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New capital regulations on securitisation in Japan: Focus on risk retention requirements

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On March 15, 2019, the Financial Services Agency of Japan ("JFSA") publicised a series of amendments to the regulations on the regulatory capital requirements for securitisation products, applicable to banks (excluding foreign banks' branches in Japan but including all banks incorporated in Japan even if owned by foreign financial institutions; hereinafter the same) and other deposit-taking financial institutions, bank holding companies and certain securities holding companies,[1] with the amendments becoming effective on March 31, 2019 (subject to certain grandfather provisions). These amendments include various changes to the pre-amendment regulatory capital treatments of securitisation products for the purposes of financial institutions' regulatory capitals.

The amendments are some of the major amendments to Japan's regulatory capital regulations in recent years, and adopt amendments addressing, among others:

- the domestic implementation of "*Revisions to the securitisation framework*" (December 11, 2014) published by the Basel Committee on Banking Supervisions ("BCBS");
- the domestic implementation of "*Revisions to the securitisation framework – Amended to include the alternative capital treatment for 'simple, transparent and comparable' securitisations*" (July 11, 2016) published by BCBS, allowing certain "*simple, transparent and comparable*" securitisation products to be applied lower risk weightings;
- the domestic implementation of "*Capital requirements for banks' equity investments in funds*" (December 13, 2013) published by BCBS; and
- the domestic implementation of "*TLAC holdings standard*" (October 12, 2016) published by BCBS.

It should also be noted that JFSA simultaneously released, via its website, its responses to the public comments and further revisions to its official Q&A for application of its regulatory capital requirements on securitisation products ("Revised Official JFSA Q&A").[2]

It is generally believed that, overall, the JFSA has adopted amendments with little deviance from the texts of these BCBS documents, compared to other notable advanced nations. However, taking into account a unique exception stipulated in the amendment (as described below), among the various amendments, the new risk retention requirements include one of the more notable features.

Thus, this article focuses primarily on the new risk retention requirements.

For the purpose of this piece, for ease of reference, descriptions focus mainly on banks, but the same principles apply to other deposit-taking financial institutions, bank holding companies and certain securities holding companies that are subject to Basel accord-based regulatory capital requirements domestically implemented in Japan.

Background

As is well documented, on November 16, 2012, the International Organization of Securities Commissions ("IOSCO") published a report recommending that "*[a]ll jurisdictions should evaluate, and formulate approaches to aligning incentives of investors and securitisers in the securitisation value chain, including where appropriate, through mandating retention of risk in securitisation products*" and to "*endeavour to take any necessary steps to implement such approaches*" with certain recommended elements clarifying, for example, "*[t]he party on which obligations are imposed*," "*[p]ermitted forms of risk retention requirements*," and "*[e]xceptions or exemptions from the risk retention requirements*."[3]

For clarification, the most recent amendments are not the first introduction of a risk retention regulation in Japan, albeit the pre-amendment regulation was indirect in its nature. The pre-amendment risk retention requirements for securitisation products applied to banks and certain other financial institutions in Japan were introduced by the JFSA in April 2015 to accommodate and implement IOSCO's recommendations, by amending its series of supervisory guidelines applicable to deposit-taking financial institutions, insurance companies, and securities companies.[4]

The guidelines adopted an indirect regime, under which the JFSA and local finance bureaus' supervisory divisions inspect/examine, in relation to investments in securitisation products by these financial institutions, whether the supervised financial institutions verified/established the relevant originator's continuous retention of a part of the risks associated with the securitisation product or, in cases where the relevant originator does not retain such risks, whether the operator thoroughly analysed the status of the originator's involvement in the underlying assets, and the quality of such assets.[5]

The new risk retention requirements maintain such existing indirect regulation, while adding new regulations to incentivise investments to be made in securitisation products satisfying the risk retention requirements, as opposed to those that do not meet the requirements.

