Recent updates in the Japanese legal landscape

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Despite "Abenomics," the pro-growth policies of the Prime Minister, Shinzo Abe, focused on pulling the Japanese economy out of deflation, which incorporated the perspective of pulling up interest rates on bank loans, the Japanese economy, and more importantly, the Japanese securitisation market, is still strongly affected by the low interest rate market environment. Notwithstanding the credit investors' appetite for alternative investments, which tend to bear higher interest rates, due to enterprises' lack of incentive to look to alternative sources of financing, there has been very little development in the Japanese securitisation market. This does not seem to be the product of a lack of confidence in securitisation products, as, in recent years, impairment of securitisation products happened only once in 2014; and this sole exception was an agreed-upon standstill for a relatively short period of time, in terms of a mezzanine tranche.

General update on JHF RMBS

Nevertheless, residential mortgage-backed securities (RMBS) originated by the Japan Housing Finance Agency (JHF) continue to be steadily issued; in fiscal year 2017, JHF issued more than ¥2 trillion worth of RMBS, and its published plan states to do the same in fiscal year 2018. And with JHF continuing to provide credit support to reverse mortgages to financial institutions, the anticipation is that we will be seeing RMBS products with reverse mortgages being securitised assets in the not-too-distant future.

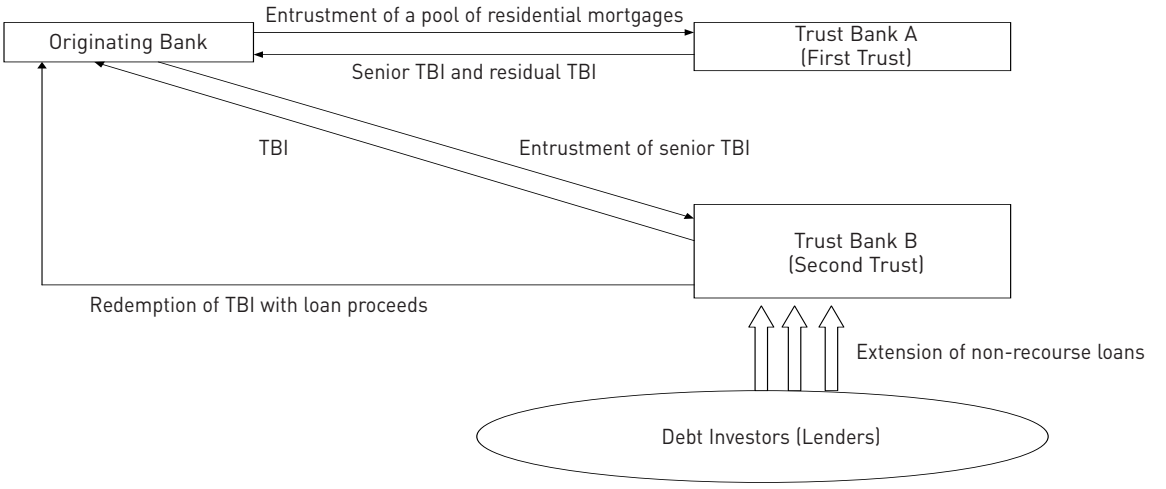
Providing an ideal capital relief to smaller banks?

Background

With regional economies suffering from a lack of steady growth in Japan (outside of the two largest cities of Tokyo and Osaka), governmental and political pressures have now long been continuing to mount on regional banks in Japan (which are, naturally, smaller banks, especially compared to the three megabanks in Japan) to build up more lending to enterprises to facilitate economic activities in those regions. On the other hand, however, with the historically low interest rate environment continuing, and with lack of sufficient opportunities to lend at higher interest rates and to find alternative investment opportunities, the regional banks are also pressured in terms of the outlier regulations, as well as the regulatory capital regulations implemented in Japan since and in accordance with the Basel II Accord.

Therefore, the regional banks have been hungry for a transactional solution that can provide capital relief, while also at the same time not decreasing their overall lending amounts. For this reason, one particular structure is now becoming a focal point of regional banks.

