency (the "**JFSA**") published final rules and FAQs responding to comments on proposed changes in the regulatory capital requirements applicable to Japanese banks and certain other financial institutions that invest in securitization transactions (respectively, the "**JFSA Final Rules**", "**JFSA FAQs**" and "**JFSA Proposed Rules**").[1] The JFSA Final Rules are intended to coordinate risk retention requirements with those in effect in other major financial markets around the world.

The major takeaway is that *there is a path forward for CLOs* which does not include a Japanese risk retention obligation based on a determination by the affected Japanese investors that the underlying loans were not "inadequately formed." Thus, the JFSA Final Rules will lead to increased loan and collateral manager due diligence by Japanese investors but will not result in wholesale changes to the CLO market.

1. How do the JFSA Final Rules Differ from the JFSA Proposed Rules?

The JFSA Final Rules impose new requirements upon Japanese banks and certain other regulated Japanese financial institutions[2] (each, an "**Affected Investor**") with respect to any "securitization exposure" acquired by such an Affected Investor. Except for a clarification that the Final JFSA Rules apply to all securitizations by amending the definition of "original assets" to include assets that the originator "*or any other person*" transfers to the securitization, the JFSA Final Rules in large part follow the JFSA Proposed Rules. The JFSA Final Rules define a "securitization exposure" as an exposure related to a "securitization transaction" in which the "credit risk related to the original assets is stratified into

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[1] The JFSA Final Rules and JFSA FAQs are available at: https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf. Note that our review has been limited to unofficial English translations of the JFSA Final Rules, the JFSA FAQs and the JFSA Proposed Rules.

[2] Specifically, the JFSA Final Rules apply to: (A) Deposit-taking financial institutions: (a) Banks (licensed under the Banking Act), other than foreign bank branches; (b) Credit unions (or shinkin banks); (c) Federations of credit unions (i.e., the Shinkin Central Bank); (d) credit cooperatives (or shinkumi banks); (e) Federations of credit cooperatives (i.e., the Shinkumi Federation Bank); (f) Workers' credit union banks (or rokin banks); (g) Federations of workers' credit union banks (i.e., the Rokinren Bank); (h) Agricultural cooperatives engaged in deposit-taking business; (i) Federations of agricultural cooperatives engaged in deposit-taking business; (j) Fisheries cooperatives engaged in deposit-taking business; (k) Federations of fisheries cooperatives engaged in deposit-taking; (l) Marine products processing cooperatives engaged in deposit-taking business; (m) Federations of marine products processing cooperatives engaged in deposit-taking business; (n) the Norinchukin Bank; and (o) The Shoko Chukin Bank, Ltd.; (B) Bank Holding Companies; and (C) Highest Designated Parent Companies*., e.g.*, *List of Licensed (Registered) Financial Institutions*, JAPANESE FINANCIAL SERVICES AGENCY, https://www.fsa.go.jp/en/regulated/licensed/index.html.

two or more exposures that are in the relationship of a senior/subordinated structure, and the whole or part thereof are assigned to a third party".

The JFSA Final Rules require Affected Investors to establish comprehensive due diligence processes and procedures in connection with investing in securitization transactions and, in order to avoid a 1.250% risk weighting for each CLO note held by Affected Investors. In particular, they will need to assure either (1) that the originator owns and will retain Japanese risk retention in the CLO required under Article 248, Paragraph 3 (the "**Japanese Risk Retention Requirements**")[3] or (2) that "on the basis of the originator's involvement in the original assets, the nature or the original assets or any other relevant circumstances" that the assets underlying the CLO "were not inappropriately formed", a concept that has been expanded to permit Affected Investors to make such determination either with respect to the loans underlying the CLO or that parties "deeply involved" in the origination of the CLO hold risk retention at a level that would satisfy or be in excess of that required by the Japanese Risk Retention Requirements[4].

2. What are the instances where the original assets can be deemed not to have been "inadequately formed"?

In FAQ 2, the JFSA provides two different approaches to determine that "original assets can be deemed not to have been inadequately formed". The second example in FAQ 2 discusses how an Affected Institution may do an "in-depth analysis" primarily of the credit underwriting of the assets underlying the CLO, but also of the servicing and stress testing of the CLO, to determine if the "original assets" are "not inadequately formed". This analysis applies to any CLO including both broadly syndicated loan "open market" CLOs and middle market CLOs. The first example in FAQ 2 explains that an Affected Investor may make this determination provided that the originator, its parent, or other entities "deeply involved" in the origination of the CLO hold and retain credit risk retention that in the aggregate is the equivalent to or more than that required by the Japanese Risk Retention Requirements. An Affected Investor may take either approach to determine that "the original assets can be deemed not to have been inadequately formed" and that the CLO notes it holds will not be subject to a 1.250% risk weighting for regulatory capital purposes.

a. Case-by-Case Determination. A determination whether the "original assets may have been inadequately formed in a securitization transaction" must be made by each Affected Investor "on a case-by-case and specific basis taking into consideration the involvement of the originator in and the quality of such original assets".[5] In this OnPoint, we discuss the first two examples, in reverse order.

b. Example 2: Examples of the "in-depth analysis" to be conducted by an Affected Investor of the quality of the "original assets" to determine that the "original assets are deemed not to have been inadequately formed". For U.S. CLOs (whether relating to broadly syndicated loans or middle market loans), in order for an Affected Investor to determine under Example 2 that the underlying loans in such a CLO are deemed to be "not inappropriately formed," the Affected Investor, on a case-by-case, specific basis must determine by reviewing objective materials relating to the

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3 Article 248. Paragraph 3 of the JFSA Final Rules. Japanese risk retention requires that originators of securitization transactions retain "a securitization exposure equal to not less than 5% of the total of the assets being securitized." The methods of satisfying the risk retention requirement include: "vertically (as an equal portion of all tranches of the securitization); horizontally (as a portion of the most subordinate tranche of the securitization) or, if the most subordinate tranche is less than 5%, as a combination of vertically and horizontally." *See* John M. Timperio et al., *Japanese Risk Retention: Tidal Wave or Ripple in Still Waters?*, DECHERT LLP (Jan. 2019), https://info.dechert.com/10/11749/uploads/japanese-risk-retention-v4.pdf.

