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The stipulation that Japanese banks invest in appropriately formed assets is unlikely to hurt the CLO industry

On 15 March, the Japanese Financial Services Agency (JFSA) published its Final Rules and frequently asked questions relating to risk retention requirements for securitisations in which Japanese banking institutions invest.

In response to discussions with industry participants, the JFSA made the prudent decision to avoid conflict with the prevailing regulations in the US and to deviate from current regulatory regimes in the European Union, which essentially always require an originator or CLO collateral manager to retain a certain amount of securities in a securitisation. The JFSA's Final Rules provide a pathway for Japanese investors to buy securitisations (including CLOs) without retention requirements — so long as certain asset-level diligence is verified.

To avoid a punitive risk weighting on securitisation holdings, the rules require Japanese banking institutions to establish comprehensive due diligence processes.

In addition, for each investment, an affected Japanese investor must confirm that either an originator will retain a 5% interest or else that the underlying assets in the securitisation "were not inappropriately formed".

With the understanding that it is likely to be difficult for a tranche security investor to determine whether each underlying asset in any securitisation is inappropriately formed on an ongoing basis, the JFSA further permitted affected Japanese investors to rely on the determination of a person deeply involved in the origination of the assets, so long as the Japanese investor can verify on an ongoing basis that such a person is following "objective and reasonable standards" in making these determinations.

Whether the underlying assets of a securitisation are inappropriately formed relates to a multifaceted subjective test that requires credit agreement covenants that are conducive to investor protection, along with standards around the appropriateness of credit underwriting criteria, adequacy of the collateral security interest and the ability of the parties to collect on the underlying assets.

The emphasis on the appropriateness of loan terms and covenants may relate to recent media attention on the increase in covenant-lite loans and certain credit agreement terms that may impair the value of an underlying loan's security interest.

Lenders may push for stronger covenants

One potential benefit for all investors from this focus by the JFSA could be to give increased leverage to large credit managers who have relationships with affected Japanese investors as they seek to favourably alter some key terms in future primary loan issuance on the basis of the Japanese regulatory requirements.

We believe this could encourage some underwriting banks and sponsors to consider mitigating concerning terms or increasing certain security interest protections in new issue loans. Although it is difficult to predict the likelihood or outcome of any shift in underlying credit terms, any focus on these requirements may lead to some beneficial tightening in credit documents for all loan and CLO investors.

> "Japanese investors must confirm assets are appropriate... CLO managers can provide assurances

Managers can continue current practice

In our opinion, a CLO collateral manager is well positioned to provide these assurances to Japanese investors in a manner that does not substantially deviate from current market practices. Thus, we expect the rules to continue to support orderly CLO investing from major Japanese participants.

We do not believe the implementation of the Final Rules will have a significant impact on CLO issuance or Japanese investor involvement. Though the new regime will require additional diligence and attention to certain loan terms, the rules provide a reasonable pathway forward for continued Japanese involvement in CLOs without a retention requirement. The focus on investor diligence and asset quality ensures that Japanese investors possess the necessary sophistication and tools to evaluate their investments, while not impairing their ability to compete in the global securitisation markets.

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