Structure diagram **Exhibit 1**



Overview of structure

i) The originating bank entrusts a pool of residential mortgage loans with a trust bank, acting as the trustee of the first trust, in exchange for a senior trust beneficial interest and a residual trust beneficial interest.

ii) The originating bank entrusts the senior trust beneficial interest with a trust bank, acting as the trustee of the second trust, in exchange for a trust beneficial interest.

iii) Credit investors extend credits to the trustee of the second trust borrowers, in the form of non-recourse loans, with the senior trust beneficial interest being the sole recourse of the loans.

iv) With the proceeds of the non-recourse loans, the vast majority portions of the trust beneficial interest of the second trust held by the originating bank will be redeemed, leaving a very small portion of the said trust beneficial interest to remain.

v) Entrustment of the pool of residential mortgage loans is perfected (as against third parties) via a registration of the entrustment in the transfer registry under the "Act on Special Provisions, etc. of the Civil Code Concerning the Perfection Requirements for the Assignment of Movables and Claims".

vi) Entrustment of the senior trust beneficial interest in the first trust to the second trust is perfected via a consent of the trustee of the first trust with a certified date (*kakutei hizuke*).

vii) The lenders to the second trust, i.e. the credit investors, will have almost all, in other words, to the extent possible under the Trust Law of Japan, of the contractual and statutory controlling rights in terms of the second trust, and the originating bank's contractual and statutory controlling rights in terms of the first trust will also be subjected to the consenting rights of the said lenders, thus allowing the lenders to not only gain economic interests in the residential mortgages, but also contractual and statutory control of the trusts.

Characteristic feature

The structure aims to secure a true sale nature for the purposes of regulatory capital, to achieve lesser risk weights, by transferring the economic interests in residential mortgages to lending investors in a manner complying with the regulatory requirements, and thus provide relief in terms of regulatory capital, while at the same time, as the accounting rules in Japan would not recognise the residential mortgages to be off the books of the originating bank, absent a "disposition" of the trust beneficial interest, providing a structure purporting to allow the originating bank to maintain its overall lending amounts despite the economical transfer of interest in the relevant residential mortgages.

Use of declaration of trust

Since the introduction of the new Trust Law (which replaced, in whole, the old Trust Law) in 2006, use of a "self-entrustment" (*jiko shintaku*) or a declaration of trust in securitisation transaction structures has been one of the anticipated developments in terms of evolution of structures. While it is not a new issue or development in that sense, there seem to have been a sufficient number of practical applications of "self-entrustments" accumulated in the Japanese structured finance arena in recent years.

Prior to the introduction of the new Trust Law, creation of a trust was generally interpreted to be possible only via a contract between two or more parties, i.e. an entrustor and a trustee. The new Trust Law enabled a party to declare that a certain asset will thereafter be held in trust, with that party in and of itself acting as a trustee of the trust, without another party being involved as a trustee.

In the context of securitisation transactions or structured finance transactions, the "self-entrustment" feature is believed to provide two features that are not available under other structures: (i) reduction of trustee related costs; and (ii) a possibility of a transaction that does not involve a "transfer" of a securitised asset or collateral, but yet could maintain a "true sale" nature.

The first feature is quite simple: a "self-entrustment" does not involve a third-party trustee, which would evidently require the gain of a certain financial benefit from the transaction. What is noteworthy, however, is that, "self-entrustment" structures could incur their unique costs separately from trustee-related costs. In particular, in cases where the relevant transaction involves 50 or more investors, and if the transaction meets certain other criteria, then the entity declaring the self-entrustment will be subjected to a requirement to register with the competent Japanese governmental authority, and also to the regulations similar to those applicable to trust companies under the Trust Business Regulations Act.

The second feature is generally anticipated to be useful in dealing with receivables/contractual claims (including loans and other monetary obligations) that are subjected to restrictions or prohibitions on transfers of the same. Under the Japanese Civil Code and other substantive private law, a "transfer" of a receivable/contractual claim is construed to require two or more parties; thus a declaration that an asset will thereafter be held in trust for a third party, on its face at the very least, does not constitute a "transfer" restricted or prohibited under contractual provisions providing for restrictions or prohibitions of transfer.

