The Disposal of Bad Loans in Japan: A Review of Recent Policy Initiatives

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1. Introduction. The argument that the deterioration of bank balance sheets has contributed to the cutback in new loans provided by Japanese banks has gained favor in many circles. (Mieno, Okina and Sakuraba) The securitization of some of the bad loans and/or the disposal of the real estate underlying those loans has been often proposed--by Japanese and non-Japanese alike--as a means to generate the necessary liquidity for banks to take advantage of new lending opportunities. (Mieno, Corrigan)

When Japanese banks formed the Cooperative Credit Purchasing Company (CCPC) in January 1993 to facilitate the write-off of bad loans from their books, it was hailed by some as a major step towards securitization. However, the CCPC principally represents a deal on taxes between the banks and the authorities. The deal has allowed Japanese banks to realize tax benefit from a troubled real estate loan more quickly and with greater flexibility. In return for considerable tax savings, banks must bring bad credits to an independent committee for review and appraisal, exposing them to some degree of accountability concerning asset valuation.

Since each bank is responsible for lending to the CCPC the funds necessary for purchasing the loan it sells, liquidity is unaffected by the initial sale. Subsequent sales of underlying real estate to third parties have to date amounted to only 1.35 percent of the appraised value of properties held. Notwithstanding write-downs which average more than 50

percent on loans sold, the restructured balances are still not yielding a market rate in terms of rent and interest.

In the text to follow, we will review the origins, structure, and operations of the CCPC through fiscal year 1993. We will addend to this an overview of the proposed formation of special purpose companies (SPCs) to assist banks in the disposal of a different class of outstanding loans. In conclusion, we will assess how these measures fit into the Japanese approach to the reconstruction of bank balance sheets.

2. The Credit Cooperative Purchasing Company (CCPC)

Origins and Structure

In August 1992, the Japanese government proposed the formation of a company which would buy real estate held by banks as collateral on bad loans. Explicitly stated in subsequent policy addresses was the intention to channel some ¥1.5 trillion of a larger emergency fiscal package into purchases of land lots held by the company. However, protests ensued from non-financial industries when it was realized that the government was proposing a taxpayer bailout of the banking sector, unpopular owing to higher salaries than industry averages, and its financing the bubble economy. In addition, the projected increase in demand for real estate contradicted other promises to bring land prices down to more affordable levels. As a result, any plans for public capital infusion were dropped.

Banks went ahead with meetings on the initiative and announced four months later the formation of a new company to buy bad debts, capitalized by ¥7.9 billion of capital from 162 financial institutions [(A) on Chart 1]. Contributing financial institutions were also to second

personnel, which numbered 26 at the end of 1993.

The operations of CCPC as planned by its founders and revealed in its "Notice of Establishment" of December 22, 1992, are reviewed in Chart 1. Banks bring bad credits[1] to the CCPC for sale (B). If applications are not rejected due to insufficient documentation, the price of each transaction is determined by an independent price appraisal committee made up of experts in the fields of law, accounting, taxation, and real estate appraisal. The relevant loan purchasing transaction (C) is then funded by the bank that brought the original loan to the CCPC (D).

According to the Notice, there are informal limitations on the amount any one institution can bring to the CCPC. Amounts to be accepted from each financial institution are to be decided flexibly in consideration of administrative capacity, and "equitable treatment for financial institutions wishing to sell credits."

Sales to the CCPC leave the selling bank with a contingent liability. The Business Division of the CCPC is responsible for collecting revenue from the bad loan, including ultimate disposal if any. However, if there were to be a "significant" difference between ultimate collections and the initial purchase price, the shortfall is charged to the respective financial institution. Thus, the CCPC has recourse to the seller of each loan.

