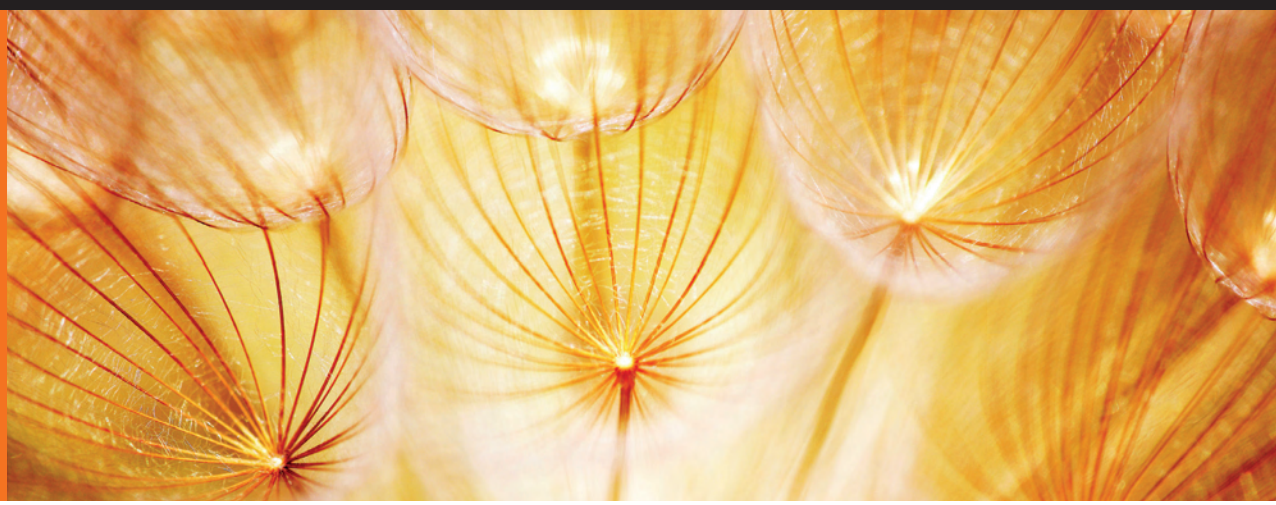


THE SECURITISATION & STRUCTURED FINANCE HANDBOOK
2022

12th Edition

Japan updates - in the midst of COVID-19 pandemic

by Hajime Ueno, Nishimura & Asahi

We do not yet know when the COVID-19 pandemic will come to an end (although one could say that, at least, we are starting to see the light at the end of the tunnel with the vaccinations being more and more made available to people around the world), nor do we know the true depth of the outbreak's impact on the overall economy.

While 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, and although vaccinations are rapidly being made available to the citizens, we do not yet know if or when the supply will be enough to cover the whole population that are electing to get vaccinated.

Further, as of the date of this article[1], the Tokyo Olympic Games is scheduled to be held in a couple of weeks; and general belief is that the Olympic Games will bring about a strong, positive economic effect to the Japanese economy in various facets, but yet, there are news media outlets reporting that the national government will be making its fourth state of emergency declaration to the Tokyo Metropolitan in the coming day or two. With a lot of unknowns left when it comes to COVID-19 and its vaccinations, and with a huge number of people visiting and moving around in Japan for Olympic Games, at the very least, it should be safe to say that, the outlook for the Japanese economy and the entire nation remains to be uncertain.

General overview

As has been widely reported, the Japanese governmental leadership has been actively promoting measures to aide and support the ailing businesses ever since the wake of the COVID-19 pandemic. And those measures have been somewhat successful in allowing enterprises to avoid immediate bankruptcy or becoming insolvent, at least prolonging the lives of the impacted enterprises.

This is evident by the fact that we have had one of the lowest recorded numbers of bankruptcies in the year 2020: for example, according to the Tokyo Shoko Research, in the 50 years since 1971, 2020 is the fourth lowest level on record. This is especially notable considering the fact that,

Hajime Ueno, Partner
Nishimura & Asahi
tel: +81 3 6250 6275
email: h.ueno@nishimura.com

in Japan, in contrast to other foreign countries and jurisdictions where courts were literally shut down for an extensive period(s), the bankruptcy courts in Japan did not close for any extended period.

