Japanese Risk Retention: Tidal Wave or Ripple in Still Waters?

Authored by Members of Dechert's CLO Team:
John M. Timperio, Cynthia J. Williams, Mary Bear, Christopher Desmond, Christopher P. Duerden, Adam Firestone, Matthew Gauthier, Cameron Mitcham, Kelly Nash and James Waddington

January 2019

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Background

On December 28, 2018, the Japanese Financial Services Agency (the "**JFSA**") published a number of notices detailing proposed changes in the regulatory capital requirements applicable to Japanese banks and certain other financial institutions that invest in securitization transactions (the "**JFSA Proposal**").[2] The JFSA Proposal is intended to coordinate risk retention requirements with those in effect in other major financial markets around the world, and like the U.S. risk retention rules, the JFSA Proposal in the context of CLOs relates to securitization transactions involving an originator that transfers assets into an issuing entity, and therefore may not apply to "open-market" CLO transactions due to how the assets underlying such transactions are acquired. Moreover, even if the JFSA Proposal applies to "open-market" CLOs, due to the nature of the assets in a CLO transaction, we believe that the retention requirement of the JFSA Proposal (the "**JFSA Retention Requirement**") should not apply pursuant to an exception for securitizations in which the original assets are not "inappropriately formed," as described further below.

Based on our discussions with industry participants in the U.S. and Japan, we are optimistic that helpful clarifications will be forthcoming which will bring greater clarity and focus to the application of these proposed requirements. In the Q&A that follows in this *OnPoint*, we provide answers to a number of the questions that face the CLO market as a result of the JFSA Proposal.

1. What are the new requirements under the JFSA Proposal?

As currently drafted, the JFSA Proposal imposes new requirements upon Japanese banks and certain other regulated Japanese financial institutions (each, an "**Affected Investor**") with respect to any "securitization exposure" acquired by such an Affected Investor. The JFSA Proposal defines a "securitization exposure" as an exposure related to a securitization transaction.[3] In turn, a "securitization transaction" is defined as a transaction where the "credit risk related to the original assets is stratified into 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 definition further excludes certain "specialized lending" transactions).[4]

There are two separate sets of requirements embodied in the new JFSA Proposal. The first component of the JFSA Proposal requires Affected Investors to satisfy a set of comprehensive (but vague) due diligence requirements with

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1 Copyright credit Grateful Dead. We intend to answer this question when the Final Rule is published.

2 https://www.fsa.go.jp/news/30/ginkou/20181228_3.html. The JFSA Proposal amends numerous JFSA capital requirements (as amended by the JFSA Proposal, the "Bank Capital Adequacy Criteria"). Note that our review has been limited to an unofficial English transaction of the JFSA Proposal and related definitions.

3 Article 1. Item (xvi) of the Bank Capital Adequacy Criteria.

4 Article 1. Item (ii) of the Bank Capital Adequacy Criteria.

respect to a securitization exposure and the related securitization transaction. An Affected Investor will have to implement a reporting/due diligence "system" that will have the following features: (i) the "continuous collection" of information concerning the risk characteristics of a securitization exposure; (ii) the timely collection of information concerning the risk characteristics and performance of the underlying assets; (iii) identification of structural characteristics of the securitization transaction and (iv) "control rules" in place to implement the foregoing system.[5] It remains to be seen how this "system" develops, although it is evident that the JFSA had the E.U. risk retention due diligence requirements in mind when drafting the general provisions.

The second component of the JFSA Proposal requires the Affected Investor to establish that the "originator" of the related securitization transaction has retained a securitization exposure equal to not less than 5% of the total of the original assets being securitized. Similar to the U.S. risk retention rules, the retained exposure can be held 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 (otherwise known as an "L-shaped" retention interest). Additionally, the JFSA Proposal states that the originator may retain a securitization exposure in a manner different than the aforementioned options so long as, due to such originator's continuous holding, the credit risk it holds is at least equal to the credit risk required to be held in any of the other options. This option may be further clarified, but could theoretically include situations in which the originator retains risk by means of a guarantee of the securitization obligations, holds risk in the form of a re-securitization, holds portions of each loan in the securitization in an amount that satisfies the required exposure, or deposits cash in an account equal to the required exposure.

