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Legal Update

New Japanese Risk Retention Rule Takes Effect on March 31, 2019

On March 15, 2019, the Japanese Financial Services Agency (the "JFSA") published the final version of its amendment to the regulatory capital requirements relating to investments by certain types of Japanese financial institutions in securitizations. The amendment adds to such regulatory capital requirements (i) a set of due diligence and information collection requirements for investments by Covered Japanese Institutions (as defined below) in securitizations and (ii) a risk retention rule for such investments.[1] The amendment will take effect on March 31, 2019. To provide guidance regarding these new regulatory requirements, the JFSA published, together with the final version of the amendment, a series of responses to selected comments that it received with respect to its initial proposal of these regulatory changes[2] (the "Responses to Comments")[3] as well as a series of answers to frequently asked questions concerning the application of these regulatory changes (the "Answers to FAQs").[4] Because we believe that it should not be overly cumbersome for many Covered Japanese Institutions to comply with the due diligence and information collection component of the amendment (based on the current due diligence practices of large Japanese banks and the type and scope of information that is already customarily reported to investors by US securitizations), this Legal Update focuses on the risk retention rule portion of the amendment (the "Japanese Risk Retention Rule").

This Legal Update is intended for originators, sponsors and underwriters of non-Japanese securitizations that are marketed to Japanese investors, although Covered Japanese Institutions and other interested parties may also find this Legal Update helpful.[5]

The Japanese Risk Retention Rule

The Japanese Risk Retention Rule was adopted in substantially the same form as in the JFSA's initial proposal, except that, in response to questions and comments submitted to the JFSA regarding the applicability of the rule to securitizations whose underlying assets were transferred by a business entity not meeting the definition of "originator" (namely, business entities that were not directly or indirectly involved in the organization of the original assets), the JFSA amended the definition of "original assets" to clarify that assets transferred into a securitization by a party other than the originator are also considered "original assets" for purposes of the rule.[6] By so doing, the

JFSA eliminated any doubt that securitizations without a classic originator, such as Open Market CLOs,[7] are within the scope of the rule. In adopting the Japanese Risk Retention Rule in substantially the same form as in the JFSA's initial proposal, the JFSA elected not to exclude from the rule any particular types of securitizations as such or securitizations from any particular jurisdictions as such and instead sought to address concerns raised by commentators and other interested parties through guidance regarding the application of the rule in its Responses to Comments and Answers to FAQs.[8]

As adopted, the Japanese Risk Retention Rule requires banks, bank holding companies, credit unions (*shinyo kinko*), credit cooperatives (*shinyo kumiai*), labor credit unions (*rodo kinko*), agricultural credit cooperatives (*nogyo kyodo kumiai*), ultimate parent companies of large securities companies and certain other financial institutions regulated by the JFSA (collectively, "Covered Japanese Institutions") that invest in "securitization transactions"[9] to apply an increased regulatory capital risk weighting—set at three times higher than that otherwise applied to compliant securitization exposures (subject to a risk weight cap of 1,250 percent)—to securitization exposures that they hold, unless such Covered Japanese Institutions can establish *either* of the following:

I. that the "originator" [10] of the applicable securitization commits to retain, in horizontal, vertical or, in some cases, L-shaped form,[11] at least 5 percent of the nominal value of the securitized exposures, or

II. that the securitization's "original assets" were not inappropriately originated,[12] based on the originator's involvement in the original assets, the quality of the original assets or any other relevant circumstances.

As was the case in the JFSA's initial proposal, securitization exposures purchased by Covered Japanese Institutions before March 31, 2019 will be grandfathered, but only while they are held by the Covered Japanese Institution that holds them on March 31, 2019. Subsequent purchasers after that date will not benefit from this grandfathering.

