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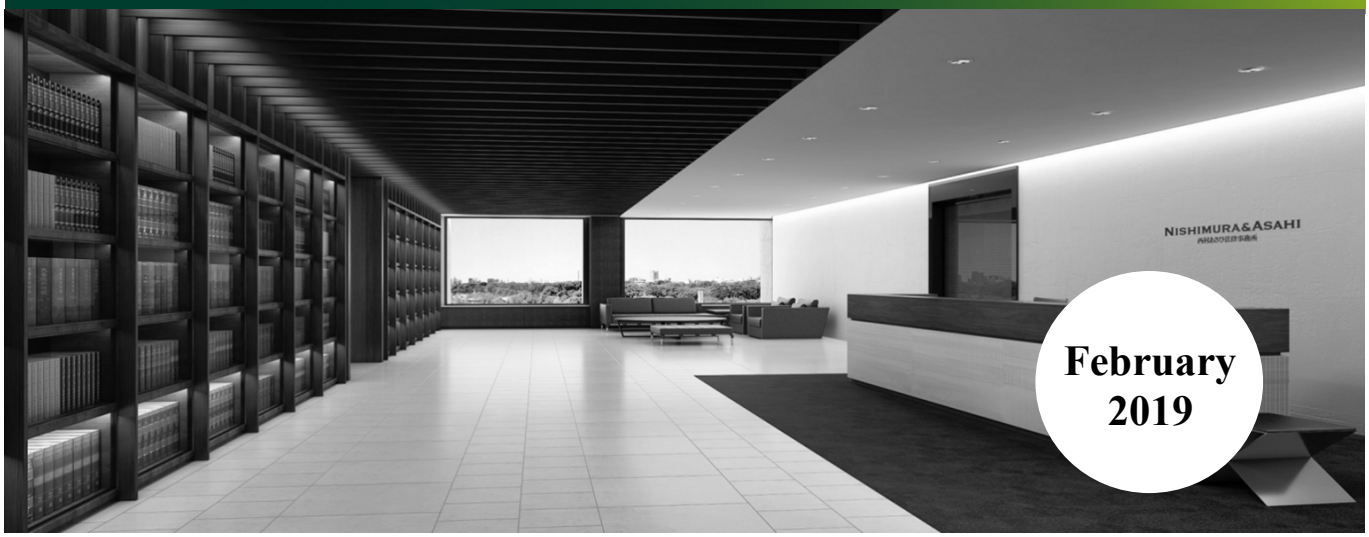
Finance Law Newsletter



New Risk Retention Rule for Securitization Proposed for Japan

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1. Introduction

On December 28, 2018, the Financial Services Agency of Japan (the "FSA") released certain proposed amendments to its notices on the capital requirements applicable to banks (excluding foreign bank branches; hereinafter the same) and certain other deposit-taking financial institutions, bank holding companies, and certain securities holding companies,[1] and invited public comments on them (the deadline for submission of such comments was noon on January 28, 2019).[2] The FSA, with other relevant ministries, further released similar proposed amendments to other notices applicable to the other deposit-taking financial institutions on January 9, 2019[3], and also invited public comments on them (the deadline for submission of such comments is noon on February 8, 2019). These proposals contain various changes to the existing capital treatment of securitization products, including implementation of special treatment on "simple, transparent and comparable" securitization products, for the purpose of the domestic implementation of the relevant Basel III documents,[4]

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1 The minimum capital requirements applicable to banks are provided in an FSA-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"). In this Newsletter, the proposed notice to partially amend the Bank Pillar 1 Notice and other FSA notices on the minimum capital requirements is referred to as the "Proposed FSA Pillar 1 Amendment Notice," and the Bank Pillar 1 Notice as amended by the Proposed FSA Pillar 1 Amendment Notice is referred to as the "Proposed New FSA Pillar 1 Notice."

2 FSA, *「自己資本比率規制（第1の柱・第3の柱）に関する告示の一部改正（案）」等の公表について (Regarding the publication of the "Partial amendments to notices on the capital ratio requirements (Pillar 1 & Pillar 3) (draft)," etc.)* (December 28, 2018) [in Japanese].