The CCPC was expected to be in operation for about ten years, and the purchases of loans backed by real estate are scheduled for the first five years. Any loans or underlying

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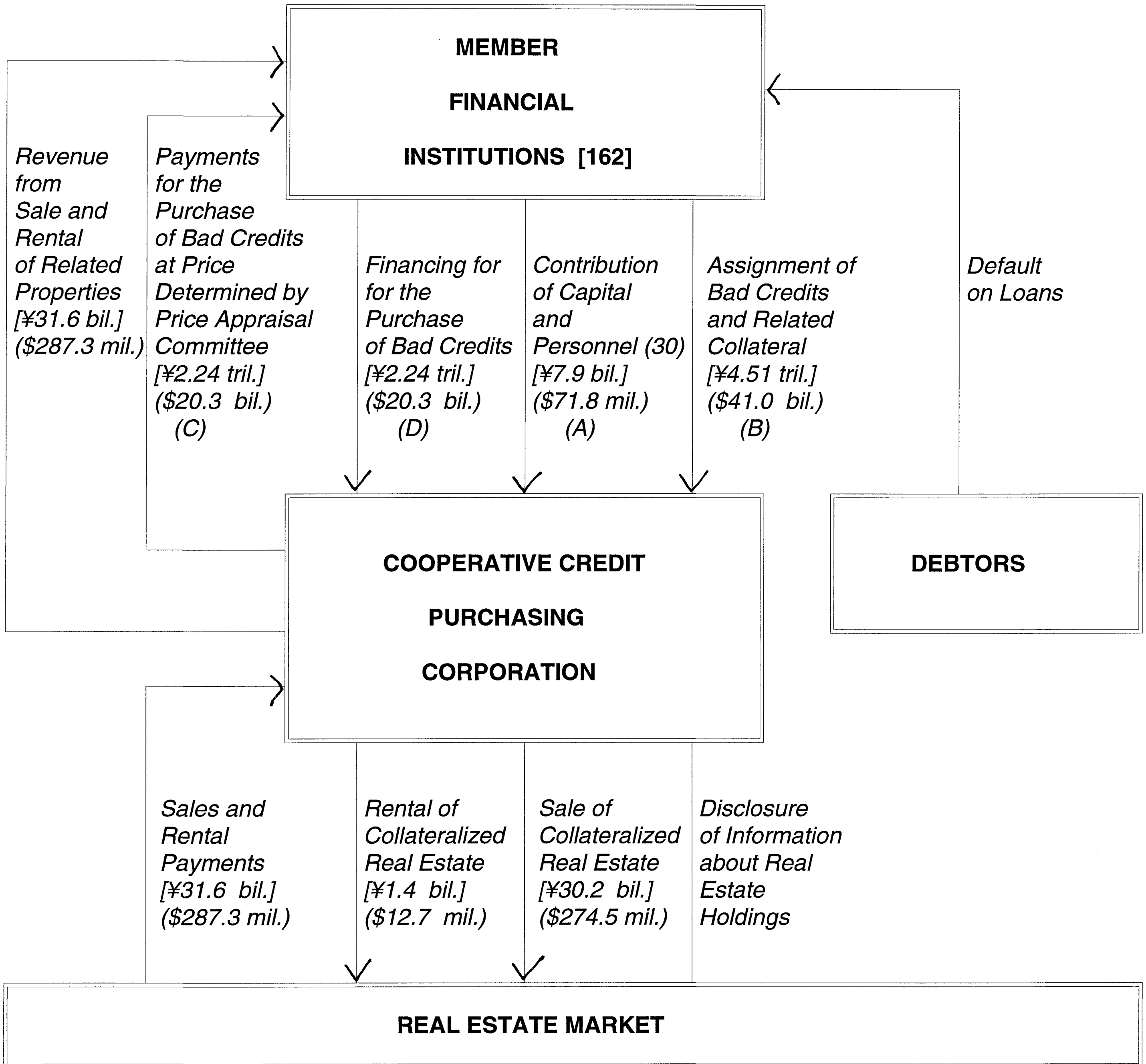
[1]The credit must be secured by domestic real estate, and neither the credit nor collateral can be subject to any dispute or legal proceeding that would be difficult to handle. The selling bank must also have fulfilled any legal requirements necessary for third-party assignment of the credit and accompanying collateral.

CHART 1

STRUCTURE FOR SELLING OFF LOANS BY THE CCPC [AGGREGATE NUMBERS AS OF APRIL 1994]



Note: Exchange rate used for dollar calculations: ¥110 = $1.

collateral not sold at that point will presumably revert back to the originating bank.

Taxes

Notwithstanding occasional exceptions for LDC loans and bad loans to major companies in industries considered of national importance,[2] the tax-free write-off of bad debts had traditionally not been allowed until a bankruptcy procedure had begun, or an excess of liabilities over assets had existed for at least two years. Neither were interest concessions on outstanding loans recognized for tax purposes: imputed interest revenue is generally taxed. Such rigorous tax treatment of troubled loans may have reflected an attempt to control profit shifting among main banks and borrowers to minimize taxes.