The JFSA's Responses to Selected Comments and Answers to FAQs

The Responses to Comments and Answers to FAQs that were published by the JFSA together with the final Japanese Risk Retention Rule provide additional guidance, among other things, with respect to (1) the application of the rule to securitizations that are exempted from risk retention pursuant to the risk retention requirements of one or more other jurisdictions, (2) the application of the rule to securitizations that are structured to comply with the risk retention requirements of one or more other jurisdictions (e.g., securitizations that comply with the US risk retention rules and/or the EU risk retention requirements), (3) instances where the original assets can be deemed not to have been inadequately originated, including based on compliance with risk retention methods other than those prescribed by the rule, (4) the factors that Covered Japanese Institutions should consider when determining, based on an analysis of a securitization's original assets, that such original assets have not been inadequately originated and (5) when and how to confirm compliance with the rule's retention requirements. We next discuss the guidance that the JFSA provided with respect to each of these matters.

1. SECURITIZATIONS EXEMPTED FROM RISK RETENTION UNDER THE RISK RETENTION REQUIREMENTS OF OTHER JURISDICTIONS

In its Responses to Comments, the JFSA clarified that Open Market CLOs in the United States and other securitizations for which no party is required to retain credit risk pursuant to their local risk retention requirements are not automatically exempted from the Japanese Risk Retention Rule as such and that, instead, Covered Japanese Institutions will need to examine whether the underlying assets in such securitizations were not inadequately originated "through in-depth analysis."[13] Similarly, in its Answers to FAQs, the JFSA clarified that if an originator or an equivalent party is not required to retain credit risk for securitization products in the jurisdiction where the products are originated, or if no one is required to retain credit risk for certain securitization products such as Open Market CLOs in the United States, Covered Japanese Institutions will need to determine whether "original assets were not inadequately originated" through in-depth analysis.[14] To that end, in its Answers to FAQs, the JFSA provided a number of examples (which we discuss below under the heading "Instances Where Original Assets Can Be Deemed Not to Have Been Inadequately Originated") of instances where the original assets can be deemed not to have been inadequately originated based on an in-depth analysis of the quality of the original assets, as well as guidance regarding the type and scope of the in-depth analysis of the quality of the original assets that is necessary for determining that the original assets have not been inadequately originated (which we discuss below under the heading "Factors to Consider in Determining That Original Assets Have Not Been Inadequately Originated").

2. SECURITIZATIONS THAT SATISFY THE RISK RETENTION REQUIREMENTS OF OTHER JURISDICTIONS

In its Responses to Comments, the JFSA also clarified that securitizations that are structured to comply with the risk retention requirements of one or more other jurisdictions (e.g., securitizations that comply with the US risk retention rules and/or the EU risk retention requirements) are not automatically exempted from the Japanese Risk Retention Rule as such and that, instead, in instances where such securitizations do not satisfy the risk retention requirement of the rule (e.g., because the retaining party is not the "originator" within the meaning of the rule or because the retention method used is not among the retention methods permitted under the rule), Covered Japanese Institutions will need to determine whether the underlying assets in such transactions were not inadequately originated. The JFSA further clarified, however, that if a risk retention regulation equivalent to the Japanese Risk Retention Rule is implemented in the jurisdiction where a securitization product is formed and such product meets the requirements under such jurisdiction's risk retention regulation, it may be determined that such product meets the requirements under the Japanese Risk Retention Rule[15] and that where an originator or an equivalent party is directly required to retain credit risk pursuant to a securitization's "local" credit risk retention rules that is equivalent to the credit risk required to be retained under the Japanese Risk Retention Rule, such securitization may be regarded as compliant with the retention requirements of the Japanese Risk Retention Rule, unless there is a special circumstance in which compliance by the originator or equivalent party with its retention obligations under the risk retention requirements of such other jurisdiction is reasonably doubted.[16] In addition, the JFSA provided a number of examples (which we discuss below under the heading "Instances

Where Original Assets Can Be Deemed Not to Have Been Inadequately Originated") for instances where the original assets can be deemed not to have been inadequately originated based on retention by the "originator" and/or another transaction party of credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.

