Note

CLOSING THE BOOK ON *JUSEN*: AN ACCOUNT OF THE BAD LOAN CRISIS AND A NEW CHAPTER FOR SECURITIZATION IN JAPAN

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INTRODUCTION

Japan breathed a sigh of relief in 1996, as it finally bid farewell to the worst recession in its post-war history.[1] With the recession behind it, however, Japan now faces the formidable task of correcting its severe fiscal deficit while at the same time reforming laws and markets to stimulate growth and foreign investment.[2] This effort is complicated by the presence of billions of dollars of nonperforming debt[3] held by Japanese banks and nonbank financial institutions,[4] including the now-defunct *jusen*.[5]

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1. *See Reluctant to Reform: Japan Must Extract More Growth from Its Fast-Maturing Economy*, FIN. TIMES (London), Jan. 2, 1997, at 10.

2. *See* Andrew Pollack, *The Question Facing Japan: Can Its Vibrant Engine Ever Be Restarted?*, N.Y. TIMES, Jan. 2, 1997, at C9.

3. Nonperforming debt refers to outstanding loans on which principal and/or interest payments are delinquent or entirely unrecoverable due to the financial distress or default of the borrower. In Japan, loans are deemed bad when they have been overdue for six months, whereas loans in the United States are deemed bad after only three. *See* Jathon Sapsford, *Japan Plans Crackdown on Bad Loans*, WALL ST. J., Dec. 26, 1997, at A5. Although this Note focuses primarily on the nonperforming debt originated by *jusen*, much of the analysis of the causes of and potential solutions to the *jusen* problem is similarly applicable to the non-*jusen* bad debt crisis currently plaguing Japan.

4. Nonbank financial institutions include entities such as brokerage and investment banking firms and real estate finance companies.

5. *See Jusen Study Mission to Visit U.S.*, DAILY YOMIURI (Japan), Aug. 26, 1997, at 12 (citing a group of Japanese banking officials established to discuss the resolution of the massive

Jusen were private, consumer-housing finance corporations.[6] The seven major *jusen* were established in Japan in the 1970s by large financial institutions, banks, and securities houses with the backing of the Ministry of Finance (MOF).[7] Much like Savings and Loans (S&Ls) in the United States,[8] *jusen* were created to facilitate private home purchases through mortgage financing.[9] During the "bubble era"[10] of the 1980s, however, *jusen* departed from the home financing

"irrecoverable" loans amassed by the defunct *jusen*); *see also, e.g.*, Yoshihiro Fujii, *Size of Bank Woes Reflected in Too-Big-to-Fail Debate*, NIKKEI WKLY. (Japan), Apr. 7, 1997, at 7 ("[T]he entire financial system [of Japan is] staggering under of [sic] massive bad debt . . . ."); Kumi Matsumara, *Mitsuzuka Predicts End to Jusen's Bad Loans*, DAILY YOMIURI (Japan), Sept. 3, 1997, at 1 (viewing the *jusen*'s bad loans as a "major factor behind the lackluster state of the [Japanese] economy"); *MOF to Help Spur 'Jusen' Loan Trade, Securitization*, Japan Economic Newswire, July 12, 1997, *available in* LEXIS, News Library, Non-US File [hereinafter *Jusen Loan Trade*] ("The problem of nonperforming loans at financial institutions is considered to be an impediment to Japan's economic recovery.").

6. *See, e.g.*, *Anatomy of the 'Jusen' Scandal*, WKLY. POST (Japan), ¶ 1 (Feb. 12-18, 1996) <http://www.weeklypost.com/960212/960212a.htm> [hereinafter *Jusen Anatomy*] (defining *jusen* as "consumer housing finance corporations"); Ken Duck, *Now that the Fog Has Lifted: The Impact of Japan's Administrative Procedures Law on the Regulation of Industry and Market Governance*, 19 FORDHAM INT'L L.J. 1686, 1699 (1996) (referring to *jusen* as "housing loan companies"). *But see* Geoffrey P. Miller, *The Role of a Central Bank in a Bubble Economy*, 18 CARDOZO L. REV. 1053, 1068 (1996) (defining *jusen* as "housing finance banks"). The distinction between "bank" and "corporation" in defining *jusen* is largely irrelevant to the analysis in this Note. For simplicity, this Note will consider *jusen* to be non-bank entities.

7. *See The Jusen Problem—Its Roots Are Deep and Ugly*, WKLY. POST (Japan) (Jan. 29, 1996) <http://www.weeklypost.com/960129/960129a.htm> [hereinafter *Ugly Roots*]; Robert Juhl, *Jusen Shori: Taxpayers to Pay Bill for Failed Housing Loan Companies* (Dec. 22, 1995) (visited Dec. 29, 1996) <http://www.smn.co.jp/keyword/0064k01e.html>. The MOF is widely considered one of the most powerful and respected bureaucracies in Japan. *See* Dennis Bower, *An Evaluation of the Proposed Fair Trade in Financial Services Act*, 27 CASE W. RES. J. INT'L L. 407, 426 (1995) (and see the sources cited therein). It acts as the primary supervisory body over banks and contains "some of the world's most incorruptible and indefatigable civil servants." DANIEL BURSTEIN, YEN! 197-98 (1988). The MOF also has responsibility for making tax policy and managing the national debt. *See* Charles Smith, *Crisis at the Finance Ministry*, FIN. TIMES (London), July 15, 1997, at 2.

8. Several commentators have made comparisons between the S&L and *jusen* crises. *See, e.g.*, Brian Bremner et al., *Rescuing Asia*, BUS. WK., Nov. 17, 1997, at 116, 119; Clay Chandler, *Japanese Feel Markets' Tremors*, WASH. POST, Dec. 24, 1997, at A1; Jathon Sapsford, *Japanese Banks' Bad Loans Constitute Bigger Burden Than U.S. S&L Debacle*, WALL ST. J., June 7, 1995, at A10; Aaron Zitner, *S&L Crisis in Japan May Take Wide Toll*, BOSTON GLOBE, Dec. 24, 1997, at A1. A full discussion of the merits of such analogies is, however, beyond the scope of this Note.

9. *See Ugly Roots*, *supra* note 7; Juhl, *supra* note 7.

10. During the mid-to-late 1980s, the Japanese financial market experienced a massive amount of speculative activity, resulting in an unprecedented rise in stock and land prices. For an in-depth discussion of the origins and impact of Japan's bubble economy, see generally CHRISTOPHER WOOD, THE BUBBLE ECONOMY: JAPAN'S EXTRAORDINARY SPECULATIVE

market in search of the higher returns of commercial real estate development deals.[11] Lending to the riskier commercial sector, including many so-called *jiageya*,[12] may have constituted as much as 80% of *jusen* portfolios.[13] When Japan's bubble economy burst in 1991, the *jusen* were saddled with a total of 8.1 trillion yen (then roughly $81 billion[14]) of nonperforming loans and other bad debts.[15] This debt, coupled with the bad loans of Japan's commercial banks, places an enormous strain on the Japanese financial system[16] and must be dealt with expeditiously if Japan is to avoid recession.[17]

BOOM OF THE 80'S AND THE DRAMATIC BUST OF THE 90'S (1992); Miller, *supra* note 6, at 1058-69.

11. *See* Toshio Aritake, *Japan Releases Data on Bad Debts of Troubled Housing Loan Companies*, Banking Daily (BNA), Jan. 22, 1996, *available in* LEXIS, BNA Library, BNABus File; *Ugly Roots*, *supra* note 7.

12. *Jiageya* are real estate brokers who, some say, unscrupulously manipulate land prices for outrageous profits. *See Jusen Anatomy*, *supra* note 6.

13. *See Ugly Roots*, *supra* note 7; *see also* Aritake, *supra* note 11 (reporting that many of the *jiageya* were associated with *yakuza* (organized crime)).

14. For all Japanese Yen to U.S. dollar conversions, this Note uses the conversion quoted in the cited source or, if no conversion was made, it uses the spot rate for a particular date or the mid-point of a particular month available at <http://www.oanda.com/cgi-bin/ncc> (last visited Jan. 20, 1998), a currency conversion facility on the World Wide Web. All monetary values will be given in U.S. dollars except when otherwise indicated.

15. *See* Juhl, *supra* note 7.

16. Bad loans place pressure on the financial system in several ways. First, banks with large portfolios of bad loans are viewed as riskier investments and therefore experience higher costs of obtaining funding. *See infra* notes 71-73 and accompanying text. Second, international banks must abide by capital adequacy requirements of the Basle Accord. *See infra* notes 146-48 and accompanying text. Since nonperforming loans are assets which bring in no new funds, the bad loans combined with the capital requirements strain the ability of banks to use their capital to make new profitable investments. Third, as banks become squeezed for capital, they can ill afford to provide new credit to borrowers, which has led to a liquidity crisis and a subsequent increase in corporate bankruptcies. *See* Paul Abrahams & Gillian Tett, *Tokyo Markets Face a "Death Spiral*," FIN. TIMES (London), Dec. 23, 1997, at 3. Finally, the general decline in Japanese stock prices, especially those linked to bad loans, has complicated the bad loan situation in Japan. The falling prices further weaken banks' capital-to-assets ratios because 45% of unrealized gains are normally treated as capital. *See* Abrahams & Tett, *supra*; *see also infra* notes 81-83 and accompanying text. Moreover, one commentator writes that efforts have been made to artificially prop up the Japanese stock market in anticipation of the March 31 fiscal year-end at which time banks are required to book gains or losses on stock portfolios. *See* Nicholas D. Kristof, *For a Shaky Japanese Economy, the Premier Is a Hesitant Steward*, N.Y. TIMES, Feb. 13, 1998, at A1.

17. *See* Editorial, *Now Is a Good Time to Address Bad Debts: Investor Skepticism Intensifies Need for Quick Action*, NIKKEI WKLY. (Japan), Mar. 24, 1997, at 6 (predicting that if Japan further delays the resolution of its bad loan crisis, massive capital flight may ensue). Even though these huge bad loans existed for several years, Japan was able to pull itself out of recession because the market factored the government's purported desires to effect meaningful solutions into its valuation of Japanese stock and real estate prices. If the anticipated

Despite the fact that losses from the seven major *jusen* represent only a fraction of the total amount of nonperforming loans burdening Japan,[18] the resolution of their bad debt problems has attracted wide media coverage and the attention of policy makers and the public.[19] The government's liquidation of the seven *jusen* in 1996, while a powerful statement of its aggressive efforts to resolve the *jusen* crisis, did little to solve the fundamental problem of eliciting repayment by delinquent borrowers.[20] Following the liquidation, the bad loan situation continues to raise important questions for Japanese taxpayers in general, and government officials and *jusen* insiders, in particular. Specifically: Who is responsible for the *jusen*'s procurement of such massive debt; and what is the best approach to settling the *jusen* crisis?

This Note briefly addresses the former question, but focuses primarily on the latter, proposing that the securitization[21] of nonperforming assets, such as commercial mortgages and real estate

government action is not taken, however, a resulting sell-off of Japanese assets could potentially plunge Japan back into recession or at a minimum stunt desired economic growth. *See id.*

18. *See* Jon Choy, *Tokyo Marshals Forces Against Nonperforming Loans*, JEI Rep. (Japan Econ. Inst. of Am.), Sep. 20, 1996, *available in* LEXIS, News Library, Nwltrs File [hereinafter Choy, *Marshaling Forces*] (noting that the sheer magnitude of bad loans held by nonbanks dwarfs those of the *jusen*).

19. *See, e.g.*, Jon Choy, *Nonperforming Loans Haunt Nonbank Financial Firms*, JEI Rep. (Japan Econ. Inst. of Am.), Nov. 1, 1996, *available in* LEXIS, News Library, Nwltrs File [hereinafter Choy, *Nonbank Bad Loans*] (noting statement by head of the Ministry of Finance that nonbank failures could become a "major problem" if their effects spread to other financial institutions); *Jusen Anatomy*, *supra* note 6 (calling the *jusen* scandal "one of the largest political blunders in the history of post war Japan"); *Mondale, U.S., Stress Neutrality on Controversial Jusen Bailout Scheme*, BNA INT'L TRADE DAILY, Mar. 12, 1996, *available in* LEXIS, BNA Library, BNABus File (discussing U.S. Ambassador to Japan Walter Mondale's statement regarding the severity of the *jusen* problem and the possibility of it causing "international instability").

