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Japan's finance markets hit by COVID-19 shock

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Japan's financing markets, as well as the overall economy, was of course not immune to the impact of the globally-spread pandemic of COVID-19. To the date, Japan has been one of the more fortunate regions/nations to experience lesser severity in terms of the fatality-population ratio and other medical statistics; however, we have yet to see the end to COVID-19's impact. No one can yet be sure of the true impact COVID-19 brought about to the nation's economy, much less the continued effect of the novel coronavirus.

General overview

For almost two months, the Japanese government declared a State of Emergency which allowed the nation's local prefectural governments to implement quarantine measures, such as to shut down restaurants, theatres, commercial complexes and other commercial establishments, and call for citizens to stay at home. With the economical and commercial activities put on halt for an extended period of time, Japan, too, has suffered economically. While the true extent of the impact is yet to be recognised, it is obvious that a lot of industries have taken a severe hit. Among those industries are: the nation's food service industry, hotel industry, airlines and transportations, automotive and other mobility companies, automotive parts manufacturers, manufacturers of non-essential products, theatres and movie complexes, clothing and other apparels, and various retail shops and franchises.

In the midst of economical downturn, the nation's government (including the local prefectural governments) have been introducing a series of emergency financing measures concurrently with measures to reduce cash payouts, especially for small to mid-sized enterprises.

Among those measures introduced to date include the following.

Special financing and grants

Financing by governmental financial institutions

Japan Finance Corporation (JFC), a wholly-owned stock company of the national government; Shoko Chukin Bank (SCB), another governmental financial institution (but owned partially by private sector); the Okinawa Development Finance Corporation (ODFC), another wholly-owned special corporation of the nation's government; as well as credit guarantee corporations of each local prefecture (each a CGC), are among those governmental institutions to have introduced emergency financing measures to the nation's corporations and enterprises, aimed to provide, at least a temporary relief to affected businesses from COVID-19's impact.

1) **Novel coronavirus infections special financing.** JFC and ODFC have introduced this new financing to affected

businesses, conditions to applications being, among others: revenue being reduced by 5% or more in comparison to the last fiscal year. The financing under the new regime is provided on an unsecured basis and can effectively be at no interest rate payable if concurrently applied for with special grants for interest payments.

JCF and ODFC have also introduced a similar loan package, which provides low-interest rate, unsecured loans, made available to small-sized enterprises affected by COVID-19, when similar conditions are met. And perhaps more importantly, JCF and ODFC are providing special loan packages to certain industries strongly affected by COVID-19: food supply businesses, hotels, cleaners, barbers and hair salons, and sanitations industry.

2) **SCB's crisis responsive financing.** Similarly with (1), SCB has introduced a new regime under which SCB provides a low interest rate, unsecured loans to affected businesses when certain conditions, such as revenue being reduced by 5% or more in comparison to the last fiscal year, are satisfied.

3) **Safety-net financing.** "Safety-Net Loans" have been around even before COVID-19 has hit the market, but the conditions for enterprises to be approved for the use of the financing regime have been relaxed and the maximum amount of loans that can be extended has been increased, following the novel coronavirus' impact. Safety-Net Financing regime is provided by JFC, banks in the private sectors with guarantees extended by CGCs and local prefectural governments with guarantees extended by CGCs. The characteristic feature of the Safety-Net Loans are that the affected businesses do not need to satisfy the condition regarding its reduction in revenue by 5% or more from the year before.

"Business sustainment grants", subsidies for layoffs and rent subsidies

1) The national government has been providing grants to small to mid-sized enterprises up to ¥2m (approx. US$200,000) and to individual business owners up to ¥1m (approx. US$100,000) when the following conditions are met: (a) monthly revenue being declined by 50% or more, (b) business has been raising revenue from 2019 or earlier and the enterprise/individual intends to continue business, and (c) in cases of corporations, has less than ¥1bn of stated capital or has 2,000 or less employees.

2) Subsidies made available by the government for temporary down-sizing of businesses aimed to support leave of absence payments; the conditions for the subsidies have now been relaxed and are now made available to business enterprises in every industry that are suffering from reduced monthly revenue or reduced production volume by 5% or more, and are taking measures to down-size by furloughs or layoffs.

3) Some prefectural governments are providing subsidies to support rent payments by businesses affected by COVID-19, and the national government is expected to budget a national rent subsidy program.