Having stated the above, however, those measures are mostly emergency loans and guarantees, and extensions for taxes and other public payments, with small amounts of grants and subsidies; hence, it should be expected that an increasing number of enterprises will be carrying more debts than their ability to repay, thus will soon be facing financial difficulties, despite little breathing room afforded through the governmental measures.

In other words, 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. If so, banks and other financial institutions more likely than not will accelerate their disposition of non-performing loans, especially once the economy resumes its more normal state. In this connection, we may see a spike in the number of securitisation transactions backed by a pool or pools of non-performing loans.

Existing securitisation products not suffering...yet

One characteristic aspect of the COVID-19 pandemic's impact on economies worldwide is that the financial markets, especially the equity markets, have not stagnated. Rather, with most if not all central governments taking proactive measures to support the economy and central banks lowering interest rates, resulting in more funds flowing through to the economy, stock exchanges and private equity markets are, in many countries, in fact, booming.

Basically, the same can be said of the Japanese market. With investors pouring in more funds into the market, "cash" is made available, one way or the other, to many enterprises at the moment, irrespective of their fundamentals. As a reflection of this backdrop, CDOs, CMBS and J-REITs are not suffering much -- at least not yet -- rather, some J-REITs are experiencing record-high stock prices.

The caution must be paid, however, to the point that, once the music stops, there most likely will not be enough chairs to go around for everyone. Once the boom stops, enterprises will soon start to face prolonged financial difficulties, and the resulting economic downturn (whether it reaches a point where it is called a recession or not) could cause CDOs, CMBS and J-REITs to start suffering as well.

RMBS starting to take hits?

It is a well-documented fact that Japanese citizens have both suffered and benefited from the long-standing low interest market. Extremely low interest rates have allowed Japanese citizens to take up residential mortgage loans to finance their purchase of homes and condominiums, and banks' credit screening for residential mortgages have gradually been relaxed over the years, further allowing citizens to be approved to borrow residential mortgage loans. And, despite the breathing room provided to individuals' residential mortgages through governmental measures soon after the COVID-19 pandemic, it has already began to be proven that the breathing room was too little, as reports regarding the spike in the number of residential debtors electing to sell their house/condominium and repay (albeit only partially, since in most cases the collateral is not enough to cover the entirety of the debt) are starting to circulate.

The reason behind the debtors electing to sell, rather than the banks foreclosing on the collateral is that, in Japan, foreclosure auctions typically yield much less proceeds, so the debtors would be better off selling, voluntarily, the collateral on their own and apply the proceeds to repay as much as they can. Unfortunately, due to such a tendency, numerical data in terms of the actual number of those *de facto* default/foreclosure cases are difficult to gather.

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, an increase in the number of defaults or *de facto* defaults should be expected. So far, the increase of defaults at the underlying pool level have not seemed to reach a point to warrant downgrades, but if

or when enough defaults (including *de facto* defaults) occur, it would start to crumble into downgrades of RMBS products sold and marketed in Japan.

Certain developments

First security token offering (STO) backed by securitisation products

In March 2021, Japan witnessed the first issuance of digital security, in the form of security token offering (STO), backed by securitisation products, namely asset-backed securities with a pool of credit card receivables as underlying assets. The STO was assigned "a-1" by Japan's Rating and Investment Information, Inc. (R&I), a domestic rating agency. The issuance of the STO was done on an experimental basis, and the tokens were short term in its maturity (presumably thus, the short-term rating of a-1, albeit the highest rating).

As a backdrop, Japan's securities law, namely the Financial Instruments and Exchange Act (*kinyuu shouhin torihiki hou*), was amended in May 2020 to adapt to the technological developments surrounding digital securities, especially those founded on the use of block-chain technologies, and introduced the concept of digitally tokenised rights and other concepts for the law to regulate security tokens, STOs and ICOs.

In order for security tokens using block-chain technologies to be placed through a STO in Japan, one of the legal issues regarded as a hurdle was how a transfer (as well as perfection of the transfer) of "rights" represented by the security tokens can be linked and matched to the transfer of the security tokens themselves which transfer would be recorded on and via block-chain technologies.

Sumitomo Mitsui Trust Bank (SMTB), the arranger, looked to introduce a feasible solution to the issue with the use of a trust structure. SMTB took a part of its own portfolio of credit card receivables and created a trust via a declaration of trust and became the trustee, with trust beneficiary interests thereof being used as back assets of the security tokens. SMTB then launched a private placement (offering), the STO, of those security tokens.