3 FSA, *「自己資本比率規制（第1の柱・第3の柱）に関する告示の一部改正（案）」等の公表について (Regarding the publication of the "Partial amendments to notices on the capital ratio requirements (Pillar 1 & Pillar 3) (draft)," etc.)* (January 9, 2019) [in Japanese].

4 Basel Committee on Banking Supervision, *Revisions to the securitisation framework* (December 11, 2014) and Basel Committee on Banking Supervision, *Revisions to the securitisation framework – Amended to include the alternative capital treatment for "simple, transparent and comparable" securitisations* (July 11, 2016).

as well as the introduction of new risk retention requirements for securitization, on which this newsletter focuses.

For ease of explanation, this Newsletter focuses on the case of banks, but the same explanation applies to other deposit-taking financial institutions, bank holding companies, and certain securities holding companies that are subject to Basel accord-based capital requirements.

2. Background

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 "endeavour to take any necessary steps to implement such approaches" with certain recommended elements: if risk retention is mandated, "[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."[5]

In order to implement such recommendations, the existing risk retention requirements for securitization in Japan were introduced by the FSA in April 2015, by amending supervisory guidelines applicable to deposit-taking financial institutions, insurance companies, and securities companies.[6] The amended guidelines adopted an indirect regime, under which the FSA and local finance bureaus' supervisory divisions examine, in relation to investment in securitization products by these financial institutions, whether they check if the originator continuously retains part of the risks associated with the securitization products or, in cases where the originator does not retain such risks, whether the operator thoroughly analyzes the status of the originator's involvement in the underlying assets, and the quality of such assets.[7]

It is proposed that the new risk retention requirements be added to such existing requirements.

3. Outline of the Proposed Risk Retention Requirements

(1) Framework of the proposed rules

The proposed new risk retention requirements also adopted an indirect regime, rather than directly regulating originators, by imposing a higher risk weight on securitization exposure held by a bank unless certain requirements are satisfied.

Under the proposed rules, if a bank cannot confirm that the securitization exposure held by it satisfies the risk retention requirements described in (2) below, triple risk weight (up to 1,250%) is adopted for such securitization exposure, subject to the exception described in (3) below.[8]

It is proposed that the new risk retention requirements will apply when the bank itself is the originator.

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5 The Board of the International Organization of Securities Commissions. *Global Developments in Securitisation Regulation: Final Report* (November 16, 2012) p. 48.

6 FSA, *証券化リスク・リテンション規制に関する監督指針の一部改正（案）等に対するパブリックコメントの結果公表について (Regarding 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) [in Japanese].

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

8 Article 248, paragraph 3 of the Proposed New FSA Pillar 1 Notice.

(2) 5% risk retention requirements

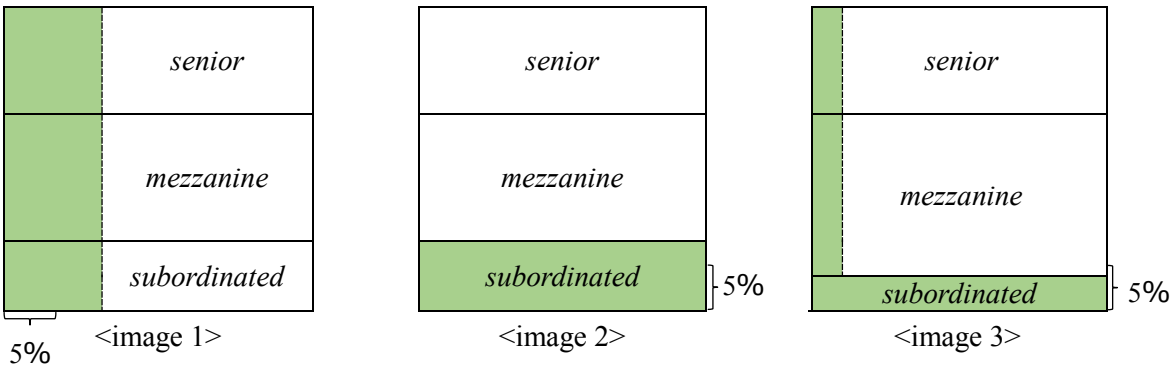
To meet the proposed risk retention requirements, the originator[9] must hold:[10]

1) an equal portion of all tranches, the total amount of which is at least 5% of the aggregate amount of the exposure for the securitized assets (see <image 1> below);

2) 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 securitized assets (see <image 2> below);

3) if the most junior tranche is less than 5% of the total exposure, all of such tranche and the equal portion of all the other tranches, the total amount of which is at least 5% of the aggregate exposure for the securitized assets (see <image 3> below); or

4) any securitization exposure continuously in such a manner that the credit risk held by the originator is equivalent to, or greater than, the credit risk required under the above three patterns.