Suspension of expenditures

The national government and local governments have taken measures to relax the due dates for various tax, pensions and other public payments. For various national and local taxes, the governments have taken measures to allow businesses suffering from reductions in revenue by 20% or more as a result of COVID-19 shock to withhold tax payments by a year (or to pay in instalments over an extended period up to a year), with no late payment penalty applied, and no collateral required. Similarly, social security insurance and pension premiums are now being allowed to be withheld for a year, or be allowed to pay in instalments over an extended period up to a year.

Effects on securitisation

While we do not yet know the depth of COVID-19 outbreak's impact on the overall economy, we are starting to see the effect of COVID-19 on corporate loans, commercial mortgage loans and residential mortgage loans.

As is the norm in many jurisdictions, securitisation instruments offered, sold or distributed in Japan are often structured to achieve high investment grade, if not the highest investment grade, in terms of credit rating.

However, even with the buffers afforded by over-collateralisation and other credit enhancement features, securitisation instruments with corporate loans, commercial mortgage loans and residential mortgage loans as securitised assets may prove to be susceptible to the unprecedented level of overall economy's downturn.

Following the financial crisis that resulted from the subprime loan issues, securitisation products offered, sold and distributed in Japan suffered significantly less defaults, in fact, more closer to nil, in stark contrast to, for example, in the US market. The problem, is that the economy's downturn due to the COVID-19 outbreak may prove to be too pervasive in terms of affected industries, and of sheer number of citizens and enterprises who are obligors of the securitised assets and affected by the downturn, in comparison to the financial crisis.

CLOs and S-CLOs taking hits?

As described above, the Japanese governmental leadership has been actively promoting measures to aide and support the ailing businesses. Despite those well-intended measures, there is no guarantee that those would be enough to allow business enterprises to sustain their businesses, or to maintain their debt service levels. Even if companies can avoid defaulting on their loans and/or seeking bankruptcy protections, if increasing numbers of debtor companies (in the case of collateralised loan obligations (CLOs)) and referenced companies (in the case of synthetic collateralised loan obligations (S-CLOs)) are to struggle in their debt service (by missing a payment, for example) or otherwise fails into a credit event, CLOs and S-CLOs can be downgraded or result in default.

To clarify, the negative impacts on CLOs/S-CLOs will also likely be hitting Japanese investors from the global economy's downturn, as the Japanese financial institutions, for example, are active investors in securitisation products issued and marketed elsewhere in the world, as well.

CMBS and J-REITs to suffer?

As business enterprises in numerous industries have gone through a sudden and unexpected "pause" on its business activities due to the fallout of COVID-19, countless number of business entities are trying to manage their fixed costs in various ways. One such measure being considered by the business enterprises, and in some cases being actually initiated, with the government's rent subsidies not yet implemented, is a workout or negotiation with the landlord in terms of reduction in the rent amount or an extension in due dates for rents.

In addition, the Japanese statutes for building leases also allow certain lessees (other than non-renewable fixed-term leases) to petition for reduction in the rent amount when there are grounds (outside of lessees' control) justifying the need to reduce the rents; while there certainly is no controlling precedent or authoritative interpretation of the statute in the context of COVID-19's unprecedented impact on the overall economy, there certainly will be lessee companies desperate enough to pursue the legal remedy if landlords do not accommodate the ailing lessees' demands for restructuring of leases.

Court decisions granting reductions in rents could cause commercial mortgage loans to become ineligible as a result of the judicially forced reduction in the rent amounts or to outright default of those loans. And, even if the Parliament passes the bill to introduce a programme for rent subsidies noted above in the coming summer, the rent subsidies alone may not be sufficient enough to allow lessees to default on their rent payment obligations and/or to lessen the need to legally petition for reduction in the rent amounts.

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Equally alarming may be the impact that the fallout of COVID-19 may prove to have on J-REITs. Performance levels of J-REIT do have strong correlations with the default rates in terms of rent payments. J-REITs basically being equity investment instruments rather than debt instruments, underperformance will not directly result in J-REIT instruments to default. However, as J-REITs are typically leveraged by loans from banks, too steep a decline in rent payments may result in some J-REITs to default on their bank loans, which could in turn trigger an insolvency event. Thus, too steep a decline in rent payments may eventually lead some of the J-REITs to be taken-over by other J-REITs, hostile or otherwise.