20. One commentator remarks that Japanese policy makers possess few economically feasible tools with which to engineer a recovery. *See* Sheryl WuDunn, *Japanese Stocks Off 10% in Grim Week*, N.Y. TIMES, Jan. 11, 1997, at 37.

21. The terms "securitization," "asset securitization," and "structured finance" are often used interchangeably. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 133 n.1 (1994) [hereinafter Schwarcz, *Alchemy*]. In essence, securitization is a process by which assets are pooled and securities are issued backed by the cash flows from these assets. *See infra* Part II. The cash flows normally consist of payment obligations, such as accounts receivables, that are owed the issuing company by some third party. *See* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 1 (2d ed. 1993) [hereinafter SCHWARCZ, STRUCTURED FINANCE]. These payment obligations are generically referred to as "receivables" and the company that is owed the receivables is usually called the "originator." *See id.*

collateral, would be one possible, efficient and productive use of these assets. In addition, the issuance of asset-backed securities (ABS) would provide those charged with handling the nonperforming debt access to new and cheaper sources of funds.[22] As a result of investor interest in developing *jusen* real estate collateral, the real estate market would experience huge infusions of cash, resulting in greater liquidity and higher prices. Japanese and foreign investors would also benefit from the increased ability to diversify their portfolios with Japanese ABS.

Although the field of asset securitization has grown relatively little in Japan since studies were first conducted in 1988, significant reforms in 1992[23] and 1995[24] precipitated the first securitizations by Japanese companies and banks, greatly increasing its acceptance as a viable financing technique. *Jusen* securitization[25] could significantly enhance Japan's ABS market by creating a broad, liquid market supported by large Japanese banks and foreign investors.[26] With taxpayer opinion adamantly opposed to a publicly-funded clean-up effort, *jusen* securitization would shift the burden from the public to the private sector. Moreover, structured finance specialists, who have honed their skills in the U.S. and elsewhere for nearly 30 years, would be eager to export their expertise to the Japanese market.[27]

Part I of this Note analyzes the causes and severity of the *jusen* crisis and the toll it has taken on the nation as a whole. Part II introduces the concept of asset securitization, outlining the primary benefits it affords corporations and investors, and then discusses the current state of securitization in Japan. Finally, Part III analyzes whether securitization would be both a desirable and feasible solution to the *jusen* crisis. While concluding that securitization of nonperforming assets would be an effective solution to some of

22. *See infra* Part II.B.

23. *See infra* note 174 and accompanying text.

24. In 1995, the MOF decided to permit financial institutions to issue ABS in Japan commencing in 1996. *See infra* text accompanying notes 178-79.

25. Throughout this Note, the term "*jusen* securitization" shall mean the securitization of nonperforming loans, including real estate collateral, originated by *jusen* and issued either by *jusen* parent companies or other entities involved in eliciting value from *jusen* assets. Similarly, "*jusen* securities" refer to securities backed by the former assets of *jusen*.

26. Creating a sophisticated and liquid Japanese ABS market in which to place "*jusen* securities" is crucial to the long-term success of this plan. Realistically, however, because the Japanese market may be unable to handle such a large issuance of securities in the short-term, the European and U.S. capital markets may be needed to help provide liquidity and capital.

27. *See infra* note 193 and accompanying text.

Japan's bad loan problems, this Note also acknowledges the existence of significant barriers to implementing such a program, particularly the nontransparency of financial statements and records of Japanese banks and corporations.

I. THE *JUSEN* BAD LOAN CRISIS

Much of corporate Japan is characterized by a system of conglomerates, called *keiretsu*.[28] The *keiretsu* are normally centered around a single large bank and consist of "groups of major corporations in disparate industries tied together by a minority of interlocking shareholdings."[29] As a result of this complicated corporate network in which debt and equity frequently change hands, it is difficult to accurately calculate the amount of bad loans outstanding in Japan;[30] it is even more difficult to estimate how much of these loans are attributable to the *jusen*. The MOF estimates the size of the *jusen* losses at $81.3 billion.[31] The ultimate cost of the *jusen* scandal will depend on future economic conditions and policy actions as well as accounting practices used to assess the losses.[32]

28. *See generally* WILLIAM S. DIETRICH, IN THE SHADOW OF THE RISING SUN 84 (1991) (describing the prevalence of *keiretsu*).

29. *Id*.

30. Estimates of the total amount of nonperforming loans on Japanese balance sheets range from $100 billion to $972 billion. *See, e.g.*, Jathon Sapsford, *Japan's Estimate on Banks' Problem Loans Leaps*, WALL ST. J., Jan. 13, 1998, at A17 (reporting that the MOF tripled its earlier estimates of the total outstanding bad loans and placing the figure at $577.5 billion); *After "Jusen" Bail-out, Japan Banks May Go*, Reuters Fin. Serv., Sept. 19, 1996, *available in* LEXIS, News Library, Reufin File (approximating the range of value of nonperforming loans to be between $100 and $450 billion); *Coalition Government Alters Jusen Scheme in Bid to Get Public Support*, Banking Daily (BNA), Mar. 7, 1996, *available in* LEXIS, BNA Library, BNABus File (estimating bad debts to be between $390 and $972 billion); *D'Amato Voices Concern over Fed's Reported Liquidity Plan with Japan,* 65 Banking Rep. (BNA) 672, 627 (Oct. 23, 1995) (reporting that private sector analysts put roughly an $800 billion total on bad loans held by Japanese banks); *Top Asian Lessors 1995*, ASSET FIN. & LEASING DIG., June 1996, *available in* LEXIS, News Library, Curnws File [hereinafter *Top Asian Lessors*] (noting, in a report by Merrill Lynch, that 21 Japanese banks wrote off $102 billion in bad loans in the year ending March 1996 alone).

31. *See Ugly Roots*, *supra* note 7. A September 1996 article in the *Weekly Post* reported that the amount of uncollectible loans held by the seven *jusen* was $133.9 billion. *See Jusen Resolution Policy Faces a Deadlock*, WKLY. POST (Japan), Sept. 9-15, 1996, *available at* <http://www.weeklypost.com/960909/960909a.htm>.

32. The analysis of the cost of the *jusen* clean-up is similar to that of the S&L bailout in this regard. For example, the cost of cleaning up insolvent *jusen* will depend on the degree of insolvencies, which will be largely determined by the future course of real estate values. *See* LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 193 (1991). The effectiveness of the government in liquidating, securitizing, or

Rising land prices and an effective securitization program[33] could dramatically reduce the ultimate price of the clean-up. Irrespective of the tactics employed, however, the bad loan problem will be an issue for the next several years.[34]

A. Causes of the Jusen Crisis

A multiplicity of factors led to the *jusen*'s acquisition of $80-100 billion of nonperforming loans. Risky lending,[35] coupled with inopportune market conditions at the end of the bubble era,[36] laid the foundation for the massive procurement of debt by *jusen*. Later, legislative inaction in the face of rising debt,[37] exacerbated by the manipulation of accounting regulations,[38] allowed *jusen* to cover up and ultimately worsen their own plight. Finally, the failing health of *jusen* balance sheets was met with a concurrent downgrading of their credit,[39] which drove them even deeper into debt.

The most important factor contributing to the *jusen* bad debt crisis was the capricious lending of *jusen* executives during the bubble era.[40] As real estate values rose to unprecedented levels, *jusen* credit officers lent aggressively and, as it turned out, foolishly, to scores of

otherwise disposing of the *jusen*'s assets will also greatly affect the ultimate cost of the clean-up. *See id.* at 194.

33. *See infra* Part III.

34. *See* Choy, *Marshaling Forces*, *supra* note 18.

35. *See infra* notes 40-50 and accompanying text.

36. *See infra* notes 54-64 and accompanying text.

37. *See infra* notes 65-67 and accompanying text.

38. *See infra* notes 68-70 and accompanying text.

39. *See infra* notes 71-73 and accompanying text.

40. The large number of arrests and indictments that have surfaced among borrowers as well as insiders of *jusen* evidence the *jusen* executives' inadequate credit and background checks. *See, e.g.*, *4 Ex-Jusen Execs Face 3.6 Bil. Yen Lawsuit*, DAILY YOMIURI (Japan), July 20, 1997, at 2 [hereinafter *Ex-Jusen Execs*] (reporting that four former *jusen* executives are being sued in connection with losses incurred through the extension of illegal credit); *Nanatomi Execs Held for Stalling Debt Recovery*, DAILY YOMIURI (Japan), Sept. 17, 1997, at 2 (noting that a major *jusen* borrower was being held on charges of obstructing recovery of real estate assets); *Real Estate Executives Held in Loan Scam*, DAILY YOMIURI (Japan), Oct. 9, 1997, at 2 (reporting that a real estate company defrauded a *jusen* out of 1.2 billion yen ($9.9 million)); *3 Arrested in Faking of Firm's Net Worth*, DAILY YOMIURI (Japan), July 18, 1997, at 2 (discussing the arrest of an attorney and two officials of a real estate company on suspicion of fabricating financial statements in order to hide assets from creditors); *Togensha Head Gets 2 Years for Shirking Debt*, DAILY YOMIURI (Japan), Aug. 7, 1997, at 2 (announcing the sentencing of a real estate firm president, whose company was a major *jusen* borrower, to two years in prison for attempting to avoid his obligations to creditors).

unworthy borrowers.[41] In connection with such lending, banks have been criticized for not keeping tighter reins on their *jusen* subsidiaries.[42]

Intense competition by Japanese commercial banks for the individual retail market was perhaps the main impetus for *jusen* involvement in riskier commercial lending transactions.[43] The banks' entry into the housing loan business may have strained *jusen* profitability, thereby "pushing *jusen* firms into the risky real estate lending business" in search of additional profit opportunities.[44] *Jusen* found themselves competing in a market about which they knew relatively little.[45] Some hired "experts" from parent companies to take charge of the new operations, but the departments could not compete with the more experienced commercial lenders.[46] In their efforts to provide "quick responses" to customers, *jusen* performed inadequate credit checks on borrowers.[47] The rise in interest rates during and immediately after the bubble era may have also increased the *jusen*'s thirst for higher returns in order to offset the considerably lower long-term mortgage rates into which they were locked.[48] To avoid being squeezed out of the market,[49] *jusen* invested in riskier deals to increase their return on capital and remain competitive with other financial institutions.[50]

Loose lending was not the only flaw of *jusen*. Consistent with the well-documented Japanese affinity for loyalty and the cultivation

41. *See supra* note 40.

42. *See* Mari Koseki, *Jusen Debtor Tells Diet Loans Can't Be Repaid*, JAPAN TIMES WKLY., May 19, 1996, at 1 (relaying remarks of former *jusen* president, Hidezo Hara).

43. *See id.*

44. *Id.*

45. *See id.*

46. *See id.*

47. *See id.*

48. *See supra* note 6 and text accompanying note 9 (defining *jusen* as corporations primarily in the business of mortgage lending). This situation was analogous to the one that faced S&Ls in the late 1970s and early 1980s. S&Ls held nondiverse portfolios of long-term, fixed-rate mortgages which were funded by short-term obligations. *See* Robert J. Laughlin, Note, *Causes of the Savings and Loan Debacle*, 59 FORDHAM L. REV. S301, S309-S310 (1991). When interest rates rose, depositors withdrew their money from the thrifts and placed it in higher return investments; however, the thrifts were stuck with their long-term loans at the lower rates with no way to procure cheap capital to make more profitable loans. *See id.* at S310; *see also* WHITE, *supra* note 32, at 67 (analyzing the increase in interest rates between the late 1970s and early 1980s, and the government's subsequent response).