The beauty of the introduced structure is in the use of a particular trust type where trust beneficial interests are not represented by any instrument, in which case the Trust Law (*shintaku hou*) allows the transfer of trust beneficial interests to be done through any method or formality agreed among the parties, meaning that the method or formality can be prescribed in the trust deed (or agreement), and the trust deed can stipulate that the transfer of trust beneficial interests would always coincide with the "transfer" recorded on the block-chain platform.

Similarly, under the Trust Law, a transfer of trust beneficial interest is perfected by an entry onto the beneficial interest record kept by the trustee, which can be maintained and be kept updated by linking the "records" on the block-chain platform. Thus, this trust structure would allow the "rights" backing the security tokens to be transferred and perfected without the need to deliver, for example, the physical instrument or to separately enter on a book-entry system for traditional securities such as bonds.

To add, SMTB did not create or develop its own block-chain platform, but rather collaborated with a third-party platform provider, namely, Securitize Japan, a subsidiary of Securitize Markets, a registered broker-dealer and member of the FINRA and SIPC.

Solar power plant project finance debts repackaged instruments

As is the same in other parts of the world, SDGs/ESG-linked financings are growing into a new norm, rather than just a short-spanned boom. In this connection, it is noteworthy that Japan's Ministry of the Environment (MoE) has adopted and publicised its "*Green Loans and Sustainability Linked Loans Guideline*" together with the updated "*Green Bonds Guideline*" in March 2020.

These MoE guidelines were formulated and devised to be consistent and aligned with the "*Green Loan Principles*" of Loan Market Association (LMA) as well as the "*Sustainability Linked Loan Principles*" jointly developed and adopted by LMA, Asia Pacific Loan Market Association and Loan Syndications & Trading Association. Furthermore, domestic agencies in Japan have been active in rendering

the third-party evaluation under these guidelines, assigning Green Bond ratings to many debt financing instruments.

In the context of securitisation or structured finance, what can be seen as becoming a trend are repackaging transactions of project bonds and/or loans in solar power plant projects.

The overall structure is not that complicated: basically uses a so-called "GK-TK" structure at the SPV level for equity capital; SPV obtains debt financing either in the form of loans or bonds; the roles and functions of asset manager/plant operator being assigned to third-party sponsor; and the debt instruments will be assigned to a separate repackaging SPV (typically trusts), with the repackaging SPV in turn issuing securitisation/repackaging products in forms varying from bonds, trust beneficial interests, to other financing instruments.

One of the reason behind the trend is securitisation structures' features such as transparency in terms of tracking use of proceeds, stricter management of cash waterfall -- resulting in relative ease in tracing the cash usage, accessibility of third-party evaluators or auditors in terms of compliance with the financing terms as well as relative affinity for reporting requirements under the guidelines.

New hope for Japanese whole business securitisation?

While there have been a few issues of whole business securitisations in Japan, unfortunately, it never picked up speed, especially compared to the US and/or the UK markets. One of the factors generally believed to have functioned as a deterrent to wide acceptance is the fact that the Japanese legal system lacks the flexibility in the foreclosure or enforcement of security interest.

While no bill has yet to be formulated, Japan's Cabinet and governmental agencies have been exploring ways in which creations, perfections and foreclosures of security interests on businesses' assets can be more flexibly adopted and applied in practice, with views to taking necessary legislative actions, including amending the relevant statutes such as the Civil Code (*minpo*) and insolvency statutes.

The Cabinet and the governmental agencies' focus is mainly on providing, in addition to traditional Japanese banks' secured lending practice where real properties are the "kings", alternative methods of secured financing to enterprises, especially small and mid-sized enterprises, experiencing financial difficulties due to lack of -- or running out of unencumbered properties -- more traditional collateral, i.e. real property.

However, reports publicised by working groups for the Financial Service Agency, the Ministry of Justice and the Small and Medium Enterprise Agency can also be seen as a new hope to the securitisation market as the reports are suggesting to introduce a security package that can certainly be utilised in whole business securitisations. Namely, a collateral package encompassing the whole business by virtue of a notion similar to a UK floating charge, and its foreclosure through a Japanese equivalent of a UK receivership.

One of the difficulties for the investors to accept, on a wider scale, for whole business securitisations in Japan has been that foreclosures of collateral are all based on a liquidation scenario, and did not have any mechanism or regime allowing a receiver or some other official to step in to the management's shoes and continue to operate while trying to sell the business as a going concern.