With such a backdrop, on December 28, 2018 and January 9, 2019, JFSA publicised a set of proposed amendments to the regulations on the capital regulations including risk retention requirements, inviting public comments on those proposals. Although numerous public comments were made to the proposals, the amendments adopted on March 15, 2019 are, by and large, without any material change from the proposals. JFSA separately addressed and replied to the public comments on its website and some of the issues raised through the public comments have been addressed in the Revised Official JFSA Q&A.

Outline of the new risk retention requirements

Framework of the new requirements

The new risk retention requirements incentivise, to an extent, banks to invest in securitisation products that satisfy certain conditions by imposing a higher risk weighting on a securitisation exposure held by a bank if those conditions are not satisfied. Put differently, JFSA's new risk retention requirements adopted an "indirect" regime where only the banks and other applicable financial institutions are the addressees of the requirements and the originators of securitisation transactions (unless the originators themselves are the banks and applicable financial institutions, as noted below) are not directly required to comply with the risk retention requirements.

Under the new rules, if a bank cannot establish that the securitisation exposure held by it satisfies the risk

retention requirements described below (see *5% risk retention requirements*), an increased regulatory capital charge, by applying a risk weight three times higher than that otherwise applied to compliant securitisation exposures, subject to a cap weighting of 1,250%, will be imposed onto the securitisation exposure, unless certain exception described below (see *Exception to 5% risk retention requirements*) is applicable.

To clarify, for the purposes of the new capital requirements for securitisation products, a "securitisation transaction" is defined as a transaction "*in which the risk associated with an underlying exposure or underlying pool of exposures is tranched into two or more senior/subordinated exposures and all or a part of such tranched exposures are transferred to a third party or parties*" (save for exempted products such as certain types of loans in commercial real estate finance, project finance and commodities finance). The definition covers most of the instruments regarded as securitisation instruments within the commercial markets, including vast majority of CLOs as well as synthetic CLOs. However, it is noteworthy that, for mortgage-backed securities issued by the Japan Housing Finance Agency ("JHF MBS"), JFSA has expressly stated – in the Revised Official JFSA Q&A – that the definition could be interpreted as not being applicable to JHF MBS due to its unique structural features.

In addition, under the new capital regulations, an "originator" is defined as (i) anyone who is directly or indirectly involved in the formation/origination of the securitised assets; or (ii) a sponsor of an ABCP conduit that acquires exposures from a third party or parties, or any other similar programme. With the definition not excluding the banks and other applicable financial institutions, it is generally understood the new risk retention requirements will also apply when the bank itself is the originator.

5% risk retention requirements

To meet the new risk retention requirements, the bank must establish that the relevant originator of the securitisation transaction retains a securitisation exposure in the transaction equal to not less than 5% of the total securitised assets by, either:

- *vertical retention:* holding equal (in terms of ratio) portions of each tranche;
- *horizontal retention:* holding all or part of the most junior tranche, the total amount of which is at least 5% of the aggregate amount of the exposure for the securitised assets;
- *hybrid - "L-shaped" retention:* if the most junior tranche is less than 5% of the entire exposure, holding all of such tranche as well as equal (in terms of ratio) portions of all other tranches, the total amount of which is at least 5% of the aggregate exposure for the securitised assets; or
- *alternative retention:* continuously holding portions of the securitisation exposure, in such a manner that the credit risk held by the originator is deemed equivalent to, or greater than, the credit risk required under the above three patterns.

It should also be noted that, for the purpose of determining the conditions above, if the originator has substantially no credit risk for any portion it holds, by hedging or otherwise mitigating such credit risk, such portion is deemed as not being held by the originator. As such, banks are required to conduct due diligence examinations on whether or not the originator has hedged or otherwise mitigated any portion of the risks it retained by use of credit default swaps, guaranties, or any other instruments.