49. As *jusen* earned low mortgage rates and borrowed at increasingly higher prime levels, their spreads (or profit margins) evaporated.

50. *See* Koseki, *supra* note 42.

of relationships,[51] *jusen* occasionally provided financial aid to key customers in financial distress. While such a practice may have enhanced customer loyalty, the amount of money *jusen* gave to subsidize certain key customers was clearly inappropriate.[52] In one instance, to aid a major borrower in dire financial straits, a *jusen* firm purchased a section of Tokyo real estate for $15 million more than the borrower paid for it that same day.[53]

The huge decline in the Tokyo stock market was also problematic for *jusen*. After the *Nikkei* index soared to 38,915 in December 1989, the government raised interest rates, hoping to thwart the "unsustainable rise in asset values."[54] Following this fiscal tightening, the *Nikkei* plunged to a low of 14,309 in August 1992.[55] The seven-year bear market,[56] which accompanied the end of the bubble era, significantly contributed to the *jusen*'s troubles. When stocks soared in the 1980s, companies were able to offset their bad debt with gains from equity.[57] However, the fall of stock prices in the post-bubble era eliminated the possibility of offset. The problem was especially pronounced for Japanese banks and mortgage companies, which traditionally hold significant blocks of stock in major borrowers.[58] Their decisions to purchase these large blocks were often based more on the goal of building or maintaining relations[59] than on the goal of maximizing investment returns. As a result, many of their portfolios were not diversified enough to spread losses.[60]

The real estate market also experienced devastating drops in value during the post-bubble years. This decline, precipitated by a

51. *See, e.g.*, Gillian Tett, *Time for a Shake-out*, FIN. TIMES (London), Dec. 16, 1997, at 4 (noting that the relationships between banks and construction groups in past decades followed the "traditional Japanese pattern of corporate loyalties").

52. *See* Koseki, *supra* note 42.

53. *See id.*

54. David Holley, *Nikkei Index Continues on Its Wild Ride*, L.A. TIMES, Jan. 14, 1997, at D1.

55. *See id.*

56. Analysts estimate the bear market began in July 1990 and continues today. *See* WuDunn, *supra* note 20.

57. *See* Holley, *supra* note 54.

58. *See* Sandra Sugawara, *Japanese Shares Take Nose Dive*, WASH. POST, Jan. 11, 1997, at D1.

59. *See* Charles Smith, *IBJ's Moment of Truth*, INSTITUTIONAL INVESTOR (Int'l ed.), Nov. 1997, *available in* LEXIS, News Library, Mags File (referring to these blocks as "semipermanent holdings of 'political' shares . . . that were originally acquired to cement business relationships").

60. *See* Sugawara, *supra* note 58.

1990 clamp-down on real estate-linked lending by the MOF, was a primary factor in the *jusen*'s inability to repay loans to parent companies and other financial institutions.[61] The 1990 MOF real estate reform imposed a duty on lending institutions to report their real estate loans to the MOF;[62] however, *jusen* were excluded from this obligation.[63] The MOF probably exempted *jusen* in an attempt to facilitate new housing construction by reducing regulatory obstacles. As a consequence of the MOF action, overall real estate lending shrunk, but the *jusen*'s proportion of lending increased as they continued to lend unencumbered by the new regulation. The home finance companies remained active in the commercial real estate market,[64] perhaps in an attempt to offset some of the losses they incurred as a result of the sharp decline in the market. *Jusen* therefore sailed into risky (and for them uncharted) waters with little MOF oversight. Had *jusen* not been exempt from the MOF regulations, the amount of real estate losses may have been significantly lower.

Some commentators have also criticized the MOF for failing to take any corrective action when *jusen* debt levels first surfaced.[65] Although an investigation of the *jusen* in 1991 and 1992 determined that their uncollectible debt totaled $46.5 billion, the MOF did not intervene[66] in the hope that an economic upturn would obviate the need for intervention.[67] In retrospect, earlier intervention by the MOF might have decreased the amount of *jusen* debt that was ultimately amassed.

While criticism of the government's failure to take affirmative steps to curtail the early signs of crisis appears warranted, there is evidence that some portion of the bad loans held by *jusen* were concealed by *jusen* insiders.[68] An audit of one of the seven major

61. *See* Koseki, *supra* note 42.

62. *See Ugly Roots*, *supra* note 7.

63. *See id*.

64. *See* Koseki, *supra* note 42.

65. *See, e.g.,* Juhl, *supra* note 7 (citing as an example of such a critique the International Monetary Fund, which, in its August 1995 report on international capital markets, assigned blame to Japanese regulatory authorities for failing to act swiftly in the bad loan crisis).

66. *See Jusen Anatomy*, *supra* note 6.

67. *See* Juhl, *supra* note 7.

68. *See, e.g.,* Koseki, *supra* note 42 (reporting that the financial records of several subsidiaries of a Tokyo-based real estate corporation did not match those of the parent company).

jusen, the Juso corporation, supports this claim.[69] The MOF's vague definition of nonperforming loans also may have contributed to the *jusen*'s ability to hide the true extent of their losses. To address some of these problems, the MOF proposed new reporting guidelines in March 1994 that would require banks to present a clearer picture of their own financial positions as well as those of their subsidiaries.[70]

The increased bad debt held by Japanese banks, *jusen*, and other financial institutions was a primary factor in the downgrading of their credit ratings by U.S. rating agencies, such as Standard & Poor's and Moody's.[71] The lower ratings raised the *jusen*'s cost of financing in the United States and Europe, making it more difficult for them to profit in the consumer or commercial lending markets.[72] This additional cost of raising funds in the capital markets is often referred to as the "Japan Premium."[73]

B. Effects of the Jusen Crisis on Japan's Economy

The *jusen* crisis has had many far-reaching effects. Since *jusen* primarily provided credit to consumers in the housing market,[74] a

69. *See Ugly Roots*, *supra* note 7 (stating that the financial information presented in the company report misrepresented its actual financial position); *see also Ex-Jusen Execs*, *supra* note 40 (reporting civil suit brought against former *jusen* executives for failure to fully investigate the financial situation of the borrowers and for failure to secure adequate collateral).

70. *See* Jon Choy, *Japanese Banks Bailing But Bad Loans Still Rising*, JEI Rep. (Japan Econ. Inst. of Am.), May 6, 1994, *available in* LEXIS, News Library, Nwltrs File [hereinafter Choy, *Rising Loans*].

71. *See id.*; *see also BOJ Exec Calls 'Japan Premium' an Overreaction*, Japan Economic Newswire, Oct. 31, 1995, *available in* LEXIS, News Library, Non-US File [hereinafter *Japan Premium*] (relaying the comment of Shigeoki Togo, director of the central bank's international department, that the risk premium which Japanese financial institutions had to pay to borrow in the overseas money market was "unjustified"); Yoko Shibata, *Japan Finally Takes the Plunge*, GLOBAL FIN., Oct. 1996, at 46-47 (noting that the downgrading of some Japanese banks' credit ratings was a result of the Daiwa Bank scandal which took place in September 1995).

72. *Cf.* ANAT BIRD, CAN S&LS SURVIVE? THE EMERGING RECOVERY, RESTRUCTURING & REPOSITIONING OF AMERICA'S S&LS 142 (1993) (explaining how, since the late 1970s, pressures on net interest margins resulted in decreased profitability in the lending businesses of banks and S&Ls in the United States).

73. *See Japan Premium*, *supra* note 71. The premium is the additional return investors require over comparable American or European securities for the additional risk associated with Japanese issuers as a consequence of the bad loan crisis. *See id.* As of November 1997, Japanese banks were paying at least a 20 basis point premium over the London Interbank Offered Rate (LIBOR) (each basis point is one hundredth of a percentage point). *See* Stephanie Strom, *Bailing Out of the Bailout Game*, N.Y. TIMES, Nov. 18, 1997, at D2.

74. *See supra* text accompanying note 9.

likely short-term effect of *jusen* insolvencies is the drying of capital for individuals who wish to purchase homes. With the loss of *jusen* financing for consumers, banks and other financial institutions will experience a barrage of excess demand that will naturally drive lending rates upward.[75]

In the midst of Japan's sluggish economy, some of the nation's largest commercial banks are experiencing strains on their balance sheets as a result of *jusen* insolvencies and rising bad debt.[76] In order to liquidate debt from some of the seven insolvent *jusen* to which they had made loans, these large banks are recalling loans and cutting off favorable treatment for their own borrowers, many of whom are nonbank financial institutions.[77]

The Housing Loan Administration Corporation's (HLAC)[78] aggressive pursuance of debt repayment by *jusen* customers has further impaired the situation for other nonbank financial institutions. Since many of the former customers of *jusen* are also customers of the nonbank entities, money that the HLAC procures from *jusen* customers is money that otherwise would have been available to repay the debts owed to nonbank creditors.[79]

In domino-like fashion, the pressure on nonbank institutions will affect investment in the capital markets since many market speculators obtain capital from nonbank entities.[80] Moreover, companies associated with *jusen* and others with bad loans in such disparate fields as banking, securities, insurance, real estate, and construction are watching their stock values plummet.[81] Because financial institutions are required to keep their capital-to-assets ratios at certain levels, the fall in stock prices encourages them to reduce lending, which further slows economic growth.[82] In addition, since Japanese banks have traditionally used unrealized gains in the stock

75. *See* Choy, *Nonbank Bad Loans*, *supra* note 19.

76. *See id.*

77. *See id.* (citing Nichiei Finance as one of the casualties of the commercial banks' recent tough treatment of nonbank borrowers).

78. The Housing Loan Administration Corporation (HLAC) was established in 1996 to deal with *jusen* insolvencies, including the disposition of their bad debt. *See infra* notes 104-06 and accompanying text.

79. *See* Choy, *Nonbank Bad Loans*, *supra* note 19.

80. *See id.*

81. *See* Sugawara, *supra* note 58.

82. *See* Gillian Tett, *Tokyo Shares Hit by Bankruptcy Fears*, FIN. TIMES (London), Dec. 27, 1997, at 3.

market to offset nonperforming loans, the stock market's plunge has weakened the banks' ability to write off portions of their bad loans.[83]

The Japan Premium associated with Japanese banks' efforts to raise funds in capital markets[84] may continue to rise if action is not taken swiftly to revive the economy and address the bad loan problem through deregulation and innovative structured financing tools.[85] If such action is not taken, the Japanese banks' high cost of borrowing will exacerbate their difficulties paying old debts and funding both new and existing business operations.[86]

C. The Clean-Up

1. *Early Efforts*. In early 1993 the MOF permitted Japanese banks to form the Cooperative Credit Purchasing Company (CCPC) to help manage the nonperforming loans of banks, *jusen*, and other nonbank financial institutions.[87] The company operated much like the Resolution Trust Corporation (RTC), which liquidated real estate collateral and bad loans of U.S. Savings and Loans from 1989-1995.[88] The Japanese banks and *jusen* transferred assets to the CCPC for disposition, but they had to absorb any losses incurred by the

83. *See* Chandler, *supra* note 8; Anthony Rowley, *Japanese Banks' Bad Loans Hit 28 Trillion Yen*, BUS. TIMES (Singapore), Dec. 24, 1997, at 4; Zitner, *supra* note 8.

84. *See supra* notes 71-73 and accompanying text.

85. *See* Sugawara, *supra* note 58. The need to inject confidence into the Japanese financial market appears especially urgent following the spurts of extreme volatility in the Asian stock exchanges in the latter part of 1997 and early 1998. *See, e.g.*, Sara Webb & Silvia Ascarelli, *Global Markets Sink, but U.S. Shares Rebound*, WALL ST. J., Jan. 13, 1998, at C1 (showing that the values of several Asian stock exchanges have plummeted since July of 1997); Shaanthi Katathil, *World Markets: Asian Stocks Continue Their Roller Coaster Ride; More Volatility Likely as Currencies Fall Further*, WALL ST. J., Sept. 5, 1997, at C14; Patrick McGeehan, *Asian Maelstrom Disrupts Smooth Sailing for New Stocks, Bonds*, WALL ST. J., Jan. 2, 1998, at R38.

