JAPANESE RISK RETENTION: KEEPING "OPEN MARKET" CLOS[1] OPEN FOR BUSINESS

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Introduction

On December 28, 2018, the Japanese Financial Services Agency (the "**JFSA**") published notices setting forth proposed amendments to regulatory capital requirements (the "**Regulatory Capital Adequacy Criteria**") applicable to certain Japanese financial institutions that invest in securitization transactions (the "**JFSA RR Proposal**").[2] On March 15, 2019, the JFSA published its final rules (the "**JRR Final Rules**")[3], answers to related frequently asked questions ("**JFAQ**")[4] and responses to public comments received on the JFSA RR Proposal ("**JFSA Responses**").[5] The JRR Final Rules, reflect an effort by the JFSA to introduce risk retention regulations pertaining to investment in securitization transactions and are scheduled to become effective on March 31, 2019 (the "**Effective Date**").[6] The JRR Final Rules bear a number of similarities to risk retention rules adopted in the United States and Europe.

A significant number of market participants, including Seward & Kissel, participated in the drafting of comments submitted by the Loan Syndications and Trading Association ("**LSTA**") to the JFSA RR Proposal. In light of the finalized JRR Final Rules, JFAQ and JFSA Responses, we believe that a path forward has been set by the JFSA for Japanese investors who abide by the enhanced due diligence and monitoring policies and procedures contemplated by the JRR Final Rules to continue to invest in U.S. "open market" CLOs without retaining the mandated CLO risk exposure. A discussion of the JRR Final Rules as they relate to "open market" CLO transactions is set forth below.

What are the Requirements Imposed by the JRR Final Rules and What Entities are Required to Comply?

Unless risk retention is undertaken by an "originator"[7] of a "securitization transaction", certain types of regulated Japanese financial institutions ("**Regulated Investors**"), including Japanese banks, bank holding companies, credit associations, credit cooperatives, labor banks, agricultural cooperatives, fisheries cooperatives, and the ultimate parent companies of large securities companies will be assessed an increased regulatory capital charge with respect to a "securitization exposure".[8] The risk retention that must be undertaken by an "originator" to avoid this increased regulatory capital charge (unless, as discussed below, it can be concluded that the underlying assets were not "inappropriately formed")

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[1] For purposes of this article, "open market" CLOs refer to those CLOs to which U.S. risk retention rules were ruled not to apply by the Circuit Court for the District of Columbia in Loan Syndications & Trading Ass'n v. SEC, 882 F.3d 220 (D.C. Cir 2018).

[2] https://www.fsa.go.jp/news/30/ginkou/20181228_3.html.

[3] https://www.fsa.go.jp/news/30/ginkou/20190315-1.html.

[4] https://www.fsa.go.jp/news/30/ginkou/20190315-1/42.pdf.

[5] https://www.fsa.go.jp/news/30/ginkou/20190315-1/02.pdf.

[6] The importance of Japanese investors to functioning CLO markets is worth underscoring. Japanese institutions hold a material share of AAA and AA-rated CLO securities which comprise roughly 75% of the capital structure of a typical CLO.

[7] The definition of "originator" is discussed under the heading "What Entities are Eligible to Retain under the JRR Final Rules" below.

[8] The JRR Final Rules are similar to the original conception of European risk retention in that they impose compliance on investors in securitization transactions.

must be not less than 5% of the securitization exposure (the "**JRR Retention Amount**").[9]

A "securitization transaction" for purposes of the JRR Final Rules is any transaction in which the credit risk associated with an underlying exposure or pool of exposures is tranched and all or part of such tranched exposures are transferred to one or more third parties.[10] The JRR Final Rules define a "securitization exposure" as an exposure related to a "securitization transaction".[11]

In addition to imposing risk retention, the JRR Final Rules also require Regulated Investors to perform due diligence and risk monitoring with respect to a securitization exposure and the related securitization transaction. A Regulated Investor is required by the JRR Final Rules to implement a due diligence and risk monitoring system that: (1) facilitates the continuous collection of information on comprehensive risk characteristics of securitization exposures; (2) allows for the timely collection of information on comprehensive risk characteristics and performance of the underlying assets; (3) facilitates the identification of structural characteristics of the securitization transaction; and (4) creates "control rules" for the satisfaction of conditions (1) through (3) above (the "**Risk Monitoring Controls**").[12]

What Methods May be Used for Retaining the JRR Retention Amount?

