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Securitisation

Japan – Trends and Developments

Contributed by
Mori Hamada & Matsumoto

2018

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Trends and Developments

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Mori Hamada & Matsumoto has been a leader in the Japanese structured finance practice from the early days of its development in Japan, and held a major role in an array of challenging transactions that were the first of their kind in the market. Lawyers have advised on a number of traditional asset-backed securities (ABS) transactions involving receivables, including accounts receivables, lease receivables, credit card receivables, and loans (residential mortgages and consumer loan receivables).
Nine partners together with approximately 35 associates regularly work on securitisation and structured finance transactions at the Tokyo office.

Authors

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General

Like other markets, the Japanese securitisation market has undergone a decline since the global financial crisis of 2007-2009. This trend has been underscored by the "unprecedentedly" low interest-rate policy adopted by the Bank of Japan, which has enabled many corporations to raise funds without resorting to securitisation. That said, some originators such as non-banks and the Japan Housing Finance Agency have continued to issue securitisation products, and quite a few institutional investors have shown a good appetite for those products. According to the "Securitisation Market Trends Survey Report" issued by the Japan Securities Dealers Association, both the issue amount and the number of securitisation products sold in the Japanese market have increased slowly but steadily in the past few years. The total issue amount for fiscal year 2016 (ie, from 1 April 2016 to 31 March 2017) was JPY4,582.1 billion (approximately USD42 billion), representing a 27% increase over the 2015 fiscal year, while the issue number was 136, which was an 8.8% increase. Residential mortgages, auto leases and shopping credits constitute a major part of the asset classes, whereas commercial mortgages and consumer loans are in decline. This trend is likely to continue.

Resurgence of Bank Capital Relief Transactions
In the last decade, the Japanese banking sector as a whole has been stable and remained prudent even throughout the turmoil and aftermath of the global financial crisis, so there has not been any imminent need for transactions to satisfy the minimum capital adequacy requirements imposed on banks.

Nevertheless, it appears that capital relief transactions for banks have returned to Japan, not for minimum capital adequacy ratio requirements, but for more strategic portfolio management of credit risk-weighted assets.

For example, *Nihon Keizai Shimbun* reported on 30 May 2017 that synthetic collateralised debt obligations ("CDOs") were issued in May 2017, with loans from The Bank of Tokyo-Mitsubishi UFJ ("BTMU") to several J-REITs as referenced obligations. Through CDOs, BTMU was relieved of its huge exposure to the J-REIT sector (JPY1.1 trillion, or approximately USD10 billion) and regained substantial capacity to provide new loans, while regional banks, pension funds and other investors have begun enjoying the benefits of a more diverse portfolio, with additional exposures to J-REITs, in their new role as providers of risk money to J-REITs.

Another type of structure commonly used in Japan for bank capital relief is a credit-linked loan to a trust, where the trustee guarantees bank loans, and the funds raised by the trust from the investors through a credit-linked loan are deposited with the bank as guarantee and provided as security for the obligations of the trustee as guarantor. This structure has been seen in the Japanese market from time to time, but in bilateral club deals rather than with a wider range of investors.

In these bank capital relief transactions, the underlying portfolio can be a diverse pool of loans, or loans to a specific industry, region or borrower. The portfolio could also include loans to lower-rated borrowers. Furthermore, the underlying assets are not necessarily limited to loans, but could be bonds, derivatives or other exposures of the bank, bearing in mind further requirements to be implemented under Basel III.

Whether bank capital-relief transactions will increase further and the extent to which portfolios will be diversified depend on the diversity and preference of Japanese investors for these products, as well as the banks' portfolio-management strategies. However, it is anticipated that more bank capital-relief transactions will be offered by the end of the next business year.

Margins for Uncleared OTC Derivatives as Applied to a Trust
In Japan, trusts are frequently used as a vehicle for securitisation and other structured finance. In this context, trusts often enter into OTC derivatives, including credit default swaps, or interest rate or currency swaps or options, for various structuring purposes. Generally, trusts did not provide credit support for such derivatives, as it would be very inefficient for structuring purposes to pool excess cash in a trust to prepare for possible margin calls. The bankruptcy remote nature of trusts under Japanese law also supported such a practice.

In harmony with other jurisdictions with major derivatives markets, on 1 March 2017 Japanese variation margin ("VM") regulations were imposed on all covered entities, including trust banks, that provide trustee services for various financial products using a trust scheme, including securitisation products. Trusts are treated as a distinct entity for purposes of the VM regulations. Accordingly, if the aggregate notional amount of the uncleared OTC derivatives entered into by a trust is JPY300 billion or more, the trust should enter into a credit-support arrangement and will be subject to margin calls. Notably, even if the aggregate notional amount is below this threshold, which is the case for most trusts established for structured finance, the guidelines of the Japanese Financial Services Agency (the "JFSA") require those trusts to enter into a credit-support agreement and deliver or return a VM, as appropriate, in line with the statutory requirement – although the JFSA also allows the parties to derivatives entered into by trusts not to abide strictly by the VM regulations, to the extent that such a "soft" approach can be justified in light of the volume and risks involved in a specific derivative transaction.

The application of the VM regulations to a trust could have a significant impact on the transaction structure and cash flows, but the extent of permissible deviation from the statutory requirement was not entirely clear until the JFSA recently issued its guidance to the relevant industries in November 2017.

According to the JFSA guidance: (i) a trust is not obliged to deliver a VM to its counterparty as long as the underlying trust assets are risk-free assets, such as Japanese government bonds, and will be paid to the counterparty with priority upon a default by the trust, but the trust must deliver a VM to its counterparty if the exposure related to derivatives exceeds the net asset value of the trust assets; and (ii) the counterparty must always deliver a VM to the trust regardless of the net asset value of the trust assets.