A separate factor may also place a downward pressure on the performance of CMBS and J-REITs: the argument that landlords/building owners will owe liabilities to ensure the buildings are sanitised if/when a positive COVID-19 infection was affirmed at the landlord's building. There is no controlling authoritative court precedent to the point, but the Civil Code of Japan is interpreted to impose an obligation on landlords to allow lessees/tenants to occupy and use the leased premise safe and sound; therefore, there is a new argument amid the COVID-19 pandemic that, other than the leased area itself where the lessee/tenant would be directly be charge of safety and soundness, a landlord owes the obligation to make sure that the common area (such as a lobby of the building where every lessee/tenant are allowed to and would use) is sanitised. If landlords are interpreted to owe such obligations, then the costs and expenses to monitor and sanitise the building's common area would negatively impact the landlords' profit margin, which could result in some of the CMBS instruments and J-REITs to underperform.

Another impact that COVID-19 has been imposing on Japanese economy is the "pause" on numerous development projects. General contractors and construction companies had long resisted to take quarantine measures at construction and development sites to allow projects to proceed as scheduled. However, the pandemic has finally taken enough toll on construction and development sites such that general contractors and construction companies, too, had to take quarantine measures and halt the projects. As a result, being forced are the restructuring and rescheduling of structured finance transactions financing constructions and developments. Some of the construction and development projects forming a pipeline to CMBS and RMBS transactions, halts on those projects, too, may have a negative impact on CMBS and RMBS on a longer time span.

RMBS taking hits?

Japanese citizens have both suffered and benefited from the long-standing low interest financial markets. Extremely low interest rates have allowed Japanese citizens to take up residential mortgage loans to finance their purchase of home and condominiums, and the banks' lack of opportunities to profit in higher interest rate markets have caused banks to relax their credit screening for residential mortgages, further allowing citizens to be approved to borrow residential mortgage loans. However, with a significant number of business enterprises being affected by COVID-19 and forced to down-size by going through a series of restructuring efforts including layoffs and furloughs, there are alarming reports that an increasing number of residential loan borrowers are starting to be late or default on their mortgage payments.

Even with various measures taken by governments, and banks in private sectors willing to work with borrowers to restructure or reschedule their residential mortgage loans, and since RMBS' terms and conditions allows lesser leeway for originating banks to alter the original terms of the securitised loans, we may need to expect that default rates on residential mortgages will go up, enough to down-grade the RMBS products sold and marketed in Japan, or at least expect banks to have less eligible residential mortgage loans to securitise going forward, resulting in less issuance of new RMBS products for the time being.

Granted, we do not yet know the true depth of the impact that COVID-19 had -- and will continue to have -- on Japan's overall economy, much less the impact it has -- or will have -- on securitisation instruments and/or J-REITs. At this point, all of the above is a mere conjecture. However, media reports concerning residential owners starting to have difficulties and business enterprises doing whatever necessary for them to survive are certainly alarming enough to warrant a careful monitoring of securitisation instruments and J-REITs.

Japanese banks to suffer?

CLOs/S-CLOs and banks

According to the statistics publicised by the Bank of Japan and the Financial Services Agency of Japan, Japanese financial institutions hold approximately 20% of the globally-issued and marketed CLOs and S-CLOs (at least on the publicly announced issuance base). Again, if increasing numbers of debtor companies (in the case of CLOs) and referenced companies (in the case of S-CLOs), both domestically and internationally, are to struggle in their debt service or otherwise default on their debts, CLOs and S-CLOs can be downgraded or result in default. Downgrades in CLOs and S-CLOs alone, even if they do not reach the point of their defaults, will require Japanese financial institutions to set aside more regulatory capital.

As a matter of fact, business enterprises' distress could have a "double" impact on the Japanese commercial banks. Compared to commercial banks in some of the other parts of the globe, Japanese commercial banks tend to own and hold on to their balance-sheet listed shares and other equity instruments in companies. So, the listed stock prices taking a steep drop at stock exchanges alone will also have a more negative impact on the banks' regulatory capital, relative to peer banks in other parts of the world.

RMBS and regional banks

With an overwhelming number of small to mid-sized businesses suffering from the COVID-19 pandemic's effect on our economy, the economic downturn may prove to be the last straw for a few Japanese regional banks. With the long persisting deflated economy in Japan, as well as the increasing urban concentration of larger-sized enterprises, an increasing number of regional banks have been experiencing gradual financial decline.