2. What is the consequence for failing to satisfy the requirements of the JFSA Proposal?

Similar to the E.U. risk retention requirements, the JFSA Proposal regulates securitizations indirectly by imposing its requirements on the Affected Investors investing in securitizations. The failure of the CLO to satisfy the JFSA Retention Requirement (if applicable) or the failure of an Affected Investor to satisfy the due diligence requirements applicable to it in connection with a securitization exposure will result in an increased capital charge to the Affected Investor subject to a maximum risk weight of 1,250% for each non-compliance securitization exposure.[6] In addition, the JFSA has the ability to impose disciplinary action on the Affected Investor depending upon the circumstances surrounding a particular securitization exposure's non-compliance.

3. What is the timetable for the JFSA Proposal?

The JFSA Proposal was released on December 28, 2018, and the final rule will apply beginning March 31, 2019. Public comments to the JFSA Proposal may be submitted by 12:00 (JST) on Monday, January 28, 2019. Prior to the effectiveness of the final rule, the JFSA is expected to publish further guidance in a frequently-asked-questions format.

4. Does the JFSA Proposal apply to existing securitizations?

The JFSA Proposal includes an express grandfathering provision, which specifies that the JFSA Retention Requirement does not apply to "securitization products held by a bank on the Date of Application, as long as the bank

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[5] Article 248. Paragraph 1 of the Bank Capital Adequacy Criteria.

[6] Article 248. Paragraphs 2 & 3 of the Bank Capital Adequacy Criteria.

continues holding them."[7] In other words, securitizations themselves are not grandfathered, but an Affected Investor's position in a CLO as of the effective date would be grandfathered. Thus, if an Affected Investor acquired securities in a securitization after the effective date, the Affected Investor's position in the securitization would be subject to the JFSA Retention Requirement even if the securitization had closed prior to the effective date.

Left open in the JFSA Proposal is whether a position in a securitization acquired by an Affected Investor prior to the effective date but that is subject to a material amendment after that date would continue to be covered by the grandfathering provision. In both the U.S. and E.U. regimes, it is possible that amendments that change the material economic terms of a securitization may constitute a new securitization transaction subject to a new risk retention requirement. However, absent any specific guidance from the JFSA, it is difficult to predict the effects of a material amendment on the grandfathering of a securitization position owned by an Affected Investor prior to the effective date.

5. Does an "open-market" CLO transaction fall within the scope of the JFSA Proposal?

The JFSA Proposal applies to each "securitization transaction," which term does not appear to capture "open-market" CLOs. As defined in the JFSA Proposal, a "securitization transaction" is a transaction which involves "original assets."[8] The relevant prong of "original assets" includes "assets that the *originator transfers* to the securitization conduit in an Asset assignment-type securitization transaction" (emphasis added).[9] However, in a typical "open-market" CLO there is no originator that transfers assets; instead, the collateral manager (the "**Manager**") directs the CLO issuer to acquire the assets directly in the open market on an arms' length basis.

In addition, the JFSA Proposal defines "originator" as an entity falling under either of the following:

i. if it is involved in the origination of the original assets of a securitization transaction directly or indirectly; or

ii. if it is a sponsor of an ABCP conduit that acquires exposures from a third party, or any other similar program.[10]

In an "open-market" CLO, there is no party that is "involved in the origination of the underlying assets directly or indirectly" under clause (i)[11], nor would there appear to be any party that is a "sponsor" under clause (ii).[12] Based on these definitions, it would not appear that an "open-market" CLO would be required to comply with the JFSA Proposed Rules since an "open-market" CLO typically does not involve a "transfer" of assets by an "originator" to the CLO issuer. Instead, the defined terms related to "securitization transaction", "original assets" and "originator" seem to encompass a traditional balance sheet type securitization transaction in which a sponsoring entity originates assets (such as receivables, auto loans, student loans, etc.) and then transfers those assets to a securitization vehicle for financing.

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7 Article 4 of the Supplementary Provisions of the JFSA Proposal.

8 Article 1. Item (ii) of the Bank Capital Adequacy Criteria.

9 Article 1. Item (xxii) of the Bank Capital Adequacy Criteria.

10 Article 1. Item (lxviii) of the Bank Capital Adequacy Criteria.

11 For our purposes, we assume that the "originator" of a loan is the entity which acts as lead bank/arranger or as a direct original lender or a member of the primary loan syndicate involved in the origination.

