Risk Retention: Just When You Thought It Was Safe (Maybe it is)

January 17, 2019 - As reported in the Asset Securitization Report, the U.S. CLO market was rocked early this year by news that the Japanese Financial Services Authority (JFSA) published on December 31, 2018, proposed rules that would impose punitive regulatory capital risk charges on banks that purchase securitization securities that are not risk retention compliant. Because Japanese banks have traditionally purchased a significant portion of US AAA CLO notes, this news was initially very concerning. However, as market participants dug more deeply into the rules and some important background information emerged, the tone improved and expectations rose that a workable solution was achievable. Following is a summary of the pertinent provisions of the rule, how we got here, what comes next, and the prospects for a positive outcome.

Background

Late this summer, the JFSA initiated informal conversations with Japanese banks and other securitization stakeholders (including US arrangers) to discuss possible capital rule changes for certain securitizations. Shortly thereafter, the LSTA initiated a high-level, informal dialogue with the FSA regarding the treatment of open market CLOs. The LSTA provided the FSA with extensive information and data about all facets of the broadly syndicated loan and CLO markets.

The Proposal

As expected, the JFSA published proposed rules just before year-end. The proposal would triple regulatory capital charges (capped at 1250%) for certain securitization positions that do not comply with a 5% risk retention requirement. Similar to European risk retention, the onus would be on investors to determine that “originators” or “sponsors” of the securitization hold the risk, whether in a vertical, horizontal or L-shape form. Even if the securitization is risk retention compliant, a bank investor would still be subject to the higher capital charges if it did not have the resources and organizational structure to be capable of monitoring on an ongoing basis comprehensive information with regard to the structure, risks, assets and performance of the securitization. Importantly, the higher risk weighting will not apply in circumstances where “it is determined on the basis of the originator’s involvement in the original assets, the nature of the original assets or any other relevant circumstances that the original assets were not inappropriately formed.” The opening provided by this clause is the most likely path for CLOs to avoid the excess capital charge.

Based on continuing informal conversations with the JFSA and other market participants who have had similar conversations, we believe that the JFSA will be receptive to the view that holdings of open market CLOs should not be subject to the higher capital charges because the underlying assets are not “inappropriately formed”. Among the factors we think the JFSA is likely to consider are the facts that the loans are underwritten by banks that are subject to federal regulation, they must be vetted and approved by multiple institutional investors in order to clear the market, and they are independently rated and monitored by the rating agencies.

There are two other aspects of the proposed rule that are both noteworthy and puzzling, both going to the question of whether open market CLOs should even be subject to the capital rules. First, the proposal requires the “originator” to hold risk retention and that term is defined as the person who is involved in
the origination of the original assets of a securitization transaction directly or indirectly. CLO managers would certainly not fit within that definition and there is no other provision in the proposal that recognizes managers as the appropriate holders of risk retention. Similarly, even the definition of “securitization transaction” may be too narrow to cover open market CLOs. Under the proposal, the somewhat circular definition seems to cover only transactions that involve “original assets” which are assets that must be transferred into the securitization by originators (not managers on behalf of the CLO). On the other hand, the JFSA has made it clear to the LSTA, others and even to reporters at Bloomberg, that it does not intend to make broad unconditional exceptions for any particular securitization product in any region.

What Happens Now?

The LSTA expects to submit a formal comment letter by the January 28th deadline. At bottom, we believe that holdings of open market CLOs should not be subject to the higher capital risk weighting because the loan assets underlying CLOs are not “inappropriately formed” for the reasons described above. And, as we have already discussed with the JFSA, open market CLOs are designed to align investor/organizer interests, have robust structural protections that benefit investors, and have performed extraordinarily well over the past 25 years, including through the financial crisis. We understand that the JFSA will publish final rules sometime during the first quarter of 2019 and are expected to publish at the same time FAQs that will address the issue of “appropriate formation of loans” and other matters.

We will continue to keep you informed of developments as they unfold. For further information please contact LSTA General Counsel Elliot Ganz at eganz@lsta.org.