It should be noted that if the originator has substantially no credit risk for any portion held by it, by hedging such credit risk or otherwise, such portion is deemed as not being held by the originator.[11]

(3) Exception to 5% risk retention requirements

Even when a bank cannot confirm that the abovementioned risk retention requirements are satisfied, there is another way for the bank to avoid an increased risk weight. If the bank determines that the securitized assets were not inappropriately formed on the basis of the relevant circumstances, such as the originator's involvement in the securitized assets and the nature of the securitized assets, then the bank does not have to treble the risk weight calculated for such securitization exposure.

4. Proposed Grandfathering

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[9] According to Article 1, item (lxviii) of the Bank Pillar 1 Notice, "originator" means (a) anyone who is directly or indirectly involved in the formation of the securitized assets or (b) a sponsor of an ABCP conduit that acquires exposure from a third party, or any other similar program.

[10] Article 248, paragraph 3, items (i) through (iv) of the Proposed New FSA Pillar 1 Notice.

[11] Article 248, paragraph 3, item (i) of the Proposed New Bank Pillar 1 Notice.

Although the proposed amendments are proposed to apply on March 31, 2019[12] (i.e., the amended notices will apply from fiscal year 2018, which ends on March 31, 2019), it is proposed that the new risk retention requirements will not apply to the securitization products held by a bank on that date, as long as the bank continues holding them.[13] Therefore, the new risk retention requirements applicable to a bank will apply to the securitization products acquired by the bank on or after April 1, 2019, if such proposal is adopted as is.

5. Responses from Industries

As far as we are aware, some relevant industrial associations are now seeking the deletion of the proposed provisions for the new risk retention requirements or a clarification thereof. For example, the Japanese Banking Association[14] and the Securitization Forum of Japan[15] are requesting to delete such proposed provisions in their respective comments on the proposals submitted to the FSA.

6. What's Next

It is expected that in February or March 2019, the FSA will release the finalized amendments with the list of public comments, and the FSA's responses thereto.

However, there is some ambiguity in the requirements (e.g., it is unclear in what circumstances a bank can determine that the securitized assets were formed appropriately as described in 3.(3) above), and thus if the proposed wording is finalized as is, it will still be necessary that the FSA publish detailed explanations on the new risk retention requirements (such as examples of the cases where the securitized assets are formed appropriately) in its responses to the public comments and further revisions to its official Q&A on its website.[16] In addition, since the proposed regime will have indirect extraterritorial effect on originators in other jurisdictions, the treatment of such securitization products should also be clarified where the originator has already been directly regulated under the risk retention requirements in any foreign jurisdiction, such as the EU or the United States.

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12 Article 1 of the Supplementary Provisions of the Proposed FSA Pillar 1 Amendment Notice.

13 Article 4 of the Supplementary Provisions of the Proposed FSA Pillar 1 Amendment Notice.

14 The Japanese Banking Association,「自己資本比率規制（第1の柱・第3の柱）に関する告示の一部改正（案）」等に対するコメント *(Comments on the "Partial amendments to notices on the capital ratio requirements (Pillar 1 & Pillar 3) (draft)," etc.* (January 25, 2019) [in Japanese].

15 The Securitization Forum of Japan,「自己資本比率規制（第1の柱・第3の柱）に関する告示の一部改正（案）」等に関する意見 *(Opinion regarding the "Partial amendments to notices on the capital ratio requirements (Pillar 1 & Pillar 3) (draft)," etc.* (January 28, 2019) [in Japanese].

16 FSA, *自己資本比率規制に関するQ&A (Q&A with respect to the capital ratio requirements)* (last updated on March 23, 2018) [in Japanese].

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