86. *Cf.* Timothy L. O'Brien, *Debt Ratings of 3 Nations in Asia Cut*, N.Y. TIMES, Dec. 23, 1997, at D5 (explaining that the recent downgrading of the sovereign debt of South Korea, Indonesia and Thailand by Moody's Investors Services, Inc. to "junk" status will have a significant effect on not only those countries' ability to raise money, but also on financial markets throughout Asia).

87. *See* Choy, *Rising Loans*, *supra* note 70.

88. *See generally* OFFICE OF PLANNING, RES., AND STAT., RESOLUTION TRUST CORPORATION, STATISTICAL ABSTRACT: AUG. 1989 – SEPT. 1995, at 1 (1995) (presenting a brief description of RTC's purpose and activities). The RTC, which took over 747 institutions collectively worth approximately $403 billion, was generally responsible for managing, marketing, and selling the assets and liabilities of failed or failing thrifts to pay creditors and insured deposit accounts. *See id.*

CCPC in the disposition of the low-grade assets.[89] These losses were often considerable as the CCPC sold only a fraction of the assets it received.[90]

As part of its 1994 economic stimulus package, the MOF permitted banks to write off losses incurred on loans to nonbank financial institutions,[91] including *jusen*. In effect, this gave *jusen* a "fresh start"[92] to proceed with their traditional lending activities, albeit with a more conservative investment strategy. Of course, the *jusen*'s larger problems stemmed not from money they owed, but from money owed to them. In an effort to reduce the tax burden on struggling *jusen* and parent banks, the MOF permitted banks to establish "special purpose companies" (SPCs) into which their most delinquent loans would be placed in exchange for equity in these new SPCs.[93] By selling these troubled assets to the SPCs at large discounts, the banks could substantially reduce their taxable income.[94]

At least one bank in 1994 took the unusual step of reducing dividends in an effort to improve its balance sheet.[95] The less than one cent dividend reduction appeared more symbolic than financially significant;[96] analysts said the cut was virtually unnoticeable on the

89. *See* Edward J. Park, Comment, *Allowing Japanese Banks to Engage in Securitization: Potential Benefits, Regulatory Obstacles, and Theories for Reform*, 17 U. PA. J. INT'L ECON. L. 723, 730-31 n.43 (1996).

90. *See* Choy, *Rising Loans*, *supra* note 70 (reporting that the CCPC had sold only $154.5 million of a total of $26.4 billion worth of property that comprised its portfolio in its first year).

91. *See id.*

92. Allowing debtors a "fresh start" is one of the fundamental principals underlying United States bankruptcy law. *See* Seth J. Gerson, Note, *Separate Classification of Student Loans in Chapter 13*, 73 WASH. U. L.Q. 269, 269 (1995). This concept recognizes the economic efficiency of debt forgiveness in enabling bankrupt parties to regain their productive capacities through the retention of future earnings. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (referring to the fresh start as a principle of bankruptcy law which gives the debtor "a clear field for future effort, unhampered by the pressure and discouragement of preëxisting [sic] debt").

93. *See id.*

94. *See id.*

95. *See id.* Banks and corporations generally refrain from cutting dividends due to the adverse effects such a measure often has on stock prices and shareholders' perceptions. *See* EUGENE F. BRIGHAM, FUNDAMENTALS OF FINANCIAL MANAGEMENT 693 (5th ed. 1989) (explaining that a corporation's stock price will generally decline if the company makes a dividend reduction or a less-than-expected dividend increase).

96. The bank that reduced its dividend was Hokkaido Takushoku Bank Ltd., Japan's smallest commercial bank. *See* Choy, *Rising Loans*, *supra* note 70. The bank subsequently went into bankruptcy after its huge portfolio of bad loans inhibited the bank's ability to raise short-term funds. *See* Strom, *supra* note 73.

bank's balance sheet.[97] But rating agencies and shareholders may have interpreted the cut as a positive sign that management was moving in the right direction. While dividend cuts may have been marginally successful in creating goodwill with Japanese taxpayers, they could not bring large enough savings to offset the losses from *jusen* loans.

2. *Later Developments*. In June 1996 the Japanese Diet passed two *jusen* liquidation bills.[98] The first bill authorized the use of $6.8 billion of taxpayer money in current cleanup efforts.[99] The second bill stipulated that public money will be used to cover half of the "secondary" losses expected to arise in the future.[100] Most agree that the issue is not whether secondary losses will exist, but rather how large they will be. The MOF stated that if the agencies established to manage *jusen* affairs have deficits after five years, it intends to use public monies to cover the gap.[101] Analysts predict the clean-up will require an additional $12 billion under current market conditions.[102]

At the heart of the government's legislative efforts was the creation of dissolution agencies to tackle the specific sectors of the market affected by bad loans.[103] Of particular interest to the *jusen* was the formation of the Housing Loan Administration Corporation. Modeled after the RTC, the HLAC was established in July 1996 to acquire the assets and liabilities of the seven failed or failing *jusen*.[104] At its inception in October, it acquired $64 billion worth of *jusen* loans and property.[105] Approximately $12 billion of that amount was considered entirely unrecoverable.[106]

97. *See* Choy, *Rising Loans*, *supra* note 70.

98. *See* Kaoruko Aita, *Diet Passes Jusen Bills Without Amendments*, JAPAN TIMES WKLY., June 30, 1996, at 5.

99. The cost per capita of this portion of the clean-up was approximately $50 ($6.8 billion/125 million people). *See id.*

100. *See id.*

101. *See* Choy, *Marshaling Forces*, *supra* note 18.

102. *See* Aita, *supra* note 98.

103. *See Jusen Loan Trade*, *supra* note 5.

104. *See* Tokutei Jyutaku Kinyu Senmon Kaisha no Saiken Saimu no Shori Sokushin Nado ni Kansuru Tokubetsu Sochi Ho [Special Treatment Law Concerning the Expedited Resolution of Debts of Certain Jusen Companies], Law No. 93 of 1996, art. 1, HOREI ZENSHO, 98-102 (June 1996); *see also Japan Forces Bankruptcy in Loan Scandal*, N.Y. TIMES, Nov. 6, 1996, at D7 [hereinafter *Loan Scandal*]. In 1996, the HLAC was also involved in the liquidation of the *jusen* as part of a $6.8 billion clean-up package. *See* Aita, *supra* note 98.

105. *See* Choy, *Marshaling Forces*, *supra* note 18.

106. *See id.*

The Deposit Insurance Corporation (DIC), Japan's version of the FDIC, provided the initial $2 billion to get the HLAC off the ground.[107] This initial support, however, was insufficient, as the Bank of Japan and other large financial institutions were required to make subsequent infusions of capital.[108] Cases that the HLAC deems too difficult are passed on to the DIC.[109] Without the benefit of dramatically improved land prices or innovative structured financings, the director of the HLAC predicted that a complete liquidation of *jusen* assets could take as long as fifteen years.[110]

Given the expected length and magnitude of the *jusen* bad loan clean-up, the Japanese public has responded vociferously to being told it must bail out the private sector for misguided investments during the bubble era. Unlike the S&L "bailout," in which U.S. taxpayers paid to make their fellow citizens whole on their federally insured deposit accounts,[111] Japanese taxpayers will derive few, if any, *direct* economic benefits from the proposed use of their funds. The potential indirect benefits, such as lower mortgage rates, may be too remote to allay the pervasive anger of Japanese taxpayers. Concerned taxpayers have organized to discuss government bailout proposals and to recommend specific legislative action.[112] Japanese citizens take the position that *jusen* and the banking industry were responsible for creating a large portion of the problem and should therefore be forced to pay the majority of the clean-up costs.[113]

II. SECURITIZATION

The foregoing discussion of the *jusen* crisis brings to light the severity and immediacy of Japan's problems. Securitization of the nonperforming assets of *jusen* could provide an alternative source of funding for Japanese banks still mired in *jusen* debt, rejuvenate

107. *See id.*

108. *See US Specialists See Profit in Jusen Loans*, NIKKEI WKLY., Aug. 5, 1996, at 12 [hereinafter *Profit in Jusen Loans*].

109. *See* Choy, *Marshaling Forces*, *supra* note 18.

110. *See id.*

111. The limit on FDIC insurance was $100,000 of principal and accrued interest per account. *See* WHITE, *supra* note 32, at 36.

112. *See* Aritake, *supra* note 11 (discussing the creation of the "Association to Ask Banks to Accept Their Responsibility as Creditors").

113. *See id.* Japanese citizens are also particularly resentful of helping an industry known to have ties with organized crime. *See* Cameron Barr & Yoshiko Matsushita, *Asia Woes Push Japan to Bold Bailout*, CHRISTIAN SCI. MONITOR, Dec. 18, 1997, at 1.

Japan's waning real estate market, and help to build Japan's ABS market. Moreover, with public sentiment strongly opposed to using additional tax revenues to solve the bad loan problem, a securitization program that shifts the burden from the public to the private sector will go far in helping the Japanese government save face and mollify the disgruntled masses.

A. Background

Securitization has been the subject of wide interest in financial and legal communities for nearly thirty years. Like many financial innovations, securitization has taken many forms and has been described in several ways.[114] In a typical securitization, a company transfers a pool of assets to another entity (the Special Purpose Vehicle or SPV),[115] which then issues securities backed by the assets transferred.[116]

Since 1970, U.S. real estate financiers have been "securitizing real estate assets via . . . securities representing ownership of individual shares in a pool of mortgages."[117] Close to 80% of new single family home mortgages are now securitized.[118] The success of this

114. *See, e.g.*, BIRD, *supra* note 72, at 130 (defining securitization as "a process of raising funds through the issuance of marketable securities backed by future cash flow from income producing assets"); Park, *supra* note 89, at 723 ("Securitization may be defined broadly as the repackaging of illiquid assets and their associated cash flows into marketable securities."); Marsha E. Simms, *Asset Securitization*, *in* ASSET-BASED FINANCING: INCLUDING SECURITIZATION AND ACQUISITION FINANCING 1995, at 431, 433 (PLI Commercial Law and Practice Course Handbook Series, No. 708 (1995)) ("Asset securitization is a means of financing a pool of assets."). For additional background on the topic of securitization, see generally 1-2 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES (1991) (writing, in a two-volume treatise, on the fields of structured financing, financial asset pools, and asset-backed securities); SCHWARCZ, STRUCTURED FINANCE, *supra* note 21 (reviewing the fundamental principles of asset securitization in a concise monograph); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991) (analyzing securitization from a theoretical and practical perspective and discussing its increased use around the world).

115. *See* STANDARD & POOR'S, STRUCTURED FINANCE – ASIA 51 (1997) [hereinafter S&P CRITERIA]. The role of the Special Purpose Vehicle (SPV) is "to limit to the greatest extent the likelihood of an insolvency of the issuer." *Id.* Furthermore, "if the issuer is a subsidiary of the seller of the assets, the use of a SPV structure will help to insulate the securitized assets owned by the issuer from the effects of the insolvency of the seller." *Id.*

116. *See* Simms, *supra* note 114, at 433.

117. BIRD, *supra* note 72, at 132. Mortgage-Backed Securities (MBS) are the product of the securitization of pools of mortgage loans. *See* 1 FRANKEL, *supra* note 114, § 2.4.2.

118. *See* BIRD, *supra* note 72, at 132.

market led to new forms of securitization involving assets such as student loans,[119] credit card loans,[120] long distance telephone receivables,[121] automobile loans,[122] and airplane leases.[123] Through innovative securitization techniques, the U.S. market for such securities experienced extraordinary growth.[124]

Outside the United States, however, the growth of securitization has been comparatively slow due to the complex nature of securitization, and restrictive regulatory environments abroad.[125] Exposing foreign corporations and governments to the benefits of securitization may lead to the adoption of U.S.-style tax, bankruptcy, and secured lending laws, which would facilitate asset securitization around the globe.