However, there are arguments to the contrary: for example, there are arguments that whether or not a

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"self-entrustment" still falls within the "transfer" restricted or prohibited under contractual provisions providing for restrictions or prohibitions of transfer is a matter of interpretation of the relevant contract; more specifically, the relevant contractual parties' intent behind agreeing to the relevant provision. One of the stronger rationales providing grounds to such arguments is that, a party looking to incorporate a restriction or prohibition of transfer of a receivable/contractual claim is looking to maintain its interests in setting-off the claim with the obligation it owes to the obligor, and while there may not be, on its face, a "transfer" of the claim in a case of self-entrustment, because the self-entrustment, when perfected, will prevent such party from exercising its setoff rights, the self-entrustment should be (or needs to be) interpreted as constituting a "transfer" for the purposes of interpretation of the provision.

With no controlling judicial precedent yet to be rendered by a court, the general practice has been that, despite the perfection of a self-entrustment, the declarations of trust are drafted and executed in such a way that the relevant obligors' setoff rights would not be affected by the self-entrustment.

Another legal issue unique to a transactional structure incorporating a "self-entrustment" arises from the statutory provision under the new Trust Law providing that a trust will be terminated (by operation of law) when the trustee continuously has held all of the trust beneficial interest as its own property for one year, and the statutory provision stating that the concept of a "trust" excludes a circumstance where the purpose of the entrustment is to exclusively promote the entrustor's own interests. These provisions raise a legal question, for example, in a structured secured lending transaction, in which the debtor purports to create a security interest over a trust beneficial interest arising from a self-entrustment, because, in such cases, the debtor will remain the substantive owner of the trust beneficial interest despite the creation of the security interest over the same, and often does not involve a third party holding the trust beneficial interest, and also because the debt often extends beyond a year from the inception of the declaration of trust.

Effect of Basel Committee's Short-term STC Standard

As well reported via many outlets, the Basel Committee on Banking Supervision ("BCBS") published its standard of "Capital treatment for simple, transparent and comparable short-term securitisations" (the Short-term STC Standard), in supplement to the "Criteria for identifying simple, transparent and comparable short-term securitisations" which were jointly issued by the International Organisation of Securities Commissions (the "IOSCO") and BCBS.

The standard is stated to be effective immediately, but evidently, the standard will not automatically come into effect as an enforceable statute or a regulation of each sovereign; rather, it would require each sovereign's legislative or regulatory action to implement a domestication or localisation of the standard. In the case of Japan, the legislative/regulatory action will take the form of an adoption by the Financial Services Agency of Japan (the FSA) of a new regulatory rule.

And as a matter of fact, it could take a while for the regulators in Japan, to adopt and introduce domestic rules implementing the BCBS's Short-term STC Standard, considering the fact that the Japanese government has yet to implement the so-called Basel III Securitisation Framework (under the BCBS's "Revisions to the Securitisation Framework"), despite the BCBS's indication to have relevant sovereigns put in place domesticated rules of the framework effective from January 2018.

As was the case with the Basel II Securitisation Framework, one of the points of concern for the financial institutions in Japan with respect to the capital treatment for STC short-term securitisation products was the "granularity of the pool" requirement, requiring that the aggregated value of all exposures to a single obligor not exceed a certain threshold within the pool. In Japan, many of the existing securitisation products are anticipated to not meet the granularity criteria under the Basel III Securitisation Framework, which calls for 1% as the threshold.

Similarly, due in part to the characteristics of the existing short-term securitisation products in Japan, as publicly

shared via BCBS's website, the Japanese Bankers Association commented during the public consultation phase of the Short-term STC Standard that the granularity requirement within the standard is more reasonably set at 5%, and likewise, the Securitisation Forum of Japan commented that the granularity requirement should be set at 3%, but the Short-term STC Standard ultimately set the requirement at 2%. Notwithstanding the 2% granularity requirement, however, upon the implementation of the regulatory rule by the FSA to incorporate the Short-term STC Standard, we should anticipate that there will be short-term securitisation products that would be assigned a risk-weight ratio of 10%, rather than 15%.

