General update on the securitisation market in Japan

by Hajime Ueno, Nishimura & Asahi

With "Abenomics," the pro-growth policies of the Prime Minister, Shinzo Abe focused on pulling the Japanese economy out of deflation, moving much lower and slower than many market players had hoped it would, and with interest rates on bank loans set at a historically low rate (in fact, we have seen the Bank of Japan adopting negative interest rates, or "minus interest rates" as we call it, in early 2016), companies and enterprises continue to have very little incentive to look to alternative sources of financing, resulting in little development in the securitisation market in Japan (not including developments in the area of J-REITs (Japanese real estate investment trusts)).

Nevertheless, there still was some issuance of securitisation products, on an announced basis of ¥3.55 trillion (not including J-REITs) during the calendar year 2015. And, residential mortgage-backed securities (RMBS) originated by the Japan Housing Finance Agency (JHF RMBS) continue to be steadily issued.

Of the total volume of issued securitisation products, the products originated by government-affiliated institutions have made up roughly half of the total issued amount for the past several years. The remainder seem to originate mostly from consumer credit companies, banks and leasing companies.

Keeping up with the CLOs

In March 2016, Japan Finance Corporation (JFC) launched a synthetic CLO for the first time in five years. The synthetic CLO, with nine regional banks being the originating banks, has SME loans originated by the banks as reference obligations. The originating banks purchased credit protections by way of credit default swaps (CDS) from JFC, and JFC in turn purchased mirroring credit protections from

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an SPC which financed the sale of the protections by issuing CLO bonds to the investors. As the issuance proceeds of the CLO bonds are not deposited with the originating banks, from the originating banks' perspective, the transaction offers asset risk reduction but no financing in any manner.

The characteristic feature of the underlying pool is that the reference obligations were required to be outstanding loans actually on the books of the originating banks, and the principal of the loans was required to be repaid by monthly instalments.

A more noteworthy feature of the transaction, though, dealt not with the characteristics of the underlying pool or with the terms of the transaction. The issuance was seemingly initiated by the JFC's desire to maintain and keep the know-how and the environment in which regional banks and other smaller financial institutions would be able to retain their experience freshly, and keep their personnel up to speed with the market practice. This backdrop can be said to be well-documented, in a report issued and published in June 2015 by the "Panel on Study of New SME Loans Securitisation" organised by the JFC. The report expressly stated, in fact highlighted in a sense, the importance of the JFC's role in taking the initiative under the recent market environment, where it is difficult to expect the private sector to take charge in launching CLOs with bank loans as underlying assets due to the rate of capital from the Bank of Japan still being set very low (or worse, at negative), making it difficult to justify the costs of securitisation transactions, as well as the capital costs under the current capital regulations for financial institutions.

Japan's incorporation of the Basel III Securitisation Framework

On July 11, 2016, the Basel Committee on Banking Supervision issued a publication entitled "Revisions to the Securitisation Framework," updating and amending the committee's 2014 capital standards for the regulatory capital treatment of securitisation exposures that included the regulatory capital treatment for "simple, transparent, and comparable" (STC) securitisations. The standards are stated to become applicable from January 2018, but evidently, the standards will not automatically become enforceable statutes or regulations of each sovereign, but rather require each sovereign's legislative action.

In the case of Japan, the legislative action will take the form of an adoption by the Financial Services Agency of Japan (the FSA) of a new rule pertaining to banks' regulatory capital requirements. It is currently expected that the FSA will be taking steps, including the solicitation of public comments on a draft of the new rule, in time to have the new rule being introduced with effect from January 2018.

The expectation being that the new standards would be incorporated into the FSA's new rule, Japanese banks are rightly interested, especially in the "STC" securitisation requirement criteria under the new standards, which would be applicable not only to new securitisations after January 2018, but also to existing securitisations already on the books of the banks prior to January 2018. To that end, it is noteworthy that a few of the STC criteria would likely be difficult to satisfy for many of the securitisation products marketed in Japan; for example, the "granularity of the pool" requirement requiring that the aggregated value of all exposures to a single obligor shall not exceed 1% of the aggregated outstanding exposure value of all exposures in the portfolio would likely be a difficult requirement to satisfy for many of the CLOs and CMBS currently on the books of Japanese banks, and for many of the RMBS currently on the books of Japanese banks, the "credit risk of underlying exposures" requirement requiring that the underlying exposures meeting the conditions under the Standardised Approach would likely be difficult to satisfy.

With the new standards subjecting banks to due diligence requirements, banks would be mandated to, on an ongoing basis, have a comprehensive understanding of the risk characteristics of their individual securitisation exposures, whether on- or off-balance sheet, as well as the risk characteristics of the pools underlying its securitisation exposures. Information necessary to verify whether or not STC criteria are satisfied is not, with respect to some of the

STC criteria, easily accessible to investors/banks under today's market practice in Japan. In this light, we may see a market to change the practice to accommodate the banks' need to verify those STC criteria in the following couple of years.

The FSA's approach to TLAC framework

On April 15, 2016, the FSA of Japan issued its statement clarifying its approach to the introduction of the TLAC (or the total loss-absorbing capacity) framework for Japanese G-SIBs (or global systematically important banks), which essentially means the three Japanese mega-bank groups.

While the Japanese financial regulations already have in place the "Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions, etc. for Ensuring Financial System Stability" through an amendment to the Deposit Insurance Act (promulgated in June 2013 and enforced in March 2014), in response to the development of a new framework for the orderly resolution of G-SIBs, the FSA clarified its approach to introduce the TLAC framework, by amending parts of the current capital regulations.