In August 1992, both as part of a bailout of Nippon Housing Finance, and to encourage city banks to assist the troubled Nippon Credit Bank in the restructuring of the debt of three of its affiliated non-bank institutions, the authorities gave banks the right not to report interest concessions as taxable income in special cases in which the borrower's survival and social interests were deemed at risk.[3] The CCPC extended the relaxation of tax policy to the reduction of principal, as all losses on sales made to the CCPC would count as deductible expenses and hence would provide a tax shield. That is, the discount between appraised and face value is in principle accepted as an expense.

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[2]For instance, when Japan Line, a terminally distressed company in the shipping industry, needed to obtain a reduction in debt outstanding prior to a merger in 1989, its main bank (The Industrial Bank of Japan) was allowed to claim deductions from income for reductions in principal after negotiations with the Ministry of Finance. (Packer, 1994)

[3]Another tax policy change was an expansion in September 1992 of the definition of the terms by which loans could be deemed to be unrecoverable for purposes of establishing special reserves.

Operations to Date

Purchase Volume

Sales to the CCPC have significantly dented reported non-performing loans of Japan's major banks. Between March 1993 and March 1994, a face value of ¥4.511.7 trillion ($41.0 billion) was sold to the CCPC (Table 1). Assuming that the loans sold were all non-performing, and after accounting for the extent of CCPC usage among banks, the amount of non-performing loans reported for the end of March 1994 by the 21 major city, long-term credit, and trust banks was 22.5 percent less than it otherwise would have been (¥13.6 instead of ¥17.7 trillion).

The scale of operations over fiscal semesters has increased exponentially. While the face value of loans sold in the first half of FY 93 was 73 percent greater than the loans sold in the second half of FY 92, loans sold in the second half of FY 93 represented a 125 percent increase over the previous semester.

Banks tend to wait until the very last month of a reporting period (March and September of each year) before selling loans to the CCPC. For instance, more than 80 percent of the reported sales for the first half of fiscal year 1993 were in September, while 63 percent of sales for the second half were in March. Banks choose a quantity of loans sold to the CCPC and the related loss on the disposition of assets after the approximate values of other items in the income statement (such as net gain on securities sales) have been determined.

Purchase Prices and Discounted Value

The discount between the face value of the loans sold to the CCPC and the value as

Table 1: Loans Sold to the CCPC: March 1993-March 1994

	Number of Loans Sold	Face Value [¥ bb] (A)	Appraised Value [¥ bb] (B)	Claimed Losses [¥ bb] (A-B)	Claimed Losses (% of Face Value)
MARCH 93 (2ND HALF, FY '92)	229	681.7	452.1	229.6	33.7%
APRIL-SEPT. 93 (1ST HALF, FY '93)	510	1,180.0	602.9	577.1	48.9%
OCT.93-MARCH 94 (2ND HALF, FY '94)	1381	2,654.2	1,176.0	1,478.2	55.7%
TOTAL	2120	4,515.9	2,231.0	2,284.9	50.6%