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The Revised Official JFSA Q&A provides certain examples of the "alternative retention" method and perhaps the most notable example is:

- the securitisation transaction is tranched into the senior tranche, the first mezzanine tranche, the second mezzanine tranche, the junior tranche;
- the originator holds the entire junior tranche, the entire second mezzanine tranche and a part of the first mezzanine tranche;
- the aggregate of the entire junior tranche and the entire second mezzanine tranche is less than 5% of the aggregate amount of the exposure for the securitised assets;

under the circumstance, although none of vertical retention, horizontal retention and the hybrid "L-shaped" retention is not met, if the aggregate of the entire junior tranche, the entire second mezzanine tranche and the portion of the first mezzanine tranche held by the originator is more than 5% of the aggregate amount of the exposure for the securitised assets, then the "alternative retention" can be deemed as met.

Exception to 5% risk retention requirements

As an exception regarded as one that is unique to Japanese regulations, the amendments allows the following exception: if the bank is able to establish/judge that the securitised assets were not "inappropriately originated/formed" on the basis of the relevant circumstances, such as the originator's involvement in the securitised assets and the nature and quality of the securitised assets, then the bank does not have to treble the risk weighting in calculating the credit risk weight for such securitisation exposure. This exception would allow banks to avoid applying increased risk weightings onto securitisation products, even when the banks cannot establish/verify that any of the new risk retention requirements described above are satisfied.

In connection with the interpretation of this exception, the Revised Official JFSA Q&A interestingly provides certain examples of circumstances where banks would be permitted to judge that securitised assets were not "inappropriately originated/formed." The Revised Official JFSA Q&A classifies the examples in three buckets:

1. where originator or other relevant party can be deemed to hold credit risks equal to or more than the 5% risk retention requirements described above;
2. where the bank's in-depth analyses on the nature and quality of the securitised assets result in the bank judging that securitised assets were not "inappropriately originated/formed"; and
3. where changes in circumstances arising after the acquisition of the securitisation exposure caused the non-compliance with the 5% risk retention requirement but the credit risk is continued to be held by the originator.

Examples of first bucket

The Revised Official JFSA Q&A stipulates the following, among others, as examples of the first bucket:

- Even if the originator itself cannot be judged as satisfying the 5% risk retention requirements described above, where the bank is able to verify that the originator's parent company or any other party, such as an arranger, who was deeply involved in the formation of the securitisation transaction, holds, itself or in the aggregate with the portions held by the originator, equal to or more than the required amount of credit risk of the securitisation exposure under the 5% risk retention requirement above.
- Even if the originator does not retain the required credit risk by way of holding the relevant securitisation exposure, where the bank is able to verify that the originator is providing credit support to the junior tranche of the securitisation exposure whereby which the amount so supported is equal to or more than the required amount of credit risk of the securitisation exposure under the 5% risk retention requirement above. Caveat is that, credit enhancements by excess spreads structured at the inception of a securitisation transaction by use of, for example, adjustments to the distributions to each tranches, does not entail the

originator's loss (as opposed to where the originator is providing credit support by a guaranty, for example), and therefore such credit enhancements are expressly stated as not satisfying the above requirement.

- In cases of synthetic securitisations, where the originator and the investor shares the risk of losses arising form the underlying assets and the originator's share of the risk is equal to or more than the required amount of credit risk of the securitisation exposure under the 5% risk retention requirement above.

Examples of second bucket

The Revised Official JFSA Q&A stipulates the following as examples of the second bucket:

- Despite the lack of the originator's risk retention, where objective evidence or materials made available to the bank allows the bank to judge that the securitised assets were not "inappropriately originated/formed," for example, in cases of real estate securitisation transactions where appropriate real estate appraisals and engineering reports are made available.
- In cases where the originator purchases the securitised assets through transactions in, for example, the open market (as opposed to originating the same), if the bank can determine that the quality and nature of those purchased assets are not inappropriate based on objective evidence or materials.