12 Article 1 of the Bank Capital Adequacy Criteria.

Similarly, the risk retention rules in the U.S. apply to a "securitizer," which is defined as "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."[13] In this context, the DC Court of Appeals[14] determined that the U.S. risk retention rules were not applicable to the Manager of an "open market" CLO in which the Manager, as agent for the buyer, directed the purchase of loans by the CLO issuer in the open market.[15]

However, there remains some ambiguity regarding the JFSA Proposal since there is no definition of "origination" and the JFSA has informally indicated that it intends for the JFSA Proposal to generally apply to all types of securitizations. We understand market participants may request the JFSA to clarify the scope of the securitization transaction definition as part of the comment process leading up to the adoption of a final rule.

6. Do other (balance sheet) CLO transactions fall within the scope of the JFSA Proposal?

The JFSA Proposal will apply to balance sheet CLOs sponsored by "originators" of loans who transfer the loans they originate to the CLO. For example, if a private fund which is a direct lender involved in the origination of loans transfers such loans to a CLO, such securitization will likely be considered a "securitization transaction" as specifically defined in the JFSA Proposal, and thus fall within the scope of the JFSA Proposal. However, certain CLOs involve transfers of assets to balance sheet CLOs where neither the transferor nor any of its affiliates could plausibly fall within the definition of "originator." For instance, a private fund subject to "season and sell" tax guidelines may purchase loans in the secondary market from a particular originator and then transfer such loans to a CLO without itself being involved in the origination of those loans. As currently proposed, such a CLO would not be required to comply, nor would it be able to comply, with the JFSA Proposal even if the private fund held an appropriate retention interest, since the private fund is not an "originator" transferring assets to the CLO.

7. If a CLO transaction falls within the scope of the JFSA Proposal, does the JFSA Retention Requirement necessarily apply?

As noted above under "*What are the new requirements under the Proposed Rules?*" the JFSA Proposed Rules include both a reporting/due diligence requirement (Paragraph 1) as well as the JFSA Retention Requirement (Paragraph 3); however, the JFSA Retention Requirement is not applicable if it is determined that "on the basis of the originator's involvement in the original assets, the nature of the original assets or any other relevant circumstances" one could determine that "the original assets were not inappropriately formed."[16] We believe that "open-market" CLOs and middle market CLOs should be exempted from the 5% JFSA Retention Requirement on this basis.

Both broadly-syndicated loans typically held by "open-market" CLOs and middle-market loans typically held by balance sheet CLOs are originated by experienced arrangers based on a significant number of history- and market-tested underwriting standards. Such arrangers frequently hold portions of such loans on their own balance sheets. Broadly-syndicated loans are generally originated by large commercial banks. Middle market loans are typically underwritten by experienced non-bank loan originators who fund their origination process by raising equity themselves or by managing private funds in which equity is raised from investors who want exposure to middle

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[13] Section 15G of the Securities Exchange Act of 1934, as amended.

[14] Loan Syndications & Trading Ass'n v. SEC, 882 F.3d 220 (D.C. Cir. 2018).

[15] See our previous OnPoint: DC Circuit Court Newsflash: "Transfer" means "Transfer", Feb 2018

[16] Article 248. Paragraph 3 of the Bank Capital Adequacy Criteria.

market loans, and by borrowing from large commercial banks, insurance companies and funds. These debt and equity investors review the underwriting, origination and servicing standards and capabilities of such middle market loan originators, their default and delinquency experience and their track record. Broadly-syndicated loans, as their name implies, are syndicated by the arranging bank to multiple third party lenders (including CLOs), including a lead agent that typically holds significant positions in the loans it originates. Middle market loans may also be syndicated by the arranger to other third party lenders, frequently in a smaller "club" style syndications. These syndicated loans and their related obligors are subject to additional scrutiny by the members of the syndicate who re-underwrite the loans based on their own underwriting standards. Given the number of parties involved in this loan origination and syndication process, the visibility such parties have into the underwriting of such loans, the information available to them with respect to such loans and loan obligors and the terms applicable to the underlying loans, there is both transparency and robustness of the origination process. When loans are included in CLOs, the collateral manager must ensure that, at the time of acquisition by the CLO, they meet various eligibility criteria and collateral quality tests. Furthermore, the loans are required to be given a credit estimate or rating by one or more rating agencies who apply their own underwriting standards in their credit review process.