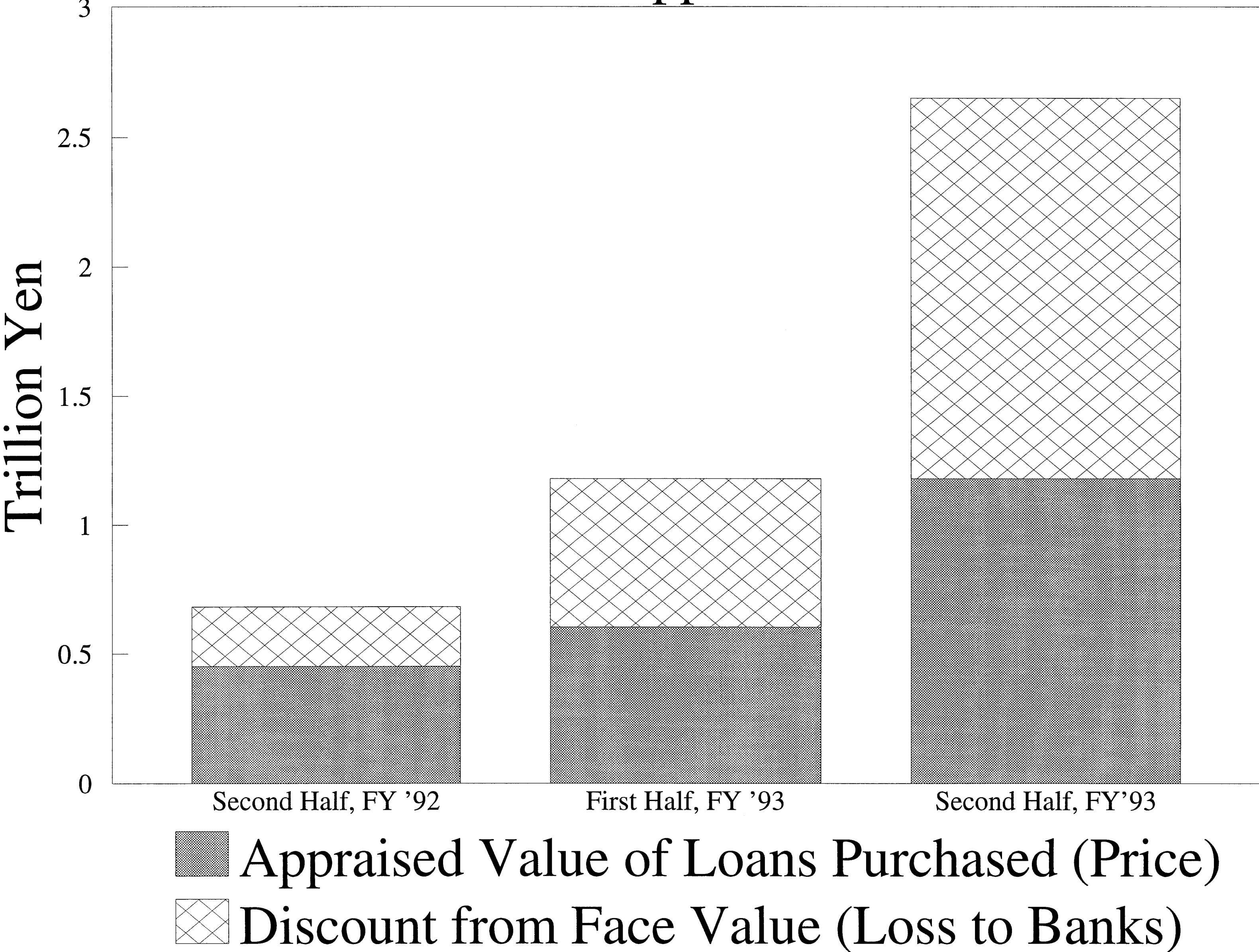
determined by the Price Appraisal Committee has increased over time. In the second half of fiscal year 1992, the appraised value of loans purchased was reported to be 66.3 percent of face value, implying a loss of one-third of the face value of loans sold. By contrast, in the first half of fiscal year 1993, the discount upon sale was nearly one-half the face value of the loans sold; the discount increased to more than 55 percent the subsequent semester (Table 1, Chart 2).

This increased discount is consistent with either a continued decline of the values of underlying real estate during the period, or a shift to the sale of loans with lower quality real estate as collateral. If the former explanation is correct, the off-balance sheet liabilities associated with assets sold to the CCPC in the first two fiscal semesters -- the undisclosed current value of the recourse -- amount to around ¥230 billion, 29 times the capital paid in to the CCPC.

Sales and Income

The CCPC has been virtually dormant on the sales side of its operation, although there are some recent signs of an awakening. Through September 1993, the CCPC had sold 14 properties for ¥2.96 billion, and obtained rental fees or interest payments from the secured loans of ¥600 million. Total revenue at that point was around one-third of one percent of the appraised value of the properties. However, by the end of March 1994, total revenue had increased nine-fold to ¥30.2 billion, representing around 1.35 percent of the appraised value of all properties.