3. INSTANCES WHERE ORIGINAL ASSETS CAN BE DEEMED NOT TO HAVE BEEN INADEQUATELY ORIGINATED

In its Answers to FAQs, the JFSA provided the following examples for instances where the original assets can be deemed not to have been inadequately originated based on retention by the "originator" and/or another transaction party of credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule[17]:

- 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 an arranger) retains the credit risk, and it can be confirmed that the aggregate of the credit risk borne by such party and, if applicable, by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.[18]
- The originator provides credit support to the subordinate tranche of the securitization (e.g., through a guarantee) and it is confirmed that the credit risk borne by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.
- The financial assets that form the underlying assets of the securitization are randomly selected from an asset pool, and the originator retains 5 percent or more of the total credit risk arising from the aggregate exposure to such asset pool by continuously holding either (i) all of the asset pool except for the financial assets that form the underlying assets of the securitization or (ii) financial assets that were randomly selected from such asset pool simultaneously with the financial assets that form the underlying assets of the securitization.[19] For financial assets to be deemed to have been randomly selected, the asset pool must in general have 100 or more financial assets and relevant factors that evidence random selection such as the timing of origination of the financial assets, their types, the place of their origination, their maturity date, the ratio of funds borrowed, the types of rights, business sectors and balance due, etc. must be appropriately taken into consideration when selecting the financial assets that will form the original assets of the securitization and the financial assets that will be retained by the originator.
- The securitization is a synthetic securitization in which the originator and the investors are obliged to jointly bear the loss incurred by the original assets, and it is confirmed that the credit risk retained by the originator is equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule.

In its Answers to FAQs, the JFSA also provided the following examples of instances where the original assets can be deemed not to have been inadequately originated based on an in-depth analysis of the quality of the original assets[20]:

- Relying on objective materials such as appraisal reports or engineering reports for securitizations whose original assets are secured by real estate properties (including trust beneficiary rights on real estate properties).
- The party organizing a securitization transaction organizes such transaction by

purchasing the securitization's underlying assets in the market (as opposed to using financial assets that such party holds) and it can be determined that the quality of such financial assets is not inappropriate based on objective materials.[21]

In its Answers to FAQs, the JFSA also provided the following example of cases in which adequate risk retention interest is deemed to be continuously retained even though the retention requirements set forth in the Japanese Risk Retention Rule are no longer satisfied due to changes after the acquisition of the securitization exposure[22]:

- The aggregate amount of the exposure held by the originator no longer meets the requirements set forth in the Japanese Risk Retention Rule due to the default of the original assets even though the originator did meet the terms set forth in the Japanese Risk Retention Rule at the time of the acquisition of the securitization product and the originator continues to hold such exposure.

4. FACTORS TO CONSIDER IN DETERMINING THAT ORIGINAL ASSETS HAVE NOT BEEN INADEQUATELY ORIGINATED

In its Answers to FAQs, the JFSA clarified that a determination that the original assets have not been inadequately originated in a securitization transaction must be made on a case-by-case and specific basis, taking into consideration the involvement of the originator in and the quality of such original assets. The JFSA provided the following guidance regarding the type and scope of the in-depth analysis of the quality of the original assets that is necessary for determining that the original assets have not been inadequately originated[23]:

- It is insufficient to determine the quality of the original assets solely based on (i) the external rating of the asset-backed securities, (ii) the market trading prices of the original assets or (iii) the short-term performance of the original assets (especially during a boom period).
- If the original assets are loans, the following should be confirmed and verified: (i) whether the originator's loan review criteria were appropriate, (ii) whether the covenants in the loan agreements are conducive to investor protection, (iii) whether the type and terms of the collateral securing such loans are appropriate and (iv) whether the collection rights of the originator, the servicer and any other relevant party are adequate. The JFSA clarified that in case it is difficult for a Covered Japanese Institution to confirm and verify the foregoing on a loan-by-loan basis, such Covered Japanese Institution may instead evaluate whether objective and reasonable standards have been implemented for loan acquisition and replacement and whether the loans are being duly acquired and replaced in accordance with such objective and reasonable standards (e.g., through a sample review).
- It is appropriate to conduct risk analysis of the securitization product as a whole through a stress test based on reasonable scenarios and periods.
- A Covered Japanese Institution's determination that the original assets of a securitization were not inadequately originated must be made in relation to such Covered Japanese Institution's investment criteria.