B. Benefits of Securitization

The benefits of securitization extend across a wide spectrum of constituencies, but this section will focus on the two primary beneficiaries: originators[126] and investors. Securitization benefits originators in primarily three ways: 1) it allows a corporation to lower its cost of capital and reduce risk; 2) it provides an alternative form of financing; and 3) it enables corporations to engage in off-balance

119. *See* 1 FRANKEL, *supra* note 114, § 2.4.3 (describing the first student loan securitization done by "Sallie Mae" in 1973).

120. *See id.* § 2.4.4 n.15 (noting the first securitization of credit card loans structured by Salomon Brothers in 1986).

121. Telefonos de Mexico was one of the first telephone companies in Latin America to issue ABS backed by telephone receivables. *See* Julia Meehan, *Telmex Taps Securitization Market*, PRIVATE PLACEMENT REP., Feb. 11, 1991, at 7.

122. The first car loan securitization was developed by Salomon Brothers in January of 1985. *See* 1 FRANKEL, *supra* note 114, at § 2.4.4 n.13.

123. The first lease-backed securities were offered in 1985 by Comdisco. *See id.* § 2.4.4 n.14.

124. The MBS market alone is well over $900 billion. *See id.* § 2.4.5. The total market of securitized assets is believed to be in excess of $1 trillion. *See* Michael T. Kawachi, *The New Law of Asset Securitization in Japan*, 17 U. PUGET SOUND L. REV. 587, 590 (1994). In 1997, the asset-backed bond market reached a record $185.1 billion in new issuances, which topped 1996's $150.1 billion. Issuances are expected to exceed $215 billion in 1998. *See* Gregory Zuckerman, *Asset-Backed Securities Face a Tricky Year*, WALL ST. J., Jan. 19, 1998, at C1.

125. *See* Park, *supra* note 89, at 727. Japan is an example of a market in which tight regulation has slowed the progress of the securitization and secondary markets for asset-backed securities. *See* Kawachi, *supra* note 124, at 591. *But see* Shenker & Colletta, *supra* note 114, at 1422-23 (arguing that securitization backed by United States assets is growing rapidly abroad). Shenker and Colletta argue that the market forces necessary to support an ABS market in Japan exist, but have been stifled (until recently) by restrictive legal barriers. *See id.* at 1424.

126. *See supra* note 21 (defining originator).

sheet financing. From the perspective of investors, securitization offers increased diversification and liquidity in the ABS market.

Companies that are not regarded as investment grade[127] by rating agencies must typically compensate capital market investors for the use of their funds at relatively high rates. Because these rates greatly exceed those charged by banks and other lending institutions, non-investment grade companies generally forego the vast resources of the public markets. Securitization structures allow originators to obtain lower cost financing in the capital markets through the issuance of securities by the SPV than if the originator had issued its own securities.[128] The lower cost issuance is made possible because the "sale"[129] to the SPV insulates the assets and attendant cash flows from the general risk to the originator.[130] Moreover, the SPV usually has no other assets or obligations other than those transferred to it by

127. Investment grade quality refers to the designation that credit agencies, such as Standard & Poor's or Moody's, give to a corporation to indicate that the corporation's capacity to pay interest timely and repay principal is very good. Bonds rated either "AAA," "AA," "A," or "BBB" by Standard & Poor's are commonly regarded as investment grade. *See* S&P CRITERIA, *supra* note 115, at 11; Schwarcz, *Alchemy*, supra note 21, at 137 n.15.

128. Simms, *supra* note 114, at 433; *accord* S&P CRITERIA, *supra* note 115, at 11 (noting that "[securitization] makes it possible to achieve a higher rating on the debt than the rating of the asset originator," thereby lowering the originator's cost of capital); *see also* Schwarcz, *Alchemy*, *supra* note 21, at 146-51 (arguing that securitization is not a "zero-sum game," rather it allows net benefits to accrue to both originators and investors).

129. The "sale" of assets to the SPV/issuer of the rated securities must be regarded as a "true sale" by one of the major rating agencies in order to decrease the likelihood that a bankruptcy court would deem the transaction a form of secured financing rather than a purchase and sale of assets. *See* S&P CRITERIA, *supra* note 115, at 41-42. The seminal case addressing the distinction between a sale and a secured loan is *Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc.*, 602 F.2d 538, 546 (3d Cir. 1979) (recharacterizing a sale transaction as a secured loan); *see also* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 31 (discussing the problems involved in attempts to harmonize court decisions in this area due to the variety of factors considered in a sale versus secured loan analysis).

130. *See* S&P CRITERIA, *supra* note 115, at 51. In some cases, however, the risks of the originator cannot be completely detached from the SPV. One example is in the franchisor-franchisee context. If the originator/franchisor goes bankrupt, the goodwill associated with the franchise and the subsequent value in the franchise contract will be jeopardized, causing the franchisee/obligor to halt payments to the franchisor. *See infra* note 261 and accompanying text. Another interesting example involves the securitization of loans made by Broken Hill Proprietary Company Ltd. (BHP) to its employees. *See* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE 791 (4th ed. 1997). The loans were made by BHP as an attempt to encourage employee stock participation in order to thwart a hostile take-over. *See id.* at 807. Since employees would only default on the loans if the stock price was low, the receivables (employee loans) transferred to the SPV were, therefore, intimately tied to the health of BHP—the originator.

the originator.[131] After the transfer, the SPV's rating and the securities it issues will be dependent on the credit quality of the receivables, rather than the creditworthiness of the originator.[132]

Lower cost financing is only possible, however, when the overall credit rating of the originator is lower than the rating of the particular assets it has available to securitize.[133] By transferring the higher rated assets to an entity structured in such a way as to make it bankruptcy-remote,[134] the SPV can access the securities markets at a lower cost than the originator would face.

Closely related to an originator's cost of capital is its level of risk. The riskiness of a company's portfolio of assets significantly affects its expected returns and ultimately plays a large role in the company's ability to timely pay its own obligations. The ability of the company to pay its obligations, of course, directly affects the company's credit rating as determined by rating agencies.[135] A company can attempt to reduce the riskiness of its asset portfolio through diversification,[136] by selling a portion of its assets to an SPV and using the cash proceeds to invest in other assets that reduce its overall risk exposure. By reducing its concentration of assets,[137] a

131. *See* S&P CRITERIA, *supra* note 115, at 51 (noting that the SPV must be set up solely to "buy and hold assets for the rated debt").

132. *See id.* at 11; *see also* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 1 ("A potential buyer of the securities . . . looks to the cash flow from the purchased receivables, and not necessarily to the credit of the selling company, for repayment.").

133. *See* S&P CRITERIA, *supra* note 115, at 11.

134. The term "bankruptcy-remote" refers to the state of an SPV or other entity when it is insulated from any claims in bankruptcy against the company (usually the originator) from which the SPV acquired its assets. For an extended discussion of bankruptcy-remoteness, see generally SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 16-27 (highlighting the possible adverse effects of the originator's bankruptcy on the SPV); S&P CRITERIA, *supra* note 115, at 51-52 (describing the characteristics which must be present to achieve bankruptcy-remoteness).

135. *See supra* note 127.

136. Just as effective diversification enables a corporation to reduce the unsystematic (stock-specific) risk of a portfolio of securities, it also enables a company to reduce the asset-specific risks associated with a particular portfolio of assets it holds. For example, if a bank holds a portfolio of loans in which all the debtors are movie studios, it is particularly vulnerable to the health of the movie industry. However, if it were to expand its debtor base to include real estate developers and individual home owners, then the bank's assets (namely, the principal and interest payments on these loans) would be exposed to less risk (assuming the risks of these three classes of debtors are not perfectly positively correlated). *See generally* ROBERT C. RADCLIFFE, INVESTMENT: CONCEPTS, ANALYSIS, STRATEGY 225 (3d ed. 1990) (discussing the concept of portfolio diversification).

137. *See, e.g.*, 1 FRANKEL, *supra* note 114, § 4.4 (illustrating the concept of diversification in the context of bank loan securitizations). For example, "[b]y selling loans and purchasing loan

company's expected cash flows should be less risky; this translates into a higher credit rating and cheaper financing costs. Furthermore, a company can shed some of its low-quality assets to redeploy its assets more profitably.[138]

Asset securitization also creates a new source of funds. S&Ls, for example, rely heavily on demand deposits as a source of funds.[139] As competition from financial and non-depository institutions for such deposits intensifies, the addition of a new funding source significantly increases financial flexibility without impairing traditional means of raising capital.[140] In the recent past, new sources of funds have become especially critical for low-quality borrowers because of the significant quantities of underperforming loans amassed by banks, both in the United States[141] and Japan.

Finally, asset securitization enables a company to engage in off-balance sheet financing.[142] If a corporation were to issue debt securities to investors, it would have to record the debt on its balance sheet.[143] When an originator transfers its assets to a bankruptcy-remote entity for the purpose of issuing ABS, however, the transaction returns cash proceeds to the originator like a debt offering, without the accompanying balance sheet liability.[144]

Off-balance sheet financing is especially significant for companies in highly regulated industries, such as pension funds, which are greatly restrained in their ability to assume high levels of debt.[145] The risk-based capital guidelines established by the 1988

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participations or loan-backed securities, banks [and other nonbank financial institutions] can better diversify their loan portfolios and continue to specialize in lending to particular types of borrowers." *Id.*

138. *See* BIRD, *supra* note 72, at 141.

139. *See id.*

140. *See id.* at 141-42; *see also infra* notes 229-36 and accompanying text (discussing the benefits of securitization to the holders of *jusen* assets).

141. *See, e.g.*, Jeff Bailey, *Continental Bank's Planned Sale Caps Stormy History That Included Bailout*, WALL ST. J., Jan. 31, 1994, at A6 (noting the $1 billion loss suffered by the FDIC because of Continental Bank Co.'s bad loans); Bernard Wysocki, Jr., *Few Economists Expect Deflation in the U.S.*, WALL ST. J., Jan. 15, 1996, at A1 (noting the similarity of Japan's bad loan problem to that of the U.S. in the early 1990s).

142. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 22.

143. *See id.* (citing FINANCIAL ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94, CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES (1987)).

144. *See id.* (discussing methods a company could use to achieve off-balance-sheet treatment for its debt issuances).

145. *See* 1 FRANKEL, *supra* note 114, § 5.10.1.

Basle Accord,[146] of which Japan is a signatory, also greatly restrict a bank's available financing options.[147] The Basle Accord requires, for example, that internationally active banks maintain sufficient levels of capital in relation to their total credit risk exposure.[148] Because securitization transactions can be structured to generate cash without increasing liabilities, the net effect will be an improvement in the originator's overall capital ratio.[149] Therefore, companies in tight regulatory frameworks can focus on investors' needs and their own investment strategies instead of concentrating on compliance with legal limitations.[150]

In addition to allowing companies to secure new and less costly funds through the capital markets and enabling off-balance sheet financing, securitization also benefits investors. Just like corporations that diversify their assets through securitization, investors, too, rely on diversification to manage the risks of their investments.[151] Accordingly, the availability of a wide spectrum of asset-backed securities affords investors more opportunities to

146. The Basle Accord, created under the auspices of the Bank for International Settlements and endorsed by twelve countries (Belgium, Canada, France, West Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, and Luxembourg), applies only to banks undertaking international business. *See* Shenker & Colletta, *supra* note 114, at 1414 & n.234.

147. *See id.* at 1413-16; *cf.* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 71 (noting that under standard U.S. risk-based capital guidelines, only an asset sale, as opposed to a security interest created in the asset, will reduce the institution's capital requirements).

148. *See* Shenker & Colletta, *supra* note 114, at 1415.