Whether sales will account for more than a small fraction of assets in the near future seems a matter of some dispute. It was initially reported that the MoF and the major banks



Source: CCPC.

had agreed that valuations of the land would be generously high both for the purpose providing a floor for real estate prices and to limit the tax write-off. (Kasahara, p. 12) More specifically, a former high-level Ministry of Construction official was quoted as saying that to attract buyers for the CCPC's land holdings, most prices would have to go to 10 percent of face value instead of the 50 percent at which they were being transferred to the CCPC at the time. (*Nikkei Kinyu Shimbun*, October 10, 1993, p. 1) The head of the CCPC, S. Goto, noted in early April that financial institutions are selling the CCPC loans that are "difficult to liquidate" and that the recession has exacerbated delays in their liquidation.[4]

Another source of concern is the lack of interest/rental income resulting from the loans and related properties. (Most of the properties are reported to be unoccupied.) Subtracting income on real estate sales from the CCPC's total revenue for the second half of fiscal year 1993, and dividing the difference by the appraised value of the loans purchased before October 1993 net of subsequent asset sales, we get an upper bound for an annualized return on CCPC assets of between one and two-tenths of a percentage point.[5] As a result, even if CCPC were to have fully drawn upon paid-in capital, it would not have the income to pay interest to its funding banks at market rates.[6]

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[4]"Financial Institutions Step Up Liquidation of Bad Loans," Nikkei Weekly, April 11, 1994, pp. 12.

[5]Total revenue other than through sales of real estate over the period was ¥0.8 billion. Multiplying by two and then dividing by the difference between the ¥1055 billion of appraised asset value held at the beginning of the period and the ¥30.2 billion sold gives a return of 0.156 percent.

[6]At a long-term prime rate of interest (4.9 percent in March 1993), total interest paid or accrued by April 1994 on the ¥452.1 billion of CCPC borrowing **in March 1993 alone** would have amounted to around ¥22 billion, well in excess of the sum of rental and interest income

(continued...)

Tax Savings

As mentioned above, a vital advantage of utilizing the CCPC is that deduction from income of the discount between appraised and face value is approved by the tax authorities. This discount has to date amounted to about ¥2.28 trillion (Table 1), thus reducing the taxes of Japanese banks by around ¥1.14 trillion, roughly equal to the taxes paid by the 21 major Japanese banks for fiscal years 1992 and 1993 *combined.*

In fact, the 21 major banks have dominated use of the institution to date, accounting for more than 90 percent of losses on loans sold to the CCPC. (Table 2) Although the percentage declined slightly in the latest fiscal semester, it remains at more than 85 percent. The 11 city banks, 7 trust banks, and 3 long-term credit banks account for 69 percent, 9 percent, and 13 percent of the losses on loans sold, respectively.

3. The Proposed Formation of Special Purpose Companies. Despite the rapid expansion in the use of the CCPC to claim losses on real-estate loans in default, there remain a large chunk of other loans that are seriously burdening Japanese banks. In the past few years, many loans to nonbanks have been "restructured" so as to charge low (often zero) interest rates, yet are not officially recognized as non-performing loans. A good portion of these restructured loans to nonbanks consist of loans to housing finance companies, which amount to ¥4.8 trillion ($46 billion) among the 21 major banks in Japan, which compares to

[6](...continued)
and paid-in capital (¥9.3 billion). The current practice of some bank analysts is to add loans to the CCPC (among others) to the reported non-performing loans when comparing the relative health of bank balance sheets. (Ogawa, 1993;1994)

Table 2: Losses on Loans Sold to the CCPC By Major Types of Bank

	Losses by All Banks [¥ bb]	Losses by City Banks [¥ bb]	Losses by Trust Banks [¥ bb]	Losses by Long-Term Credit Banks [¥ bb]	Losses by 21 Major Banks [¥ bb]
MARCH 93 (2ND HALF, FY '92)	229.6	154.1 (67.1%)	10.7 (4.7%)	53.2 (23.2%)	218.0 (94.9%)
APRIL-SEPT. 93 (1ST HALF, FY '93)	577.1	433.0 (75.0%)	56.1 (9.7%)	78.2 (13.6%)	567.3 (98.3%)
OCT.93-MARCH 94 (2ND HALF, FY '94)	1,478.2	978.7 (66.2%)	148.2 (10.0%)	156.8 (10.6%)	1,283.7 (86.8%)
TOTAL	2,284.9	1,565.8 (68.5%)	215.0 (9.4%)	288.2 (12.6%)	2,069.0 (90.5%)

an amount of officially recognized bad debt for those banks of ¥14.1 trillion ($134 billion).[7]