To be sure, market participants in Japan had tried to introduce a "structured WBS" using true sale structures applied to the whole business, but with relatively less liquidity in the market for back-up operators for the securitised businesses in Japan (at least in industrial sectors where structured WBS were contemplated to be introduced) led to investors bearing concerns over the practical feasibility of the securitised business surviving the originator's trigger events (e.g. insolvency). Hence, if the suggestions made in those reports of the working groups pick up any stream and a floating charge together with a UK receivership-like foreclosure regime is to be introduced into Japanese legal system, that could be the hope that whole business securitisation in Japan had long awaited.

Having stated the above, however, there are numerous

hurdles for such a regime (especially the foreclosure regime) to actually be introduced in Japan: with a long history in Japan of having only liquidation-based foreclosures with court-appointed executioners taking charge of the foreclosures of collateral, in practicality, we may have difficulties in locating or designating the right individuals (who at first will have no experience whatsoever) to continue to operate a business or to strike the right balance in the court's supervision/involvement in the process to ensure fairness and transparency through the foreclosure process.

Usury not applicable to bonds? Securitisation market can rest easier

The Supreme Court of Japan has rendered its ruling on a legal issue that the market participants had long awaited to gain clarity. While it is also true that the Supreme Court's ruling unfortunately did not bring about a bright-line rule, it should provide a better guidance, allowing the market participants to have more legal predictability.

While basic usury law in Japan, namely the Interest Rate Restriction Law (*risoku seigen hou*), expressly covers only the interests on loans, the Money Lenders Business Law (*kashikin gyo hou*) expands the restriction on interest rate to interest rates on promissory notes, purchase financing transactions and other similar methods of financing. However, there is no explicit statutory provision nor were there any controlling court precedent whether interest rates on corporate bonds issued by companies pursuant to the Corporations Act (*kaisha hou*) will be regulated by the Interest Rate Restriction Law.

The Supreme Court, in January 2021, rendered its ruling on the issue, which can be summarised as follows:

- as a general rule, the Interest Rate Restriction Law does not apply to corporate bonds;
- however, in cases where the creditor in question misappropriated or abused the law to circumvent the Interest Rate Restriction Law, i.e. when the creditor used the legal formality of corporate bonds as a loophole to charge interest rate north of the restriction provided under the said statute, the restriction on interest rate thereunder shall yet be applicable to corporate bonds, as well.

According to the Court's ruling, the determination of whether or not the creditor in question misappropriated or abused the system will be made on a case-by-case basis, taking into account factors such as the purpose of the bond issuance, terms of offer/subscription and how the corporation made its business decision in terms of the bond issuance and the terms thereof.

In light of the Supreme Court's ruling, while it does not necessarily provide a bright-line rule for a bank that is contemplating to subscribe for a bond in lieu of extending a bilateral loan, securitisation market participants should be able to rest more comfortably in structuring or purchasing, for example, a mezzanine tranche with a yield higher than 15% per annum -- which is the limit under the Interest Rate Restriction Law, since, in contrast to a bank's subscription of bonds in lieu of a bilateral loan, when it comes to the issuance of securitisation products, there should be legitimate reasons (other than to merely circumvent the application of the Interest Rate Restriction Law) to adopt the form of corporate bonds in financing the debtor looking to raise capital through the issuance.

"Bits" of additional updates regarding amendments to Civil Code

Transfer restrictions on receivables deemed void

As reported by various outlets, the amended Civil Code now deems, as a general rule, any contractual restriction of transfer of receivable/claim to be void. While there are certain exceptions and caveats to the general rule and thus would require certain level of scrutiny, the amendment opens up opportunities for receivables/claims with transfer restrictions to be securitised.

On a related note, the Personal Information Protection Commission has publicised its interpretation of certain provisions of the Personal Information Protection Act in the form of an FAQ, and in it, it stipulates that obligors of receivables/claims can be presumed (albeit rebuttable) to have consented to provision of their personal information to

potential purchasers of the receivables/claims as the amended Civil Code's general rule is that the receivables/claims can be transferred without the consent of the obligors.

Creditors' avoidance rights coinciding with avoidance under insolvency statutes

One of the legacy regimes in the pre-amendment Civil Code was a statutory right afforded to creditors where obligors became insolvent. With the insolvency statutes' amendments pre-dating the amendment of the Civil Code, there was a contortion between the creditors' rights to avoid certain preferential transactions under the Civil Code and the rights of the insolvency officials to avoid certain preferential transactions, in that the Civil Code had more latitude in allowing certain transactions where the consideration for transferred assets was at market value to be avoided, resulting in a somewhat peculiar circumstance where creditors could try to avoid certain transactions that would not be avoidable if the debtor sought insolvency protection and insolvency proceedings were commenced.