149. Since cash from the sale of the receivables is added to the balance sheet without a corresponding increase in liabilities, if the cash proceeds are used to pay off debt, the debt-to-equity ratio decreases (that is, it improves). *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 2 (illustrating the disparate impact the method of financing has on a company's debt-to-equity ratio). A company's credit rating may also improve as a result of the improved capital ratio since the company appears healthier. Moreover, capital guidelines may assign higher risk weightings to repossessed assets or other nonperforming assets. Thus, in choosing among assets, a bank could securitize its higher risk-weighted assets, thereby achieving substantial reductions in its capital requirements. *See* Shenker & Colletta, *supra* note 114, at 1416 n.246; *see also* BIRD, *supra* note 72, at 143-44 (explaining that the securitization and sale of high-risk loans can result in a significantly lower risk-based capital profile of the selling institution since the loans' high-risk capital requirements could be replaced by low-risk Treasury or agency securities).

150. *See* 1 FRANKEL, *supra* note 114, § 5.10.1.

151. Diversification is not limited to institutional investors. Rather, small individual investors, with wide-ranging levels of sophistication, utilize diversification as a useful method of reducing the stock-specific (or "unsystematic") risk in their portfolios. *See* RADCLIFFE, *supra* note 136, at 225.

manage away their overall risk levels[152] and better match their investment horizons with their obligations.[153]

C. Drawbacks of Securitization

While the benefits of asset securitization are numerous, the extremely high transaction costs of structuring and implementing a securitization preclude many issuers from employing this financing tool. The astronomical fees of attorneys, investment bankers, and accountants generally make such transactions cost-effective only if the financing will raise more than $50 million.[154] Even the cost of acquiring computer programs to monitor, analyze, and document the pooled assets can be daunting.[155] In light of the high transaction costs, a company with alternative *attractive* sources of funds should think twice about whether securitization of its assets will net any value.

Drawbacks also exist for investors. As with any debt security, the issuer may default on the fixed payment or become insolvent, thereby causing the debt to become nearly worthless. Default risk should be relatively low for most ABS issuances, however, because of the protections built into securitization structures. For example, most structures will satisfy the criteria which make the SPV bankruptcy-remote, thereby protecting the underlying pool of assets in the event of an originator's default.[156] In addition, most rated ABS transactions will involve some form of credit enhancement;[157] this further ensures that investors will get paid in the event of an SPV or originator default.

The risks inherent in the underlying assets pose more of a threat to ABS investors than do the risks of an originator default.

152. *See* 1 FRANKEL, *supra* note 114, § 5.10.2.

153. *See* BIRD, *supra* note 72, at 143 (describing the use of securitization to "match fund assets with equal maturity liabilities").

154. *See* Schwarcz, *Alchemy*, *supra* note 21, at 139. One commentator believes the threshold is closer to $75 million. *See* BIRD, *supra* note 72, at 159.

155. *See* BIRD, *supra* note 72, at 145.

156. *See supra* note 134 and accompanying text.

157. "Credit enhancement" refers to the guarantee by a highly rated third-party to repay all or part of a security's principal in the event of an issuer default. For a discussion of credit enhancement, see 1 FRANKEL, *supra* note 114, § 5.11.3 (discussing third-party guarantees); SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 13-15. The term "liquidity facility," conversely, refers to a third-party guarantee of timely payment of a security's accrued interest and principal in the event of an issuer delay. *See id.* at 5, 13-15. Both of these forms of enhancement may constitute a significant portion of the cost of a securitization structure. *See infra* text accompanying note 220.

Securitization of a company's assets shifts much of the risk associated with those assets to the investors of the securities.[158] These risks include prepayment,[159] obligor default, and changes in market conditions that affect the value of the receivables.[160] For example, when a bank securitizes receivables that are prepayable, such as mortgage loans, there is a substantial risk that the obligors will prepay the loans if interest rates fall. Although collection should be sufficient to pay off the principal amount of the debt, the security holders may have bargained for a specific rate of interest over an extended period.[161] Unstable conditions in the economy also increase the risk of fluctuations in the value of the collateral.[162] While these risks are serious, SPVs can generally reduce the risk to investors by effectively diversifying the pools of assets underlying the securities and utilizing credit or liquidity enhancement.[163]

Investors may also incur high information costs analyzing the quality of the asset pools in which they invest.[164] Since asset pool structures differ markedly from deal to deal, investors cannot rely upon historical default rates to accurately predict the risk of the current pool.[165] Moreover, unstable economic conditions make predictions based on past experiences wholly unreliable. Therefore, in order to assess the true risk associated with particular securities, investors must obtain information from other costly sources, such as originators, insurance companies, and rating agencies.[166]

Given the wide disparity in the depth of the secondary markets in which ABS are traded, investors may also incur substantial liquidity risks.[167] An investor in a less active ABS market, such as

158. *See* 1 FRANKEL, *supra* note 114, § 4.5.

159. *See id.* § 5.11.5 (explaining that borrowers are likely to repay their loans when interest rates fall).

160. While investors assume the risk of loss on the acquired interest in the receivables, the credit enhancement that accompanies most rated securitization transactions lowers this risk. *See* Park, *supra* note 89, at 732.

161. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 10 n.10.

162. *See* 1 FRANKEL, *supra* note 114, § 5.11.1.

163. *See Japan Asset-Backed Securities to Boost Corp. Funding*: *Report*, CAPITAL MARKET REP. (Dow Jones & Co.), Feb. 1, 1996, *available in* WL-ALLNEWS PLUS; Park, *supra* note 89, at 732.

164. *See* 1 FRANKEL, *supra* note 114, § 5.11.2.

165. *See id.*

166. *See id.*

167. Liquidity may be defined as "[t]he amount of time required to convert an asset into cash or pay a liability." 2 GLENN G. MUNN ET AL., 2 ENCYCLOPEDIA OF BANKING & FINANCE 660 (libr. ed., 9th ed. rev. 1993). "Liquidity risk," then, encompasses the risk that the holder of

music royalty-backed securities,[168] may experience more difficulty entering or exiting the market than if he were trading in mortgage-backed securities.

Finally, the holders of ABS face risks associated with dynamic legal environments. Laws relating to tax, bankruptcy, and exchange controls will greatly affect both the originator's ability to structure a securitization transaction as well as the investors' ability to reap the benefits of their investments.

D. Securitization in Japan

1. *Background and Development.* After the tremendous success of mortgage and other asset-backed securities in the United States, markets around the world have begun to experiment with this financing tool.[169] Japanese government-sponsored committees began researching the field of asset securitization in 1988.[170] Two years later, the Securities and Exchange Council, an organization sponsored by the MOF, published its first report dealing with "the legal and institutional improvements necessary to cope with asset securitization" in Japan.[171] Also in 1990, the first "quasi-securitization" in Japan was accomplished by the nation's railway monopoly, Japan Railways.[172]

In 1992, a research group sponsored by the Ministry of International Trade and Industry (MITI) published its own study on securitization.[173] Following that study, the Japanese Diet enacted the Law Regarding Regulation of the Business Concerning Specified

the ABS will not be able to readily convert her security into cash via market transactions or that she will be able to liquidate her holdings, but only at a substantial loss.

168. This niche of ABS may become more active in the near future, however, due to the recent interest in the first-ever music royalty-backed securities offering, issued by David Bowie in February of 1997. *See Wall Street Backs Bowie with $55 Million*, CHI. SUN-TIMES, Feb. 4, 1997, at 4; *see also* David Usborne, *Money Is the New Rock'n'Roll as the Stars Take Bowie's Lead*, INDEPENDENT (London), Oct. 1, 1997, at 5 (projecting that the entertainment industry will be the next big market tapped by ABS innovators).

169. *See* Shenker & Colletta, *supra* note 114, at 1421-26.

170. *See* Kawachi, *supra* note 124, at 591.

171. *Id.*

172. *See* Shenker & Colletta, *supra* note 114, at 1425 n.289. The transaction involved the issuance of fifteen-year convertible bonds by an asset management company set up by the rail monopoly. *See id.* The debt was convertible to fractional interests in the underlying assets of the loans. *See id.*

173. *See* Kawachi, *supra* note 124, at 591.

Claims (the Specified Claims Law or SCL), which permitted limited securitization of leases and credit card claims beginning in June 1993.[174] Far from giving nonbank entities carte blanche to restructure their balance sheets through innovative financing, the legislation required lease and credit card companies to obtain MITI approval before pooling and securitizing their assets, and MOF approval prior to the ABS issuance.[175] Nonetheless, the new legislation provided the impetus for the first securitizations involving Japanese assets. In the vanguard was Nippon Shinpan, a consumer finance corporation which in November of 1994 issued ¥15 billion (then $153 million) worth of auto loan-backed securities in the U.S.[176] One month later, Japan Leasing, a leading lessor of industrial and computer equipment in Japan, issued bonds in the U.S. backed by a pool of its lease receivables.[177]

In response to the growth of securitization abroad and the increasing rate at which Japanese companies were issuing ABS offshore, in May of 1995 the MOF proposed a liberalization of the financial markets that permitted financial institutions and certain credit corporations to begin issuing asset-backed securities in Japan commencing in 1996.[178] This liberalization was intended to encourage financial institutions to create domestic special purpose corporations (*yugen kaisha*), which would acquire assets and issue securities.[179]

With the ball in motion, companies with valuable assets began to take advantage of the MOF's liberalization to issue asset-backed securities in Japan. After a successful first effort in the United States, Nippon Shinpan completed its second securitization in March of 1996. This time, however, the ¥50 billion (then $473 million) worth

174. *See id.* at 591 n.33 (citing Tokutei Saiken Nado ni Kakaru Jigyo ni Kansuru Horitsu [Law Regarding Regulation of the Business Concerning Specified Claims], Law No. 77 of 1992). For a discussion of the provisions of this law, see *id.* at 591-604.

175. *See* Park, *supra* note 89, at 736.

176. *See Japan's Nippon Shinpan Re Enters Market*, ASSET SALES REP., Mar. 4, 1996, at 1, *available in* LEXIS, News Library, Nwltrs File.

177. *See* Laura Lorber, *First Japanese Asset-Backed Deal to Debut in US This Week*, BONDWEEK, Dec. 19, 1994, at 1. Japan Leasing completed a second deal worth ¥16 billion ($133 million) in May of 1996. *See Citi, JLS Complete Japanese ABCP Deal*, ASSET SALES REP., May 20, 1996, at 2, *available in* LEXIS, News library, Newltr File [hereinafter *Citibank Deal*] (quoting the head of Citicorp's Japanese securitization department: "These transactions reflect the growth of the securitization market in Japan and the increasing recognition by Japanese issuers of the corporate finance benefits associated with securitization.").

178. *See* Christopher P. Wells & Richard D. Thieme, *Japan: Legal Report*, INT'L FIN. L. REV 43, 44 (Oct. 1995) (discussing the deregulation of ABS issuances in Japan).

179. *See id.* at 44-45.

of auto loan-backed securities were floated in the Tokyo market.[180] Standard & Poor's and Moody's each gave the offering its highest rating,[181] reflecting their utmost confidence in the SPV's ability to pay principal and interest on the securities.

A major development occurred in November of 1996, when Prime Minister Hashimoto initiated a plan for massive reformation of Japan's financial system.[182] The "Big Bang,"[183] as it is called in Japan, will attempt to create a "free, fair, and global" Japanese economy by the year 2001.[184] The swift resolution of the bad loan problem facing Japanese banking institutions is a top priority of this initiative.[185] Toward this end, the Big Bang proposed several measures that will facilitate the securitization of bank assets. These measures included a legal provision that permits the creation of Special Purpose Companies,[186] which are the primary conduits of ABS,[187] and an authorization for banks to sell security investment trust certificates (another common vehicle for ABS) without going through subsidiaries.[188] There have been several notable ABS transactions in 1997, indicating that the "Big Bang" is having a significant effect on Japan's financial markets.[189] Moreover, the MOF and other govern-

180. *See Japan's Nippon Shinpan Re Enters Market, supra* note 176.

181. *See id.* (reporting that both Standard & Poor's and Moody's gave the securities a triple-A rating).