Noteworthy points include:

- between the choice of the two stylised approaches of "single point of entry" (SPE) resolution and the "multiple points of entry" (MPE) resolution as described by the Financial Stability Board in July 2013, the FSA considers the SPE resolution strategy as the preferred resolution strategy for Japanese G-SIBs;
- the basic model for G-SIB resolution as described in the statement by the FSA would call for distribution of internal TLAC from a bank-holding company's subsidiaries or sub-groups which include not only overseas subsidiaries or sub-groups but also domestic subsidiaries or sub-groups;
- with the FSA's approach resulting in unsecured bonds issued by bank holding companies of G-SIBs being designed to function as TLAC, Japanese mega-bank groups would most likely continue their new trend to have their holding company issue unsecured bonds (as opposed to banks themselves issuing unsecured bonds, as historically has been the case); and
- while the FSB's target is to have the TLAC framework plans be in place from the start of 2019, the FSA is intending to have the target date set at the end of March 2019.

First major legislative step to set the framework for FinTech's ascent

Introduction and background

As is the case in other parts of the world, Japan is seeing more and more financial technology (FinTech) companies trying to disintermediate incumbent financial systems and challenge traditional financial institutions, especially securities houses. With increased attention and interest in the area surrounding FinTech companies, especially with respect to the legal and regulatory frameworks, and in response to the progress of information and communications technology, on May 25, 2016, the Payment Services Act, the Banking Act, and several other finance related statutes were amended.

Amendments to the Payment Services Act

On December 22, 2015, the Financial System Council of Japan, through its Working Group on the Sophistication of Payment Services, etc., published a report entitled "*Strategic Approach for Sophistication of Payment Services*" ("WG Report on Payment Services"). The report, in light of the lessons learned from the insolvency of Mt. Gox, as well as the insights provided by the "*Guidance for A Risk-Based Approach to Virtual Currencies*" published by FATF in June 2015, proposed the introduction of:

(a) regulations on customer protection applying to virtual currency exchangers; and

(b) regulations concerning anti-money laundering (AML) and countering financing of terrorism (CFT) in relation to virtual currency activities.

The report's proposal in item (a) above was realised by the

introduction of the Amended Payment Services Act; the amendment has newly defined "virtual currency" and "virtual currency exchange services," and introduced various regulations, including a registration requirement for commencement of business, on virtual currency exchange service operators.

The following are the main points of the amendments relating to virtual currencies.

- Defining "Virtual Currency": While the definition of "virtual currency" is not simple, components can be broken down to the following:
  (i) can be used for payment to unspecified persons in the purchase, or lease of goods, or paying consideration for the receipt of the provision of services;
  (ii) can be purchased from and sold to unspecified persons;
  (iii) has financial value;
  (iv) is recorded by electromagnetic means in electronic devices or other items;
  (v) is not the currency of Japan, foreign currencies, nor an asset denominated in such currencies; and
  (vi) can be transferred using electronic data processing systems;

or:

  (i) can be mutually exchanged with the virtual currency as set forth above, with unspecified persons as the counterparty; and
  (ii) satisfies the requirements listed in items (iii) to (vi) above.

- Registration requirement for "Virtual Currency Exchange Service" Operator: A person or a firm that carries out as its regular business, either:
  (a) purchase, sale, or exchange of virtual currencies;
  (b) intermediation, brokerage, or agency in conducting actions set forth in (a); or
  (c) management of cash or virtual currencies in relation to (a) and (b),

  is required to register with the Prime Minister as a "virtual currency exchange service operator." As this definition can be construed quite broadly, when establishing a business model using a medium that may fall under the definition of a virtual currency, it is necessary to consider whether the business model involves virtual currency exchange services. For example, international remittance using virtual currencies could require registration as a virtual currency exchange service, if the service provider's business is characterised as any of (a) to (c).
- Customer protection and government supervision: For customer protection purposes, the amendment mandates that registered virtual currency exchange service operators comply with certain rules of conduct, including: taking measures to safely manage their data/information, taking measures to ensure appropriate and secure conduct of business pertaining to outsourcing (including subcontractors), providing appropriate information to customers (instructions for preventing misrecognition between virtual currencies and fiat currencies, provision of information on the contents of the contract, etc.), segregating managed assets.

  Registered virtual currency exchange service operators will be subject to government supervision, and to that end, registered virtual currency exchange service operators are required to prepare and hold financial documents and books, to submit business reports to the authority, to prepare and submit property management reports, and to allow on-site inspections and follow business improvement orders (if issued).

Amendment to the Act for the Prevention of Transfer of Criminal Proceeds

Based on and taking into account the proposals by the WG Report on Payment Services, an amendment to the Act for the Prevention of Transfer of Criminal Proceeds, the AML/CFT law of Japan, now designates operators of "virtual currency exchange services" as "specified business operators" for the purposes of the statute. And, as “specified business operators,” virtual currency exchange service operators are now required to follow the KYC procedures and other regulatory obligations pursuant to the statute; for example, they are required to verify matters for transactions including customer identification, checking the purpose of the transaction, and the contents of business of counterparts, among other matters to comply with the KYC requirements.

Amendment to the Banking Act

The Banking Act has also been amended to relax the regulations on the scope of the business of the companies in which bank groups may invest, which will make it easier for the bank groups to invest in FinTech companies or other finance IT-related companies.

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