With the amendment to the Civil Code now catching up to the amended insolvency statutes, the criteria for avoidance are streamlined, matching one with the other to resolve the contortion.

Easier execution of devising of master leases

Prior to the amendment of the Civil Code, the Supreme Court's ruling that whenever the ownership of a real property is transferred, the contractual status as a lessor under a lease contract (together with the entirety of the lease contract) will automatically and mandatorily transfer with the ownership was the law. This meant that if in a structured finance setting, an owner of a real property was to transfer the ownership but contemplates to remain as the lessor to the existing tenants, i.e. becoming the master-lessee and the sub-lessor, the owner had to obtain consents from all the existing tenants or else the tenants will only be required to recognise the transferee of the ownership as the new and sole lessor to that tenant.

Under the amended Civil Code, however, the owner can now choose to retain and maintain its contractual status as the lessor despite selling the real property to a third-party purchaser, thereby foregoing the need to obtain consents from the existing tenants.

Note:

[1] Article written on July 6, 2021.

Contact us:

Nishimura & Asahi

Otemon Tower, 1-1-2 Otemachi, Chiyoda-ku

Tokyo 100-8124, Japan

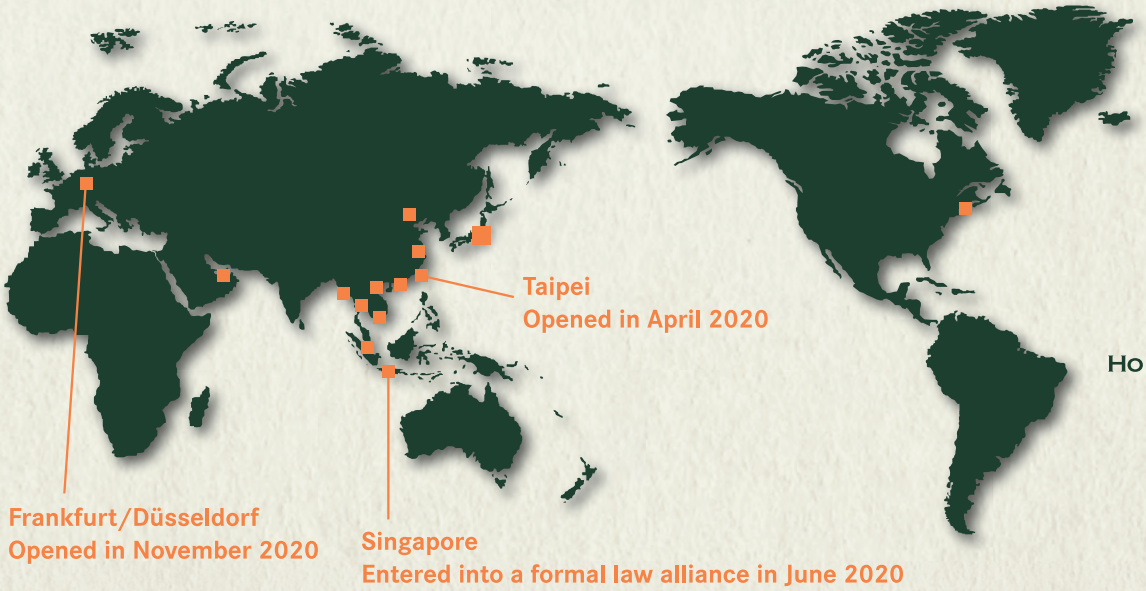
tel: +81 3 6250 6200

email: contacts@jurists.com

website: www.nishimura.com/en

Lawyers: 700+

Offices: 18+



Tokyo
Nagoya
Osaka
Fukuoka
Bangkok
Beijing
Shanghai
Dubai
Düsseldorf
Frankfurt
Hanoi
Ho Chi Minh City
Jakarta
New York
Singapore
Taipei
Yangon
Hong Kong

Nishimura & Asahi

Nishimura & Asahi is Japan's largest full-service international law firm.

Our fundamental mission is to realize an affluent and fair society based on the rule of law. Committed to "Leading You Forward," we aim to contribute to the growth of our clients and our society.