The non-discriminatory nature of the novel coronavirus' pandemic has not only affected the concentrated economical centres of Japan, such as metropolitans of Tokyo and Osaka, but also severely hit regional parts of the nation. The toll COVID-19 is taking on the regional small to mid-sized business enterprises include the significant drop in the inbound flow of foreign tourists, and reductions in production volume in many smaller manufacturers spread throughout the country, causing revenues of businesses to take a nose-dive, in turn, resulting in an increasing number of bankruptcies of small to mid-sized companies at an alarming rate. Concerns emerging on declines in rent income on commercial buildings and complexes, and perhaps more so in the revenue levels of hotels, are also factors warranting a careful monitoring.

As if the decline in the commercial area alone is not enough to impair regional banks' sustainability, the regional banks will most likely -- if not definitely -- suffer also from the distressed residential mortgage loan market. With the regional banks not having been able to identify -- for a sustained period of time now -- enough opportunity to yield higher profit margins through higher interest rate markets, and due to the constraints of capital regulations under the Basel Accord, extensions of residential mortgage loans and issuance of RMBS products have been one of the more stable set of avenues to invest their capital and raise enough profit to sustain their business. But as the residential mortgage loan borrowers are also suffering from the non-discriminating COVID-19 due to layoffs, furloughs and other results of economic downturn, regional banks virtually have no choice but to be willing to engage in restructuring and rescheduling of residential mortgage loans to accommodate the financial difficulties borrowers are facing, and that would most certainly negatively affect the way regional banks have been raising profits under the constraints of capital regulations.

The media outlets have recently been reporting that the national government, more specifically, the Financial Services Agency of Japan, will be relaxing its threshold conditions, as well as the subsequent terms (including contractual obligations to be imposed on banks under the capital injection agreement), to inject capital into regional banks to financially support them, especially by way of equity capital. The measure will require the Parliament to pass the relevant bill to legislate the change, and details of the bill is yet to be publicised, but the expectation is the legislation will be completed during the course of this summer, i.e. the summer of 2020. Reported relaxation of terms of capital injection include: the lifting of the requirement to redeem the injected capital within 15 years, lowering of annual dividend rate and relaxing the requirements relating to the banks' projected business plans.

Securitisations to re-emerge?

On the other hand, there is a possibility that banks' possible struggles in Japan could result in more business entities looking for alternate sources of financing, rather than merely relying just on bank loans as a source of financing.

As is well-documented, before the financial crisis, the securitisation market was very developed in Japan. During 2006, for example, the actual issuance of securitisation products on an announced basis reached about ¥11 trillion. However, following the global financial crisis originating from the subprime mortgage crisis, the demand for securitisation products decreased (despite no substantial issues having arisen relating to securitisation products themselves in the Japanese market, save for certain defaults of commercial mortgage-backed securities (CMBS) transactions that had resulted primarily from the reduction in the number of non-recourse real estate financing providers, and the general unwillingness to provide credit support to real estate financing). General belief is that a part of the reason that resulted in the decline in securitisation market was the very low interest rate environment that has been prolonging in Japanese corporate sectors. While we do not yet know the true depth of the COVID-19 outbreak's impact, let alone where the economy will head as a result, if the banks' struggles would lead us to a higher interest markets, then that factor can be the last "push" the securitisation market in Japan has long been waiting for.

Force majeure and material adverse change

While there is no statistical or empirical evidence to support, our experience suggests that loan or other finance contracts in Japan typically do not have any specific language covering a pandemic or outbreak of infectious virus or disease (such as COVID-19) addressing them as a factor for the purposes of *force majeure* provisions, material adverse change termination provisions, material adverse effect languages for representations and warranties and/or events of default provisions, or for similar languages in conditions precedent. Therefore, whether or not the COVID-19 outbreak will constitute a ground for termination, breach of representation or warranty, event of default or non-satisfaction of a condition precedent will be completely a matter of interpretation of contract languages not specifically addressing a pandemic or outbreak.

We are recently starting to see disputes or disagreements regarding the application of these contractual languages between borrowers and financing parties. And, as COVID-19 has been an unprecedented saga, we do not yet have any controlling court precedent, apparently applicable to the situation, in determining the outcome of such disputes.

Note:
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