The FSA's revised position on the TLAC regulation

As previously reported, the FSA has been continuously introducing its approach to its incorporation of the TLAC (or the total loss-absorbing capacity) framework for Japanese G-SIBs (or global systematically important banks), starting with putting in place the "Measures for Orderly Resolution of Assets and Liabilities of Financial Institutions, etc. for Ensuring Financial System Stability" through an amendment to the Deposit Insurance Act (DIA; promulgated in June 2013 and effective as of March 2014). On April 13, 2018, the FSA further publicised its position paper, entitled the "Revisions to The FSA's Approach to Introduce the TLAC Framework" (Revised Position Paper) revising the original position paper "The FSA's Approach to Introduce the TLAC Framework" released in April 2016.

Under the Revised Position Paper, the FSA now states that Nomura Holdings, Inc. and its subsidiaries will now be treated in the same manner as the three Japanese megabanks, for the purposes of the TLAC framework, despite the fact that the Nomura group is not a bank holding company or a group thereof for the purpose of Japanese financial regulations; provided that the TLAC regulations will be imposed on Nomura from March 31, 2021, as opposed to March 31, 2019 being the stated commencement date of the imposition of the TLAC regulations upon the three Japanese megabanks.

Contrary to the hopes of those concerned, the Revised Position Paper still does not clarify the criteria for the TLAC; i.e. we still do not know what sort of instrument/product will counted towards the TLAC. The criteria will surely be consistent with the "Term Sheet" published by the Financial Stability Board (FSB) in November 2015, but as the Term Sheet provides little clarity in terms of details, those concerned have long been waiting for clarification on the criteria. As the imposition of the TLAC regulation upon the Japanese three megabanks is still stated in the Revised Position Paper to commence from March 31, 2019, we are anticipating that the FSA will be putting together a proposed draft of the regulation sooner rather than later.

In this connection, we should also be mindful of the fact that, the criteria for the TLAC concerns not only the covered SIBs, but also the non-covered domestic financial institutions, as risk weight ratios for TLAC instruments issued by foreign SIBs and held and owned by domestic financial institutions will in effect significantly differ from non-TLAC instruments (and even with respect to TLAC instruments, once the aggregated exposure exceeds 5% of the core capital of the relevant SIB, the risk weight ratio will significantly increase).

The Revised Position Paper now expressly sets out the following as an example in terms of the model procedures of orderly resolution under the SPE strategy (that is, as already publicised in the original position paper, between the choice of the two stylised approaches of "single point of entry" (SPE) resolution and "multiple points of entry" (MPE) resolution, as described by the FSB, and the FSA considers the SPE resolution strategy to be the preferred resolution for Japanese G-SIBs):

i) a domestic resolution entity, typically the ultimate holding company of a Japanese G-SIB group, absorbs the losses incurred at a domestic sub-group that is designated separately as systemically important by the FSA, or at a foreign sub-group that is subject to TLAC requirements or similar requirements by the relevant foreign authority (Material Sub-groups);
ii) with respect to the domestic resolution entity after absorbing the losses of the Material Sub-groups, the

Prime Minister confirms the necessity to take "Specified Measures Under Item (ii)" as set forth in Article 126-2, paragraph (1), item (ii) of the DIA, and issues an Injunction Ordering Specified Management as set forth in Article 126-5 of the DIA (following such confirmation, the domestic resolution entity will be referred to as a "Non-viable Holding Company");

iii) the Non-viable Holding Company transfers its business relating to systemically important transactions (including shares of Material Sub-groups) to a "Specified Bridge Financial Institution, etc.," as set forth in Article 126-34, paragraph (3) of the DIA; and

iv) after transferring its business, the Non-viable Holding Company will be subjected to court-supervised insolvency proceedings.

What is also noteworthy, however, is that the FSA also expressly stated that the above may not be applicable to all resolutions of Japanese G-SIBs, by noting as follows: "While an announcement of a preferred resolution strategy by the relevant authority is expected to increase transparency for market participants, the credibility of the resolution regime, and the feasibility of timely resolution, the exact measures to be taken shall be determined by the relevant authorities on a case-by-case basis, considering the actual condition of the Covered SIB in its resolution phase," and has expressly kept a window open to the possibility of the government's injection of capital as a "rescue" version of a resolution for Japanese G-SIBs.

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