In February of this year, the Ministry of Finance announced the framework for a new approach to dealing with these loans.[8] The new guidelines will permit "Special Purpose Companies" (SPCs) to be created, which receive transfers of restructured loans in return for a specified number of shares in the new entity. The difference between the face value of the loans and the appraised market value of the shares can be deducted by the banks from income for tax purposes. The appraised value at the time of transfer will be determined by discounting the contracted cash flow from the loans at a market interest rate. The figure will be updated every year, and changes in the figure will be reported as bank income, as will interest payments that pass through the SPC. (Chart 3)

The proposed scheme and related tax deductions take effect in fiscal 1994. There will be numerous advantages to the banks of using the new scheme as opposed a tax-equivalent write-down of principal. Clearly, they will not have to recognize the restructured loans as non-performing. Further, since the SPC does not transform the claim on the ultimate obligor, banks can maintain the pressure on the nonbanks to restructure their operations, as

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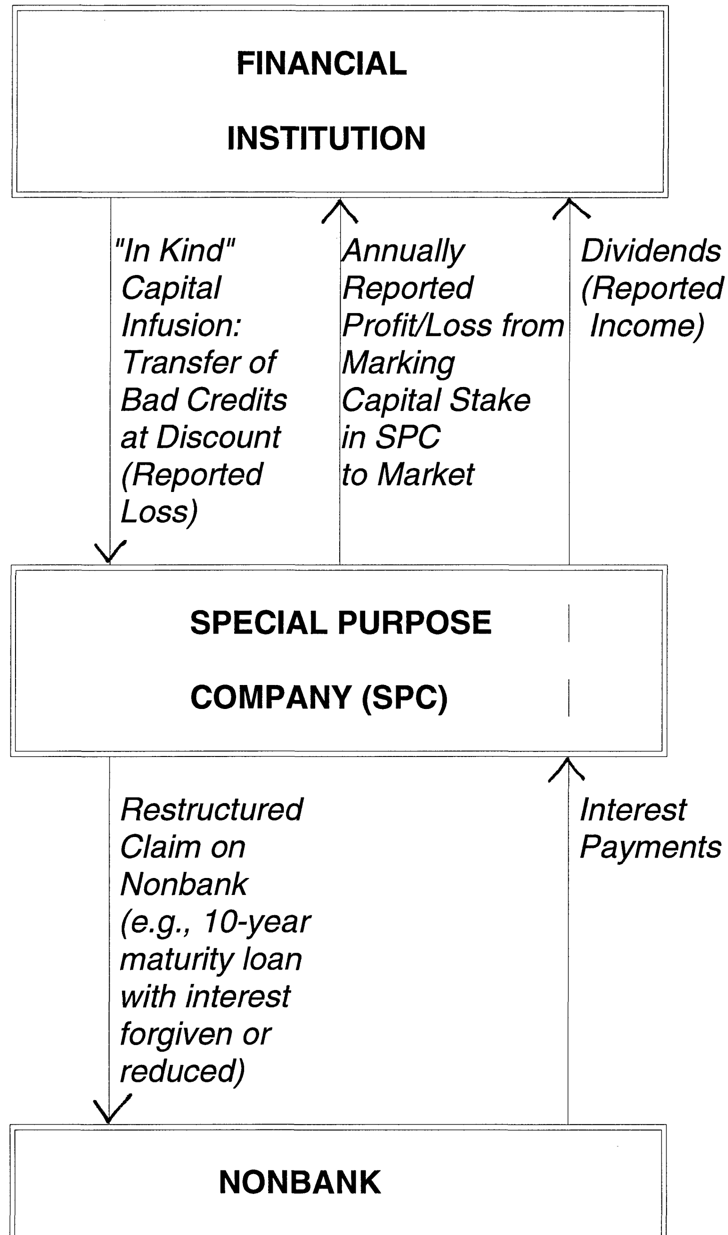
[7]Some nonbank loans have ended up in the CCPC: as of October 1993, a total of ¥230 billion of the face value of the loans purchased, or 12.4 percent, had been of loans originated by nonbanks and sold to the CCPC through their sponsor institutions. However, relative to their holdings of bad real estate loans, nonbanks have been inactive in their use of the CCPC. This is in large part because their main banks had been required to sponsor the sales to the CCPC, and take on the full contingent liability implicit in the sale of bad loans to the CCPC. Given the large number of creditors for major nonbanks, main banks have often found this burden unacceptable.