Therefore, it is our view that "on the basis of the originator's involvement in the original assets, the nature of the original assets or any other relevant circumstances that the original assets" in a CLO "were not inappropriately formed," and that a persuasive argument can be made that CLOs should be exempted from the JFSA Retention Requirement of the Proposed Rules.

We expect further clarification[17] regarding the exception for original assets which were not "inappropriately formed" in the comment process and hope that such guidance will include the types of factors which must be taken into consideration for purposes of analyzing a securitization. We anticipate that these factors could include items such as transparency of information available to investors, the presence of independent ratings or credit estimates, and securitization documents which provide investor protections.

8. How does a CLO satisfy the JFSA Retention Requirement?

In the event a CLO is required to satisfy the JFSA Retention Requirement, we expect that the party holding the retention interest in such CLO will attempt to do so as an "originator" pursuant to clause (i) of the definition thereof, which defines "originator" as: "(i) a person who is involved in the origination of underlying assets directly or indirectly."

In a typical middle market balance sheet CLO, an investment adviser acting as agent for one or more clients (for instance, private funds or business development companies, each an "**Investment Vehicle**") and their respective subsidiaries sources middle market loans from originators who may be affiliated or unaffiliated with the investment adviser. The investment adviser underwrites such loans and, if a decision is made to acquire such loans, the investment adviser allocates them in accordance with its allocation policy to one or more Investment Vehicle clients or their subsidiaries. Such externally managed Investment Vehicles finance portfolios of these loans using a variety of types of financings, including CLOs. Although such an Investment Vehicle acquiring as a direct lender at closing or as a member of the primary loan syndicate should constitute an "originator," the definition in the JFSA Proposal does not clarify what it means to be "directly or indirectly" involved in the "origination" of underlying loans, nor does it clarify what percentage of the underlying loans in the securitization must be thus "originated." To address this ambiguity, the market may adopt the view that "origination" in this context should be understood consistently with how it is

[17] The JFSA has informally discussed some examples of cases where "the original assets were not inappropriately formed" that we understand will be finally published in the JFSA's official Q&A.

understood for EU risk retention purposes under limb (a) of the E.U. definition of “originator,” i.e. if the holder of the risk retention or one or more of its related entities was involved in the origination process of the majority of the underlying assets, then it was “directly or indirectly” involved therein as an “originator. Nonetheless, we hope for further clarification on this matter.

The JFSA Proposal also fails to specify what actions, if any, taken by an affiliated entity may constitute “indirect” origination. For instance, if an affiliate of the Investment Vehicle (such as a subsidiary) was the original lender of record, it is unclear whether that would constitute “indirect” involvement of the origination of underlying assets by the Investment Vehicle. Alternatively, if neither the Investment Vehicle nor a subsidiary was involved in the original creation of the loan, would such an Investment Vehicle still be considered the “originator” if its external manager or an affiliate acts as the lead arranger or agent for such loan? Thus, there remain a number of issues regarding satisfying the JFSA Retention Requirement that will require further clarification.

9. Does an E.U.-compliant deal satisfy the JFSA Proposal?

Not necessarily. The definition of “originator” under the E.U. risk retention rules differs from the definition of “originator” under the JFSA Proposal for Affected Investors, and the term “sponsor” is used in a different context in the JFSA Proposal than in the E.U. risk retention rules.

The E.U. retention holder for most U.S.-based balance sheet CLOs (generally found in the middle market space) typically satisfies the E.U. retention requirement under limb (a) of the definition of “originator” of the E.U. risk retention rules (the so called “**limb (a) originators**”), which includes “an entity that itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitized,”[18] This limb (a) is similar, although not identical, to clause (i) of the definition of “originator” in the JFSA Proposal: “a person who is involved in the origination of underlying assets directly or indirectly.”[19] As a general matter, it appears that a balance sheet originator which satisfies limb (a) of the E.U. risk retention rules will likely also satisfy clause (i) of the JFSA Proposal; however, we note that the JFSA Proposal does not explicitly provide that the origination can occur “through related entities,” which the E.U. risk retention rules permit, nor is there any requirement (or market view as of yet) regarding the appropriate percentage of assets that must be “originated.” As noted above under “*How does a CLO satisfy the JFSA Retention Requirement?*” we hope that the final rules implementing the JFSA Proposal will clarify these points.