In addition, the JFSA clarified in its Responses to Comments that in order to determine that the "original assets were not inadequately originated," the organization of original assets underlying individual securitization products must be "examined substantially" and that, therefore, it cannot be uniformly judged for Open Market CLOs based solely on the general characteristics of their organization

process that their original assets "were not inadequately originated."[24]

Finally, in response to a comment received by the JFSA suggesting that, it should be acceptable to determine that "the original assets were not inadequately originated" based on the fact that the original assets are priced and traded in the secondary market, the JFSA advised that it is particularly important to conduct an in-depth analysis on the quality of original assets from the perspective of credit risk when determining whether "the original assets were not inadequately originated" and that, in this regard, it cannot be said that the mere existence of a market price indicates the adequate formation of the original assets.[25]

5. WHEN AND HOW TO CONFIRM COMPLIANCE WITH THE RULE'S RETENTION REQUIREMENTS

In its Answers to FAQs, the JFSA clarified that, in general, Covered Japanese Institutions need to establish a due diligence framework and confirm compliance with the retention requirements of the Japanese Risk Retention Rule not only at the time of acquisition of the securitization product but also each time a Covered Japanese Institution is required to calculate the risk weighting of its assets for capital adequacy purposes. The JFSA further clarified that when determining compliance with the retention requirements of the Japanese Risk Retention Rule, it is generally appropriate to receive confirmation from the originator in writing, but it may be acceptable to confirm compliance by another reasonable method such as an interview with a related party, if it is practically difficult to receive written confirmation.[26]

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1 The final amendment is available (in Japanese) here: https://www.fsa.go.jp/news/30/ginkou/20190315-1/09.pdf.

2 The JFSA published its initial proposal to amend the regulatory capital requirements relating to investments by Covered Japanese Institutions in securitizations in December 2018. The JFSA's initial proposal is available (in Japanese) here: https://www.fsa.go.jp/news/30/ginkou/20181228_3/01.pdf .

3 The JFSA's Responses to Comments are available (in Japanese) here: https://www.fsa.go.jp/news/30/ginkou/20190315-1/02.pdf.

4 The JFSA's Answers to FAQs are available (in Japanese) here: https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf.

5 Important Notice: This Legal Update describes new Japanese regulations whose interpretation is ultimately a matter of Japanese law. Nothing in this Legal Update should be construed as legal advice concerning Japanese law. Furthermore, the new regulations and related guidance were all published in Japanese and this Legal Update is based on an unofficial translation of the regulations and selected guidance. Finally, as is the case with all regulations, we expect that deference will be given to the JFSA, as the drafter and enforcer of these regulations, with respect to their interpretation.

6 See responses nos. 41 and 44 in Responses to Comments.

7 The term "Open Market CLO" is used herein as defined in the decision of the U.S. Court of Appeals for the District of Columbia Circuit in the legal action captioned The Loan Syndications and Trading Association v Securities and Exchange Commission and Board of Governors of the Federal Reserve System, No. 1:16-cv-0065.

[8] See responses nos. 31 and 41 in Responses to Comments.

[9] "Securitization Transaction" is defined in Article 1 of the JFSA's capital adequacy criteria pursuant to Article 14-2 of the Banking Act and generally includes any transaction in which the credit risk associated with an underlying exposure/pool of exposures is tranched into two or more senior/subordinated exposures and all or a part of such tranched exposures are transferred to one or more third parties. This is similar to EU risk retention, which is also keyed off of tranching for purposes of covered transactions, and different from US risk retention, which applies to asset-backed securities as defined in the Securities Exchange Act of 1934, as amended.