The JRR Retention Amount may be retained via various methods including by: (1) holding a vertical strip of equal portions of all tranches in the securitization transaction (vertical risk retention); (2) holding the most subordinate tranche of the securitization transaction in an amount equal to the JRR Retention Amount (horizontal risk retention); (3) if the most junior tranche is less than the JRR Retention Amount, holding all of that most subordinate tranche, and equal portions of each of the more senior tranches (L-shaped risk retention), or (4) holding a "securitization exposure" by alternative means if the credit risk borne by the originator for the life of the transaction is at least equal to the JRR Retention Amount. Under the JRR Final Rules, the originator is not considered to hold its retention interest if that originator hedges or otherwise substantially mitigates its credit risk in respect of such retention interest.[13]

The JFAQ contains what might be considered examples[14] of method (4) above, including (A) the originator's parent company or a relevant party other than the originator (such as the arranger) that was deeply involved in the organization of the securitization transaction retaining the credit risk in an amount equal to or greater than the JRR Retention Amount; (B) the originator providing credit support to the most subordinate tranche such as in the form of a guarantee from the originator[15] in an amount such that the aggregate credit risk borne is equal to or greater than the JRR Retention Amount; (C) holding a random selection[16] of the underlying assets from an asset pool that includes multiple assets (excluding securitization exposures), provided that the originator continues to hold the pool assets (other than the securitization exposures) or the originator continues to hold assets randomly selected from the same asset pool as the assets underlying the securitization transaction selected at the same time as the assets underlying the securitization transaction, and such holding represents 5% or more of the aggregate exposure of the asset pool; and (D) in a synthetic securitization transaction, the originator and Regulated Investors jointly bearing

[9] Article 248, Paragraph 3 of the Regulatory Capital Adequacy Criteria. It is not readily apparent from the currently available translations of the JRR Final Rules whether the JRR Retention Amount, in the case of horizontal risk retention and the equity portion of L-shaped risk retention, should be based on the fair value of, or the face amount of the equity portion of, such JRR Retention Amount.

[10] Article 1, Item (ii) of the Regulatory Capital Adequacy Criteria.

[11] Article 1, Item (xvi) of the Regulatory Capital Adequacy Criteria.

[12] Article 248, Paragraph 1 of the Regulatory Capital Adequacy Criteria.

[13] Article 248, Paragraph 3 of the Regulatory Capital Adequacy Criteria.

[14] The JFAQ suggests these examples are also instances where the underlying assets can be deemed by a Regulated Investor not to have been "inappropriately formed" as more fully discussed below.

[15] Note that the JFSA made clear that the use of excess spread to provide such support to a securitization transaction would not suffice. *See* JFAQ, Q2 on Article 248, Paragraph 3.

[16] The JFAQ states that random selections must have sufficient quantity (at least 100 assets) and quality (diversity of assets with respect to many types of criteria such as vintage, maturity date and asset type).

losses on the underlying assets and confirmation that the amount of credit risk retained by the originator is equal to or greater than the JRR Retention Amount.[17]

What Entities Are Eligible to Retain under the JRR Final Rules?

As noted above, the JRR Final Rules require Regulated Investors to verify compliant risk retention by an "originator". The JRR Final Rules define "originator" as (i) a person who is involved in the origination of "original assets" directly or indirectly or (ii) a sponsor of an ABCP conduit or other similar program which acquires exposures from third parties.[18] The JFSA RR Proposal originally defined "original assets" to be assets transferred to a securitization conduit by the originator in an asset transfer securitization transaction. Market participants, including the LSTA, pointed out that there are no "original assets" in an "open market" CLO and thus no "originator" as the underlying assets in an "open market" CLO are acquired through open market purchase at the direction of the collateral manager. In response to this observation, the JFSA clarified that the assets transferred to a securitization conduit by a party other than the originator also qualify as "original assets".[19] Additionally, as described in the immediately preceding paragraph, the JFAQ clarified that compliant risk retention could be accomplished by the originator's parent company or a relevant party other than the originator (such as the arranger) that was deeply involved in the organization of the securitization transaction retaining the credit risk in an amount equal to or greater to the JRR Retention Amount.[20]

When the JFSA was expressly asked whether the collateral manager of a CLO could be an "originator" for purposes of the JRR Final Rules, the JFSA responded that if the collateral manager is deeply involved in the organization of the CLO, retains the risk associated with that CLO and it is confirmed that such credit risk is equivalent to or more than the JRR Retention Amount, then a Regulated Investor could determine that the underlying assets were not "inappropriately formed" as discussed below.[21]

Do the JRR Final Rules apply to Transactions that Close Prior to the Effective Date of the JRR Final Rules?

Although the JRR Final Rules "grandfather" securitization transactions that close prior to the anticipated Effective Date of the JRR Final Rules from the mandates of such JRR Final Rules, a subsequent purchaser of a securitization exposure would be subject to an increased regulatory capital charge unless compliant risk retention is accomplished or not required as this grandfathering expressly applies only for so long as a Regulated Investor continues to hold the grandfathered securitization exposure.[22] This means that for CLO notes purchased in the secondary market, compliance with the JRR Final Rules would be required by a Regulated Investor as purchaser (unless the underlying assets were not inappropriately formed) in order to avoid a punitive regulatory capital charge. It is not yet clear whether a material amendment to an indenture for a CLO or a refinancing or reset of a CLO transaction would trigger the imposition of the JRR Final Rules on otherwise grandfathered securitization exposures.[23]

Under What Circumstances Would Japanese Risk Retention Not Apply to "Open Market" CLOs?