In connection with this bucket, the Revised Official JFSA Q&A expressly reiterates the importance of "in-depth" analyses and other due diligence examinations in making investments in securitisation instruments, on matters such as the quality and nature of the securitised assets. The Revised Official JFSA Q&A provides relatively detailed descriptions as to how those analyses and examinations need to be conducted, and also cautions that the JFSA does not deem, reliance on external credit rating agencies' ratings, prices marked on the market or short-term historical performance of the securitised assets, as sufficient analyses or due diligence examination.

Example of third bucket

The Revised Official JFSA Q&A clarifies, as an example of the third bucket, that even if the 5% risk retention requirements came not to be met, if the non-compliance with the requirements arose from, for example, defaults on the securitised assets causing the amount of risk held by the originator to be lower than the required threshold amount under the 5% risk retention requirement, for so long as the 5% risk retention requirements were met at the time of the acquisition by the bank of the securitisation exposure, and if the originator continues to hold the same instruments since the bank's acquisition, then the exception to the 5% risk retention requirements would be interpreted as being available to the bank.

Notable grandfathering

Although the amendments became effective on March 31, 2019 (i.e. the new regulatory capital requirements, including risk retention requirements, will be applied to capital charge calculations from banks' fiscal year 2018, which ends on March 31, 2019 under Japanese banking regulations), among various grandfathering provisions in connection with the introduction of the amendments, there is a grandfathering provision – which is unique to Japan – in terms of the new risk retention requirements. That is, the new risk retention requirements are stipulated as not being applied to the securitisation products held by a bank on March 31, 2019, as long as the bank continues to hold such products, meaning that there is no need to treble the risk weighting despite its possible non-compliant status.

In other words, the new risk retention requirements will be applied to only those securitisation products acquired by banks on or after April 1, 2019. This is believed to be one of the conditions allowing banks in Japan to not be forced to dump their securitisation portfolio due to the sudden increase in the risk weightings as a result of the new capital requirements for securitisation products under the amended regime. However, any subsequently acquiring bank will not enjoy the grandfathering despite the securitisation product being already in existence on March 31, 2019.

Re-securitised products

In line with the BCBS documents, JFSA has clarified its position to include re-securitised products within the definition of securitisation products for the purposes of capital requirements of financial institutions. And as the amendments has expressly stated to set the floor of risk weights for re-securitisation exposures to be at 100%, the importance of satisfying the risk retention requirements for re-securitisation exposure is especially high.

Effect of non-compliance

As noted above, for those investors that are banks or certain other types of financial institutions (which are subject to the capital requirements for securitisation products), increased regulatory capital charge on their securitisation portfolio would be realised if their investment or investments in securitisation products were found to be non-compliant of the new risk retention requirements.

Separately from the increased capital charge, disciplinary action may also be imposed or brought against the financial institution who invested in a non-compliant instruments, as the supervisory guidelines of JFSA – which were amended concurrently with the capital regulations for securitisation products in March 2019 – require Japanese financial institutions to conduct in-depth analyses and other due diligence on securitisation products, including facts relating to risk retention requirements.

Notes:

1 The minimum capital requirements applicable to banks (other than foreign bank branches) are provided in a JFSA-issued notice named the "*Criteria for a Bank to Determine Whether the Adequacy of its Equity Capital is Appropriate in Light of the Circumstances such as the Assets Held by it under the Provision of Article 14-2 of the Banking Act*" (Financial Services Agency Notice No. 19 of 2006; the "Bank Pillar 1 Notice").

2 JFSA, "*Q&A with respect to capital ratio requirements*" (last updated on March 15, 2019).

3 The Board of the International Organization of Securities Commissions. *Global Developments in Securitisation Regulation: Final Report* (November 16, 2012) p. 48, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf

4 FSA, "*On the publication of the results of public comments on the partial amendments to the supervisory guidelines in relation to risk retention requirements (draft), etc.*" (April 30, 2015).

5 For example, III-2-3-3-2(3)(ii)d of the Comprehensive Guidelines for Supervision of Major Banks, Etc.

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