4 Article 248-Q2(1) of the JFSA FAQs.

5 *Id.*

basis of the originator's involvement in such loans, the nature of the loans and any other relevant circumstances, that such loans were "not inappropriately formed", i.e. were well underwritten from a credit perspective and will be appropriately serviced. The JFSA specifically rejected an analysis of the quality of the loans based on the credit rating of the CLO notes, the marketing or trading prices of the loans or the short term ("particularly during the boom period") performance of the loans. With a focus on the credit quality of loan origination and servicing, an Affected Investor must confirm and verify (i) whether the originator's loan review and credit underwriting criteria were appropriate, (ii) whether the specifics of the covenants of the loan agreements are "conducive to investor protection", (iii) whether the specifics and terms of the collateral securing the loans are appropriate and (iv) whether the collection abilities of the parties responsible under the CLO for collecting on the loans are adequate.[6] With respect to the ongoing acquisition and replacement of the loans permitted by the CLO after the date an Affected Investor acquires its notes in the CLO, the Affected Investor must confirm that objective and reasonable standards have been established for such acquisition and replacement of loans relating to the issues discussed above and suggests that Affected Investors may conduct risk analysis on the CLOs through stress tests based on reasonable scenarios and assumptions. Any determination that assets are "not inappropriately formed" must be made by an Affected Investor in relation to the investment criteria established by such Affected Investor. It is our understanding that the Affected Investor makes this determination in the first instance and that such determination may be reviewed by its regulators in the course of their regulatory oversight of the Affected Investor.

We expect that this will lead to increased due diligence by Japanese investors not only with respect to the loans in the CLO at the time the Japanese investors acquire their CLO notes, but also with respect to the credit underwriting and servicing practices of the collateral manager and the stress testing and structuring of the CLO.

c. Example 1: Risk Retention Held by the Originator, its Parent, and/or One or More Parties "Deeply Involved in the Organization of the [CLO]". The JFSA has significantly expanded the universe of parties who, if they do hold Japanese risk retention, will enable Affected Investors to determine with respect to such a CLO that "the original assets can be deemed to not have been inappropriately formed". Under the JFSA Final Rules only the "originator" is technically permitted to hold risk retention. In our comments to the JFSA on the JFSA Proposed Rules, Dechert explained how there are many entities other than the originator who are permitted to hold risk retention under the U.S. risk retention rules[7] and the EU risk retention rules[8] and requested that the Japanese rules be expanded to permit such entities to hold risk retention under the Japanese risk retention rules. We believed this was particularly important for credit funds and BDCs investing in loans who use CLOs as balance sheet financings of their loan portfolios. Although the JFSA did not modify the items relating to the Japanese risk retention requirements in the Japanese Risk Retention Requirements, in FAQ 2 Example 1 it did provide examples of situations where "the original assets can be deemed not to have been inadequately formed" if Affected Investors can confirm that the originator or certain other persons retain credit risk equivalent to or more than the credit risk required by the Japanese Risk Retention Requirements. The JFSA included an example where "[e]ven if it cannot be confirmed that the originator retains credit risk meeting the terms set forth in the respective items of Article 248, Paragraph 3", if "the originator's parent company or a relevant party other than the originator that was deeply involved in the organization of the securitization product (such as the arranger) retains the credit risk, and it can be confirmed that the aggregate of the credit risk borne by such company or party and by the

6 Article 248-Q2(2) n.3 of the JFSA FAQs.

7 Credit Risk Retention, 17 C.F.R. Part 246 (2018).

8 Regulation (EU) 2017/2402.

originator is equivalent to or more than the credit risk set forth in the above mentioned items", then "the original assets can be deemed not to have been inadequately formed".[9]

We believe, that being "deeply involved in the organization" of the CLO means that an entity (i) is a party to the engagement letter with the investment bank underwriting or placing the CLO and is involved in the structuring of the CLO, (ii) negotiates the CLO documents and (iii) undertakes credit underwriting of the initial loans going into the CLO. Such entities may include not only the originator of the loans and its parent but also other entities permitted to hold risk retention under either the U.S. risk retention rules or the EU risk retention rules. Helpfully, this example permits more than one of such entities to hold risk retention, so long as in the aggregate, such entities hold the equivalent or more of the credit risk that is required to be held under the Japanese Risk Retention Requirements.

9 Article 248-Q2(1) of the JFSA FAQs.

Conclusion

The Japanese regulators opted for a measured approach to risk retention in the JFSA Final Rules. In so doing, they eschewed restricting the ability of Affected Investors to make CLO investments or disrupting the CLO market and instead focused on formalizing and enhancing the diligence and reporting standards currently followed by many of the largest Japanese investors.

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