In an exception that is of significant interest to participants in "open market" CLOs, retention of the JRR Retention Amount by an "originator" is not required if a Regulated Investor determines that, on the basis of the originator's involvement in the underlying assets, the nature of the underlying assets, or any other relevant circumstances, the underlying assets were not

[17] JFAQ, Q2 on Article 248, Paragraph 3.

[18] Article 1, Item (lxviii) of the Regulatory Capital Adequacy Criteria.

[19] Article 1, Item (xxii) to Regulatory Capital Adequacy Criteria and JFSA Responses, Comment 41.

[20] JFAQ, Q2 on Article 248, Paragraph 3.

[21] JFSA Responses, Comment 47.

[22] Article 6 of the Supplementary Provisions to Regulatory Capital Adequacy Criteria which can be found at https://www.fsa.go.jp/news/30/ginkou/20190315-1/10.pdf.

[23] Even though Regulated Investors that purchase securitization exposures prior to the Effective Date are grandfathered from the risk retention requirements of the JRR Final Rules, it would seem that such Regulated Investors that have not implemented Risk Monitoring Controls in respect of such securitization exposures as of the Effective Date (including such grandfathered exposures) will still be subject to the punitive regulatory capital charge of the JRR Final Rules.

"inappropriately formed".[24] According to the JFAQ, determination of whether assets were "inappropriately formed" must be made on a "case-by-case basis" taking into account the involvement of the originator in and the quality of the underlying assets.[25]

While the guidance provided by the JFAQ does not delve into specifics, it does provide certain factors for a Japanese investor to look to in formulating such determination, including: (1) the appropriateness of the originator's underwriting criteria; (2) whether the covenants in the documentation of the underlying assets is "conducive to investor protection"; (3) the appropriateness of the terms and the nature of the collateral securing the underlying loans; and (4) the adequacy of "claim collection abilities" of relevant transaction parties.[26] These criteria, although helpful, still do not concretely address the question of what level of compliance would allow the underlying assets to be considered to be not "inappropriately formed". The only real guidance provided by the JFSA is that the level of compliance with respect to these factors should be determined in relation to the investment criteria established by the Regulated Investor. In addition, to these criteria, the JFAQ also states that Regulated Investors should confirm and verify that objective and reasonable standards have been created for the acquisition and replacement of the underlying assets in a securitization transaction and whether excessive discretion concerning the selection of original assets has been given to parties involved in the organization of the securitization transaction. The JFAQ also states that Regulated Investors should timely confirm and verify whether the underlying assets are being acquired and replaced in accordance with these objective and reasonable standards including through sample checks. The JFAQ further states that Regulated Investors should conduct risk analysis of the securitization transaction through the use of stress tests based on reasonable scenarios and periods. Finally, the JFAQ provides two examples where the underlying assets would be deemed not to have been inappropriately formed including where (1) objective materials such as third party reviewer reports have been prepared substantiating that such assets were not inappropriately formed, and (2) if the party organizing the securitization transaction does so by purchasing assets in the market rather than by securitizing assets such party has held on its balance sheet, using "objective materials" to determine that such assets were not inappropriately formed.[27] These examples, however, are vague at best and leave open-ended the question of what "objective materials" could be used for this determination in "open market" CLOs and what those "objective materials" would need to establish.

What are the Ramifications for Regulated Investors of Non-Compliance?

The failure of Regulated Investors in an "open market" CLO to satisfy the JRR Final Rules would result in an increased regulatory capital charge for each non-compliant securitization exposure which would be three times higher than it would be for a compliant securitization exposure subject to a maximum weight of 1250%.[28] The JFSA may also impose disciplinary action on a Regulated Investor on a case-by-case basis dependent on the facts surrounding non-compliance.

Conclusion

We believe that the JFSA has cleared a path for U.S. "open market" CLOs to comply with the JRR Final Rules through enhanced due diligence and Risk Monitoring Controls by Regulated Investors such that such investors might confirm and verify that the original assets in such a CLO were not "inappropriately formed". As Regulated Investors continue to invest in U.S. CLOs, we are hopeful that the question as to what level of compliance with the criteria outlined by the JFSA is sufficient for such investors to reach the conclusion that no risk retention is required will begin to assume greater clarity.

[24] Article 248, Paragraph 3 of the Regulatory Capital Adequacy Criteria.

[25] JFAQ, Q2 on Article 248, Paragraph 3.

[26] JFAQ, Q2 (footnote 3) on Article 248, Paragraph 3.

[27] JFAQ, Q2 on Article 248, Paragraph 3.

[28] Article 248, Paragraph 2 of the Regulatory Capital Adequacy Criteria.

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