[8]"Transfer of Restructured Loans," part 2 of "Policy Guidelines on the Problem of Non-performing Loans Held by Financial Institutions" (Translation), Ministry of Finance, February 8, 1993.

CHART 3

PROPOSED STRUCTURE FOR TRANSFERRING BAD LOANS TO SPCs



Source: Kinyu Zaisei Jijo, Feb. 14, 1994.

well as gain any upside benefits from a prospective recovery. Finally, discounting of a loan by any individual bank will not affect the priority of their claims vis-a-vis other creditors in case the nonbank fails.

The implications of this measure on the banks' tax bill has the potential to be of the same order of magnitude those of the CCPC. If the ¥4.8 trillion ($46 billion) of loans to housing finance companies were to be transferred to the SPCs at 60 percent of face value[9], ¥1.9 trillion ($18 billion) of losses can be claimed for those loans alone. At a tax rate of about 50 percent, the 21 major banks stand to save over ¥0.9 trillion ($9 billion), more than the ¥0.8 billion they paid in taxes in fiscal 1992, and more than twice the ¥0.35 trillion they paid for fiscal 1993.[10]

Although the accounting and legal structure as well the class of loans affected will be different, in some fundamental respects SPCs will be similar to the CCPC. Both will allow Japanese banks to realize tax benefits from troubled loans more quickly than before. Both will ensure that the rate of realization of these tax benefits will be determined by the strength of operating earnings and the stock of unrealized gains on crossheld shares. And both can assist banks in slimming risk-weighted assets and thereby raise risk-weighted capital ratios.

The pricing of transferred loans and the losses taken obviously depend on the rate at which contracted cash flows are discounted. Articles cited above give hypothetical examples

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[9]Such a number was given in both the February 14, and the February 28, 1994 issues of the Ministry of Finance's weekly publication, Kinyu Zaisei Jijo, in articles which explained the proposed mechanism.

[10]Although tax authorities will not allow losses to be carried back, they can be carried forward five years. (Price Waterhouse, Doing Business in Japan, 1993.) Of course, this remains a moot point as long as Japanese banks act as if constrained to report positive profits.

of the mechanism which discount a bullet payment due in 10 years by 40 percent. (ref. footnote 8) This discount corresponds to an annual rate of 5 percent. Such a discount rate builds in little margin to reflect the underlying uncertainty of receiving payments from troubled nonbanks.

Since long-term credit banks and trust banks are relatively more exposed in terms of restructured loans to nonbanks than city banks, the projected benefits of the measure are asymmetrically distributed across classes of banks. In fact, according to reports of the Nikkei Financial Daily, the Industrial Bank of Japan was responsible for proposing the SPC guidelines, and city banks are not as enthusiastic. City and other banks fear that the scheme - which at least in theory allows sales of bad loans without the consent of other creditors - would legitimate a pro rata solution to the distribution of losses. Of course, this would represent a departure from an implicit assumption of the "main bank system": that the main bank would be responsible for bearing a disproportionate share of the losses in the event of default of an affiliated nonbank.

4. Conclusion. The CCPC greatly facilitates the realization of losses for tax purposes. Japanese banks have saved as much in taxes from losses on sales to the CCPC as they in fact paid over the last two years. The proposed formation of SPCs will further expand the range of assets for such preferential treatment.

However, loan sales to the CCPC have not yet been accompanied by much of the sort of asset disposal--such as market sales of land or bulk sales to third party investors--that would have reduced bank's exposure to real estate. As a result, the CCPC has not gained for banks any of the following: 1) *Liquidity.* 2) *More certainty about future asset valuations.*

The claims on the CCPC retain some characteristics of the troubled loans sold to the CCPC, in the form of contingent liabilities and a problematic cash flow; 3) *Less diversion of management effort.* Even with the CCPC, time is spent monitoring its management of the assets sold with recourse; 4) *Greater availability of risk capital.* In the U.S., the transparent disposal of bad loans has at times been combined with measures to recapitalize once the confidence of investors has been restored.

To cite these advantages is not to advocate disposals as a one-size-fits-all approach. U.S. banks have pursued a variety of strategies from wholesale bulk disposal to selective sales. A complementary policy--new equity issuance--is hindered by current securities market regulation, most recently the suspension of the planned issuance of preferred shares by banks. (Nishimura) In the absence of a return of banks to the issuance market, a prolonged term of write-offs for the Japanese banking sector appears likely.

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