New market practice in line with the JFSA guidance has yet to be developed to solve remaining structuring issues, such as how to fund a trust if the trust is obliged to deliver a VM.

Securitisation of Project Finance Loans
Project finance has been boosted in the Japanese market since the enforcement of the Feed-in Tariff Law in 2012, particularly in the field of renewable energy. While investors and banks had focused on solar energy, they have recently shifted to other types of renewables, such as wind farm and biomass energy. On a different note, there has also been a new development in the Japanese infrastructure/PPP market. The 2011 amendment to the PFI Act enabled the authorities to grant "concessions" to the private sector, ie, the right to operate public infrastructure facilities for a substantial term. The Japanese government has been promoting PFI/PPP as a key part of its growth policy, and several deals in relation to airports, toll roads, and water and sewerage systems either have been completed or are pending.

Banks actively provide debt finance for those energy and infrastructure projects. While banks seem to be more inclined to hold such project finance loans for a while, as they generate relatively better margins than other types of lending, they may find it increasingly difficult to take on such illiquid and long-term credits due to regulatory reasons, such as Basel III, or their internal credit policies. Securitisation can help banks remove credit and regulatory risks associated with such long-term assets from their balance sheets. It may also allow banks to share the risks and benefits of such project finance loans with institutional investors, who are often more prepared and well suited to make long-term alternative investments. Recently, lenders such as Goldman Sachs and Sumitomo Mitsui Banking Corporation have securitised the loans they have extended to renewable energy projects by using a Japanese trust scheme.

Governmental agencies are also interested in project bonds. Prompted by the Green Bond Principles issued by the International Capital Market Association, the Ministry of Environment issued the "Green Bond Guidelines – 2017 version" on 28 March 2017, with a view to promoting green bonds in the Japanese market and suggesting desirable market practices. Under the initiative of the Ministry of Economy, Trade and Industry, a special report was issued in January 2017 on the export of the Japanese infrastructure system to foreign markets. The report explores the possibilities of using project bonds in place of bank loans.

Recent Legislative Development – Amendments to the Civil Code

There have been legislative discussions regarding the Civil Code of Japan, which provides the basic rules on commercial and non-commercial transactions. While the law has undergone changes in some parts, other parts have not been amended at all since the Civil Code was originally enacted in 1896, such as the chapters relating to "credits" and "contracts" (the "Credit Law"). As Japanese society and economy have significantly developed and changed since then, it is generally recognised that the old regime established by the Civil Code more than 100 years ago is no longer suited to the realities of current society and markets, particularly in the era of the global economy, and thus needs to be overhauled in its entirety. In fact, various legislative initiatives abroad – including the Convention on Contracts for the International Sale of Goods (CISG) – have stimulated the momentum for the proposed amendments to the Credit Law.

Against this backdrop, and after prolonged debates at the Diet, the "unchanged" parts of the Civil Code will finally change, ie, the Credit Law, including the rules applicable to the transfer of financial receivables. The bill amending the Credit Law (the "Amendment") was passed by the Diet on 26 May 2017 and will be enforced within three years of the date of its promulgation (2 June 2017).

In the context of securitisation, new rules will be introduced in relation to the assignment of "non-assignable" receivables. Under the current law, if there is a special agreement between a creditor and a debtor whereby the creditor may not assign the credit to a third party without the debtor's consent (a "Non-assignment Covenant"), any attempt to assign that credit would be void and the assignee cannot acquire any proprietary rights in respect of the credit, except in certain limited circumstances. Japanese companies are often obliged to enter into such Non-assignment Covenants with corporate customers who are reluctant to see their debts transferred to a third party. This practice is believed to present a significant obstacle for companies that want to securitise corporate customer credits. The Amendment allows a creditor to assign its receivables even if it has agreed to a Non-assignment Covenant and even if it has not obtained the consent of the debtor, provided that the debtor can act as if the assignment did not take place – ie, the debtor can continue to pay the original creditor (assignor) and may assert all defences it has under the underlying contract or law. This change may open a way for, and fit well with, the securitisation of receivables that are not assignable under the current law, particularly given that an originator (the assignor of the receivables) is normally appointed to act as the servicer to collect and administer the securitised credits.

Notably, the debtor may no longer continue to pay the original creditor and assert all defences it has under the underlying contract or law if said debtor fails to perform its obligations and continues to do so even after receiving a notice from the assignee requesting the debtor to cure such default within a reasonable period.

In addition, under the new rules, a debtor can deposit the payment with an official depository if they are confused as to whom they should pay. In this case, only the assignee may demand the depository to release the deposited money. Furthermore, if the assignor becomes bankrupt, the assignee who has completed the required perfection procedures (against third parties) may request the debtor to deposit its payments with an official depository, so that the assignee can have recourse to the deposited money. As far as these exceptions apply, an SPV as the assignee may be able to collect the securitised credits for itself or through a third party (such as a back-up servicer), and these new rules may enhance the ability of prospective originators to carry out more securitisations using these "restricted" receivables. That said, it should be noted that the assignee may not be able to collect the credits by itself or through a third party in all circumstances, and the "commingling risk" has yet to be overcome in relation to moneys collected by the assignor before these exceptions are triggered.

It should also be noted that the Amendment does not completely invalidate a Non-assignment Covenant. In this regard, the Amendment takes a different approach from the Uniform Commercial Code. Under the Amendment, a Non-assignment Covenant is still contractually valid between the creditor (assignor) and the debtor; thus, a creditor may not be willing to securitise its restricted receivables, for fear of breaching the covenant. Some legal commentators and practitioners argue that a breach of a Non-Assignment Covenant should be regarded as "immaterial" so as not to entitle the debtor to terminate its contracts with the creditor. It remains to be seen how this issue will be dealt with.

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