With respect to U.S.-based “open-market” CLOs, most E.U.-compliant CLOs in this space typically achieve compliance by causing an entity that falls under limb (b) of the definition of “originator” (the so-called “**limb (b) originators**”) to hold the retention interest. A limb (b) originator is “an entity that purchases a third party’s exposures for its own account and then securitises them.”[20] There is no obvious corollary to this concept in the JFSA Proposal, as the definition of “originator” under the JFSA Proposal would only pick up entities that are “directly or indirectly” involved in the “origination” of the assets or which sponsor an ABCP conduit “or similar program.” The limb (b) originator in an E.U.-compliant CLO does none of these things[21]. However, since most of these limb (b) originators do not involve a “transfer” of assets from an “originator,” we hope the JFSA Proposal will not apply to them in any case,

[18] Article 2(3)(a) of Regulation (EU) 2017/2402.

[19] Article 1. Item (lxviii) of the Bank Capital Adequacy Criteria.

[20] Article 2(3)(b) of Regulation (EU) 2017/2402.

and if they do, one can make the argument that the loans are not “inappropriately formed” and thus no retention interest is required to be held (see Question 5 *“Does an ‘open-market’ CLO transaction fall within the scope of the JFSA Proposal?”* on page 3 of this OnPoint).

With respect to retention holders that satisfy the definition of “sponsor” under the E.U. risk retention rules, there is no obvious corollary to such a term under the JFSA Proposal. Managers are not mentioned, and the term “sponsor” is narrowly defined to only include entities sponsoring ABCP conduits or other similar programs. However, similar to the analysis for limb (b) originators, most of these CLOs do not involve a “transfer” of assets from an “originator,” and if they do, one can make the argument that the loans are not “inappropriately formed” and thus the JFSA Retention Requirement does not apply.

10. How might the JFSA Proposal affect the CLO market?

Although it is difficult to make predictions related to the JFSA Proposal since there is limited guidance available and many unanswered questions remain, we anticipate the JFSA Proposal will not have a negative impact on the CLO market as we are optimistic that “open-market” CLOs will be carved out of the risk retention requirements (because they do not constitute a “securitization transaction,” they are not “inappropriately formed,” or both).

For balance sheet CLOs which would fall within the scope of JFSA Proposal, powerful arguments can be made that the underlying assets are also not “inappropriately formed,” for the same reasons that apply to “open-market” CLOs. To the extent balance sheet CLOs are required to satisfy the JFSA Retention Requirements, in most cases the relevant originator may already be required to hold a retention interest pursuant to the U.S. risk retention rules in any event (as they do not meet the “open market” CLO description in the DC Circuit Court Decision). However, as noted above, there exists uncertainty regarding whether affiliates of the originator can hold a retention interest and what percentage of the assets must be originated.

We at Dechert are actively involved on behalf of our clients in the process surrounding the JFSA Proposal and are hopeful that further helpful clarifications will be forthcoming in the ensuing months.

This update was authored by:

John M. Timperio
Partner
Charlotte & New York
+1 704 339 3180
Send email

Cynthia J. Williams
Partner
Boston
+1 617 654 8604
Send email

Mary Bear
Consulting Attorney
Charlotte
+1 704 339 3162
Send email

Christopher Desmond
Partner
Boston
+1 617 728 7170
Send email

Christopher P. Duerden
Partner
Charlotte & New York
+1 704 339 3113
Send email

Adam Firestone
Associate
Charlotte
+1 704 339 3108
Send email

Matthew Gauthier
Associate
Charlotte
+1 704 339 3117
Send email

Cameron Mitcham
Partner
London
+44 20 7184 7570
Send email

Kelly Nash
Associate
Charlotte
+1 704 339 3119
Send email

James Waddington
Partner
London
+44 20 7184 7645
Send email

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