182. *See About the Financial System Reform (The Japanese Version of the Big Bang),* (visited Nov. 20, 1997) <http://www.mof.go.jp/english/big-bang/ebb1.htm>.

183. Although the "Big Bang" originally referred to the astrological theory that the universe was created out of a gigantic explosion, the term has subsequently been used to refer to the massive top-down economic reform of the United Kingdom's stock exchange, initiated in 1986. *See The Originator of the Big Bang, England* (visited Nov. 26, 1997) <http://www.mof.go.jp/english/big-bang/ebb24.htm>.

184. *Id.*

185. *See id.*

186. *See* Anthony Rowley, *Japan Govt Plans to Allow Securitisation of Land*, BUS. TIMES (Singapore), Mar. 25, 1997, Asia, at 10 (reporting on plans to allow the establishment of SPCs that would take over foreclosed property and issue bonds to finance that takeover). The term SPC has the same meaning as the term SPV. The MOF's previous failure to allow SPVs in Japan had been one of the main impediments to the growth of Japan's ABS market. *See* Shenker & Colletta, *supra* note 114, at 1424.

187. *See Financial System Reform—Toward the Early Achievement of Reform* (June 13, 1997) (visited Nov. 26, 1997) <http://www.mof.go.jp/english/big-bang/ebb32.htm>.

188. *See id.*

189. *See* S&P CRITERIA, *supra* note 115, at 9 tbl.1. While such transactions appear promising for the future of Japan's ABS market, a strong secondary market in which to trade the securities may take time to develop. *See Top Asian Lessors, supra* note 30; *see also MOF to Consider Securitization of Bad Loans by Brokers*, Japan Economic Newswire, Mar. 22, 1996, *available in* LEXIS, News Library, Non-US File [hereinafter *MOF Considers Securitization*]

ment entities have now openly endorsed the securitization of land as a viable means for dealing with some of the nonperforming debt burdening the banking industry.[190]

The increasing presence of commercial paper, securitized commercial and residential real estate mortgages, residential mortgage trusts, bank loan securitizations, and other sophisticated finance structures in Japan strongly corroborate reports of economic deregulation.[191] Although the markets for these products are currently less developed than their counterparts in the United

(noting some of the harsh short-term effects on banks and the real estate industry as a result of bad loan disposals). The recent failures of Hokkaido Takushoku Bank, one of Japan's commercial banks, and Yamaichi Securities Co., one of Japan's "Big Four" securities firms, are also evidence that free market measures of the Big Bang are transforming Japan's banking industry into a more Darwinian financial landscape. *See* Strom, *supra* note 73; *see also* Peter Landers, *Men and Boys: Big Bang Separates Strong from the Weak in Japan*, FAR E. ECON. REV., Sep. 25, 1997, at 153 (discussing the weakening of Japan's "convoy" system, in which the "large banks move together like trucks in a convoy").

190. *See Jusen Loan Trade, supra* note 5; Rowley, *supra* note 186; *The Comprehensive Package to Stimulate Real Estate Liquidity* (visited Nov. 26, 1997) <http://www.mof.go.jp/english/big-bang/ebb29.htm>. A government Tax Commission recently suggested that the government promote securitization of land assets via tax reforms in order to help institutions relieve their bad loan problems. *See Panel Suggests Cut in Corporate Tax to 'U.S. Level'*, Japan Economic Newswire, Dec. 16, 1997, *available in* LEXIS, News Library, Non-US File. Yasunari Ohtsuka, manager of the financial engineering division of Fuji Bank, expects Fuji Bank to market financial products that include bad loans, but fears that presently "there are still some hurdles to expanding securitization of bad loans." Kazunari Yokota, *Banks Turning to Securitization to Improve Ratios*, NIKKEI WKLY. (Japan), Oct. 6, 1997, at 1 (quoting Yasunari Ohtsuka).

191. Several recent reports submitted by the Japanese government also evidence Japan's renewed campaign for economic and financial reform. *See* Coordination Bureau, Economic Planning Agency, Japanese Government, *Economic Outlook and Basic Policy Stance on Economic Management for FY 1997*, *in* THE JAPANESE ECONOMY: RECENT TRENDS AND OUTLOOK 1997, at 25-30 (1997); *see also* Coordination Bureau, Economic Planning Agency, Japanese Government, *Structural Reform in Six Areas*, *in* THE JAPANESE ECONOMY: RECENT TRENDS AND OUTLOOK 1997, *supra,* at 50, 57-60 (stating government's intention to "implement drastic and comprehensive reform . . . by the end of the 20th century"). Moreover, prominent individuals both inside and outside of Japan have openly endorsed further deregulation of Japan's financial system and the development of securitization. *See, e.g.*, *Corrigan Urges Japanese Banks' Fast Disposal of Bad Loans,* Japan Economic Newswire, Sept. 24, 1996, *available in* LEXIS, News Library, Non-US File (quoting the chairman of Goldman, Sachs, and Co., who urged the Japanese banks to promote securitization and liquidation of problem loans to improve their health); *Top Asian Lessors*, *supra* note 30 (pushing for the development of asset securitization by the Bank of Japan); *Top Banker Pledges to Recover Credibility in Banks*, Japan Economic Newswire, July 24, 1996, *available in* LEXIS, News Library, Non-US File (quoting Shunsaku Hashimoto, Chairman of the Federation of Bankers Association of Japan, who endorsed credit securitization options and further deregulation). The head of the HLAC, Kohei Nakabo, appears ready to pursue securitization of some of the assets the HLAC acquired from the failed *jusen*. *See Agencies Charged with Recovering Bad Loans Need to Move Aggressively*, NIKKEI WKLY., Sept. 9, 1996, at 6.

States,[192] these economic and financial trends signal the coming of a full-fledged ABS market in Japan. The *jusen* bad loan crisis presents an opportunity to further develop Japan's ABS market by securitizing the nonperforming loans and collateral formerly held by *jusen*.[193]

2. *Potential Obstacles to Securitization in Japan*. While issuers, investors, and taxpayers may be prepared to embrace an ABS market in Japan, the combination of restrictive securities laws, inter-ministerial conflicts, and cultural barriers may impede realization of that goal. This section discusses some of the factors that have traditionally impeded the full development of an ABS market in Japan; with the Big Bang still in a formative stage, it is unclear which of these barriers will be eliminated and which will remain.

The Japanese securities industry is regulated by the Securities and Exchange Law (SEL) of 1948.[194] Article 65 of the SEL maintains a separation of commercial banking and investment banking activities, as the 1933 Glass-Steagall Act does in the United States;[195] thus only securities firms may sell ABS in Japan.[196] This restriction has prevented Japanese banks from restructuring their balance sheets by issuing loan or other asset-backed securities. The 1992 Financial

192. *See* Kawachi, *supra* note 124, at 591; *see also* Yokota, *supra* note 190 ("Securitization of bank loans is far more advanced in the U.S. than in Japan.")

193. Hoping to take advantage of the MOF's desire to encourage a market in Japan's bad debt, two foreign banks have formed alliances with major Japanese banks. Bankers Trust New York teamed up with Nippon Credit Bank and Swiss Bank formed an alliance with the Long-Term Credit Bank of Japan. *See* Bremner et al., *supra* note 8, at 122.

194. *See* Park, *supra* note 89, at 740 n.119 (citing Shoken Torihiki Ho [Securities and Exchange Law], Law No. 25 of 1948 [hereinafter SEL], *reprinted in* Japanese Laws Relating to Securities and Exchange & Foreign Securities Dealer, IV Law Bull. (Series Japan (EHS) MA 51 (1987) [hereinafter Japanese Laws]).

195. *See* Banking (Glass-Steagall) Act of 1933, ch. 89, §§ 5, 11(a), 20-21, 32, 48 Stat. 162, 181, 188-89, 194 (codified as amended at 12 U.S.C. §§ 78, 335, 374a, 377-78). While the Glass-Steagall Act continues to statutorily separate commercial banking and investment banking, in late 1996 the Federal Reserve relaxed some of the regulations enforcing that separation. *See* Anita Raghavan, *Walls Fall Down: Bankers Trust Agrees to Buy Alex, Brown as Merger Blitz Grows*, WALL ST. J., Apr. 7, 1997, at A1. Specifically, the Federal Reserve raised the cap on banks' corporate underwriting from 10% to 25% of their securities affiliates' revenues. *See id.* This relaxation allowed many banks to merge with investment banks, including the $1.7 billion merger of Bankers Trust New York Corp. with investment bank Alex, Brown Inc. *See id.* Some industry observers have commented that the transaction sounded the "death-knell" of the Glass-Steagall Act. *See* Edmund M. Remondino, *Glass-Steagall: Dead at Last?*, CONN. L. TRIB., Dec. 29, 1997, *available in* LEXIS, Legnew Library, Clt file.

196. *See* SEL, *supra* note 194, art. 65, *reprinted in* Japanese Laws, *supra* note 194, at 42.

Reform Law[197] attempted to reduce the severity of Article 65 by allowing banks to form subsidiaries that could deal in securities, but restrictions on some of the activities of the subsidiaries deflated their appeal.[198]

On its face, the SEL's definition of a "security"[199] excluded most types of instruments typically issued in a securitization. Therefore, with limited exceptions, ABS could not be issued or traded on the securities exchanges in Japan.[200] The Financial Reform Law of 1992, however, "expanded the definition of security to include commercial paper, certificates of deposit issued outside of Japan, foreign securitized credit card receivables, and mortgage-backed trust certificates."[201] A 1995 agreement between the Japanese and United States governments proposed that asset-backed financial products be incorporated into the definition of a "security" under the SEL.[202] This agreement should facilitate securitization of Japanese assets in the future.

Conflicts between MITI and the MOF, the two most powerful economic ministries in Japan, have also been a significant factor in

197. *See* Park, *supra* note 89, at 740 n.126 (citing Kinyu Seido Oyobi Shoken Torihiki Seido no Kaikaku no Tame no Kankei Horitsu no Seibito ni Kansuru Horitsu [Law to Provide for the Reform of the Financial and Securities Trading Systems], Law No. 87 of 1992 [hereinafter Financial Reform Law]).

198. *See id.* at 740-41 (observing that the Japanese restrictions separated "those with the ability to market and [to] sell ABS, the securities firms, from those with the greatest need to issue ABS, the banks").

199. *See* SEL, *supra* note 194, art. 2, § 1, *reprinted in* Japanese Laws, *supra* note 194, at 2 (enumerating the only instruments defined as "securities" in Japan).

> The SEL defines a security as one of the following items: (1) government debt security; (2) municipal debt security; (3) debt security issued under a special statute by a corporation; (4) secured or unsecured debt security issued by a business corporation; (5) stock issued by a corporation organized under a special statute; (6) stock and warrant issued by a business corporation; (7) beneficial certificate under a securities investment trust or loan trust; (8) a promissory note issued by a corporation for funding for its business, as designated by MOF regulation; (9) security or certificate issued by a foreign government or foreign corporation that has the characteristics of the security or certificate listed in (1)-(7) above; (10) a security or certificate issued by a foreign corporation that represents a beneficiary trust interest or similar interest in loans by a bank or any other lending institution, as designated by MOF regulation; and (11) any other security or certificate designated by cabinet order as necessary to ensure the public interest or investor protection, with consideration given to its transferability and other conditions.

Kawachi, *supra* note 124, at 593 n.37.

200. *See* Park, *supra* note 89, at 742-43.

201. *Id.* at 743; *see also supra* note 197.