[10] "Originator" is defined in Article 1 of the JFSA's capital adequacy criteria pursuant to Article 14-2 of the Banking Act, as (i) an institution involved in the origination of underlying assets directly or indirectly; or (ii) a sponsor of an ABCP conduit or other similar program that acquires exposures from third parties.

[11] Under the Japanese Risk Retention Rule, (i) eligible vertical retention interest means a pro rata portion of each tranche of securitization exposures, the total of which is equal to or greater than 5 percent of the total exposure of the securitized assets, (ii) eligible horizontal retention interest means an amount of the first loss tranche equal to or greater than 5 percent of the total exposure of the securitized assets and (iii) eligible L-shaped retention interest, which is only permitted if the most junior tranche in the applicable securitization is less than 5 percent of the total exposure of the securitized assets, means all of the first loss tranche and a pro rata portion of the more senior tranches. Regardless of the form or retention, the retained interest needs to be retained for as long as investor interests remain outstanding.

[12] We note that the direct translation of the JFSA's language concerning the creation of the original assets is the "formation" of such assets (as opposed to "origination"). However, because the creation of financial assets is commonly referred to in the United States as "origination," we refer to the creation of the original assets in this Legal Update as the "origination" of such assets.

[13] See responses nos.41 and 47 in Responses to Comments.

[14] See answer to Article 248-Q5 in Answers to FAQs.

[15] See response no. 47 in Responses to Comments.

[16] See answer to Article 248-Q5 in Answers to FAQs.

[17] See answer to Article 248-Q2 in Answers to FAQs.

[18] See also responses nos. 38 and 43 in Responses to Comments, in which the JFSA clarified that, with respect to securitizations that comply with the risk retention requirements of one or more other jurisdictions but do not comply with the risk retention requirements of the Japanese Risk Retention Rule because the retaining party in such transactions is not the "originator" within the meaning of the rule, Covered Japanese Institutions may determine that such transactions are exempted from the risk retention requirements of the rule on the basis that the original assets in such transactions were not "inadequately originated" if they are able to confirm that the parent company of the "originator" or another party that was deeply involved in the organization of such securitization (such as an arranger) retains the credit risk in such transaction and that the total credit risk borne by such party and, if applicable, by the originator, is equivalent to or higher than the risk required to be retained under the Japanese Risk Retention Rule. See also response no. 47 in Responses to Comments, where in response to questions and comments submitted to the JFSA regarding whether CLO managers are included in the definition of "originator" for purposes of the rule, the JFSA advised that, depending on the direct or indirect involvement of a CLO manager in the origination of underlying assets, a CLO manager may fall under the definition of "originator" and that if a CLO manager is deeply involved in the origination of a CLO and retains the credit risk equal to or higher than the risk required under the Japanese Risk Retention Rule, it may be determined that "original assets were not inadequately originated" in light of the purpose of the Article.

[19] See also response no. 29 in Responses to Comments, where, in response to a comment that Covered Japanese Institutions should be permitted to determine that the underlying assets in a securitization transaction "were not inadequately originated" on the basis that such transaction complies with the EU risk retention requirements under the "representative sample method" (which is not among the permitted retention methods under the Japanese Risk Retention Rule), the JFSA advised that taking into account the purpose of this provision (the risk retention by originators), even if an originator does not hold a securitization product itself, if underlying assets of a securitization product are randomly selected from an asset pool that includes multiple claims, it may be determined that "the original assets were not inadequately originated" if the originator retains credit risk equivalent to or higher than the credit risk required to be retained under the Japanese Risk Retention Rule, through continuous holding of such asset pool except for the underlying assets.

[20] See answer to Article 248-Q2 in Answers to FAQs.

[21] Note that, as discussed below, the JFSA has confirmed that it is insufficient to determine the quality of the original assets solely based on the market trading prices of the original assets.

[22] See answer to Article 248-Q2 in Answers to FAQs.

[23] See answer to Article 248-Q2 in Answers to FAQs.

[24] See response no.42 in Responses to Comments.

[25] See response no.46 in Responses to Comments.

[26] See answer to Article 248-Q5 in Answers to FAQs.