202. *See* Yoshiki Shimada & Shinji Itoh, *Japanese Asset Securitization: A Guide for Practitioners*, 38 HARV. INT'L L.J. 171, 195 (1997).

slowing financial and legal reform regarding securitization.[203] Under the MITI's watchful eye, leasing and financing companies have sought to lessen their dependence on traditional credit financing by securitizing leases and other receivables.[204] The MOF, on the other hand, is charged with regulating financial institutions, such as banks, securities firms, and insurance companies.[205] Each seeks to keep the emerging field of securitization within its own jurisdiction.[206] Because securitization transactions often involve the services of investment bankers in structuring and placing the asset-backed issues, and since these banks are within the domain of the MOF, it is difficult for nonbanks to structure deals so that they are not subject to MOF regulation.[207]

One of the essential components to any securitization transaction is the ability of the originator to transfer its assets to an independent entity in order to separate the risk of the originator from the risk of the assets. In the United States, such transfers and sales of assets are facilitated by the fact that the Uniform Commercial Code (UCC) does not explicitly require originators to provide notice to obligors. In contrast, secured lending laws in Japan require originators to give notice to obligors before transferring or assigning any assets.[208] Moreover, the typical debtor-creditor relationship in Japan often involves a significant amount of personal contact nurtured over a period of years.[209] Japanese banks, therefore, may be reluctant to sell off their loans for fear of alienating their corporate clients.[210]

203. *See* Park, *supra* note 89, at 741-42.

204. *See id*. at 741.

205. *See id*.

206. *See id.*

207. *See id*.

208. *See id.* at 738; Shimada & Itoh, *supra* note 202, at 179, 192 (referring to requirements under Article 467 of the Japanese Civil Code and the Money Lenders Laws).

209. *See supra* notes 51-53 and accompanying text.

210. *See* Park, *supra* note 89, at 738. Shimada & Itoh discuss two responses to this problem employed by practitioners in Japan. *See* Shimada & Itoh, *supra* note 202, at 180. One response is to elicit the obligor's advance consent to future transfers at the origination of the receivable. *See id.* Alternatively, "several written consents may be bound together in a manner that minimizes the risk that they will be separated from each other, and the *kakutei hizuke* [certified date] certificate may be affixed to the cover page of this bound group of consents or notices." *Id.* Moreover, the Ministry of Justice of Japan is reported to be considering the implementation of a perfection system similar to the UCC system of filing financing statements in the United States. *See id.* at 183-84.

Another problem with securitizing the assets of a bank or corporation is the issue of "setoff." Setoff in its most basic form is the cancellation of cross demands.[211] For example, a debt owed by A to B may be satisfied by simultaneously discharging a debt owed to A from B. In the United States, banks can use account deposits to setoff overdue loans made to their depositors.[212] When securitized assets are used to setoff claims of creditors, the SPV may face substantial risks of delay or default on its payments to investors. Even a true sale of assets to the SPV does not preclude creditors from setting off their claims against the securitized assets.[213] One method of insulating the assets of the SPV from the risk of setoff is to procure a waiver from the bank in which the SPV's proceeds are kept and, as appropriate, from third party obligors who may also have claims against the SPV's assets.[214] Similarly, the prospect that *jusen* or other nonperforming assets transferred to an SPV would be used to setoff claims by creditors is a risk that could greatly complicate the pricing, placement, and pay-off of "*jusen* securities."

Finally, some lawyers and bankers have expressed concern over the nontransparency in Japanese financial reporting.[215] Since Japanese accounting rules allow wide flexibility in the manner in which financial conditions are presented, financial statements of banks and corporations may not provide sufficient disclosure of information pertinent to investment decisions and to securities valuation. Within the context of asset securitization, however, nontransparency only poses a problem when meaningful due diligence cannot be performed directly on the assets to be securitized. For example, if the securitized assets are real estate properties and related loans on which investors can do their own due diligence and cash flow analysis, the misleading disclosures are largely irrelevant. In contrast, if a bank desires to securitize loans made to a corporation

211. *See* Stephen L. Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 WM. & MARY L. REV. 51, 51 (1988). For a discussion of the history of the setoff doctrine see William H. Loyd, *The Development of Set-Off*, 64 U. PA. L. REV. 541 (1916).

212. *See* Sepinuck, *supra* note 211, at 54. In the bankruptcy context, setoff effectively permits a creditor to recover a greater portion of his claim and in a more timely fashion than other creditors. *See id.* at 56 n.20. Such setoff of claims is only permitted, however, to the extent that the debtor incurred the debt within 90 days of filing for bankruptcy. *See* Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103, 2146 (1994).

213. Interview with Steven L. Schwarcz, Professor of Law at Duke University School of Law, in Durham, N.C. (Jan. 15, 1998).

214. *Id*.

215. Those interviewed requested that their comments be kept anonymous.

about which there is no meaningful disclosure, then lack of transparency would be a problem since investors must rely on the company to provide the information necessary for valuation. Thus, the nature of the assets securitized will determine the significance of the deficient disclosure.

III. SECURITIZATION OF *JUSEN* ASSETS[216]

The two foremost concerns of financial institutions plagued by nonperforming loans are the removal of these bad loans from their balance sheets and the procurement of new capital. Securitization of *jusen* assets, namely loan and real estate portfolios, would partially address[217] both of these concerns; it would also help to bolster the real estate market, to stabilize the stock market, and to popularize asset securitization in Japan. Although these last macroeconomic benefits should not impact a particular institution's decision to securitize its assets, they should inform the Japanese government's decision to endorse and facilitate securitization through continued financial reform and monetary support. This section discusses the desirability and feasibility of securitizing *jusen* assets.

A. Securitization is a Desirable Solution: A Cost-Benefit Analysis

1. *Costs of Securitizing Jusen Assets*. Securitization should be attempted only after an extensive comparison has been made between the costs and benefits of securitized and alternative sources of funding.[218] The most significant costs associated with securitization

216. This section is a theoretical analysis of the financial and legal viability and desirability of securitizing the nonperforming debt of former *jusen*. For a more extensive discussion of specific issues involved in Japanese securitization from the perspective of two practitioners in the field, see Shimada & Itoh, *supra* note 202.

217. As a senior analyst at Moody's points out: "Securitization should not be viewed as a cure for current bad loans. Instead, it is a partial solution . . . ." *See Moody's Upbeat on Japan's Real-Estate Securitization*, Japan Economic Newswire, Aug. 12, 1997, *available in* LEXIS, News Library, Non-US File (quoting Ben Bystrom, Senior Analyst, Moody's Investors Service).

218. *See* Schwarcz, *Alchemy*, *supra* note 21, at 154. Professor Schwarcz advises that, "[a] company considering securitization should compare (i) the expected differential between interest payable on non-securitized financing and interest payable on securities issued by an applicable SPV with (ii) the expected difference in transaction costs between the alternative funding options." *Id.* at 137-38. Schwarcz also points out that if the securitization transaction will be achieved "off-balance sheet," then a strict debt-to-debt comparison may understate the benefits involved because of the inherent advantages in such off-balance sheet structures. *See id.* at 138 n.18.

are those paid for letters of credit, surety bonds, or other such credit enhancements required to assure investors that the ABS will pay the commensurate return. Fees for such credit enhancements take between 75 to 150 basis points (bp)[219] from the originator's expected return.[220] Underwriter's fees and annual reporting and accounting costs are also substantial, reducing the originator's pie by 40-100bp and 20-35bp respectively.[221] In addition, when the securities are placed in the private market, investors typically require a liquidity premium on the order of 10-20bp.[222]

In addition to these direct costs, there are indirect expenses associated with each securitization structure.[223] For example, Professor Steven Schwarcz notes that there are costs associated with the "true sale" requirement necessary to achieve bankruptcy-remoteness.[224] These costs result from the originator[225] having to "limit, if not forego, its right to the residual value of the receivables sold to the SPV . . . . Such 'overcollateralization' is needed to assure investors and providers of liquidity and credit enhancement that they will not suffer losses from delayed collection or defaults."[226] The issuers must weigh these transaction-specific costs with the proposed benefits of securitization. Significantly, some of these costs may be mitigated if issuers are able to generate economies of scale from their enormous portfolios of securitizable debt.

2. *Benefits of Securitizing Jusen Assets.* Financial institutions currently have few ways to eliminate nonperforming loans from their balance sheets:[227] They either may choose to write them off, sell them to one of the dissolution agencies, or sell/auction them off at deep discounts to large institutions that specialize in distressed assets.[228]

219. A basis point represents one-hundredth of a percentage point. For example, a yield rise from 8.25% to 9.00% represents a 75 basis point increase. *See* RADCLIFFE, *supra* note 136, at 31.

220. *See* BIRD, *supra* note 72, at 159.

221. *See id.* at 160-61.

222. *See id.* at 160.

223. *See* Schwarcz, *Alchemy*, *supra* note 21, at 141-42.

224. *See id.* at 147.

225. In this case, the originator would be the banks or dissolution agencies that hold the former *jusen* assets.

226. Schwarcz, *Alchemy*, *supra* note 21, at 141.

227. *See* Park, *supra* note 89, at 729 n.43.

228. The RTC was quite successful in selling large blocks of real estate formerly held by S&Ls to funds which developed the properties and re-sold them at handsome profits. *See infra*

Securitization provides an alternative. It creates the ability to sell off large blocks of bad loans to a trust or to an SPV. With the proceeds from the sale, the originator can pay down its liabilities and improve its financial ratios.[229]

The effect of reducing nonperforming debt is twofold. First, with stronger capital-to-assets ratios, originators would be able to secure a lower cost of financing.[230] Securitizing their bad loans would enable banks to tap the capital markets and thus operate with a more attractive cost of capital. Second, the potential for off-balance sheet financing through an appropriate securitization structure would facilitate compliance with the capital requirements of the Basle Accord.[231]

Securitization may also provide originators with a new source of capital. Presently, Japanese banks are scaling back loans due to their fear that they may lack the funds to pay depositors.[232] As new Big Bang measures become effective in April of 1998, banks with low capital adequacy will be forced to either strengthen their balance sheets by injecting new capital or close down their operations.[233] These stricter regulatory standards may create a "capital crunch" in Japan's banking industry. The situation may be further complicated for those crunched for capital by the fact that lending practices in Japan are often the product of years of relationship building.[234] As a result, clients of collapsed lenders may face the near impossible task of securing credit from new private lenders.[235] Since the capital markets rely more heavily on economics than they do on relationships, Japanese institutions can utilize securitization to tap

notes 276-77 and accompanying text. Banks that engage in such discounted sales lose the potential upside from effective development of their assets through means such as securitization.

229. *See* Yokota, *supra* note 190 (reporting that international banks are securitizing loans to keep capital-to-asset ratios above 8%, as required by the Bank for International Settlements); *see also* Park, *supra* note 89, at 729 (discussing the benefits of improved financial ratios). Furthermore, if structured properly, the banks or other originators could reap the benefits of excess cashflows on the receivables transferred to the SPV, which they could not do if the assets were sold directly to institutions.

230. *See* Park, *supra* note 89, at 729.

231. *See supra* notes 146-50 and accompanying text.

232. *See* Steven Pearlstein, *In Tokyo's Case, Crisis Sprang from an Excess of Riches*, WASH. POST, Dec. 17, 1997, at C15.

233. *See* Abrahams & Tett, *supra* note 16 (quoting a senior Japanese government official: "What we are seeing is not just a credit crunch, but a capital crunch.").

234. *See* Chandler, *supra* note 8.

235. *See id*.

the public sector, supplying them with the capital necessary to operate in Japan's new, more demanding, financial milieu.[236]

In addition to these microeconomic benefits for originators, a large-scale securitization of nonperforming assets would also inject confidence and renew interest in Japan's real estate and stock markets. The real estate market would benefit as special purpose companies purchase real estate collateral on defaulted loans from creditors, causing prices to ride up the demand curve. The SPCs would fund these purchases by issuing trust certificates or bonds to capital market investors, who would get paid by the income stream from the properties.[237] This new capital flowing into the market through SPC or Real Estate Investment Trust (REIT)[238] conduits would increase liquidity in the market, which would also serve to stimulate prices.[239] The management expertise and efficiency of large companies is another reason given for increases in property values following large real estate acquisitions.[240]

236. In efforts to improve its capital position, Sumitomo Bank, Japan's second largest bank, recently made a $1.8 billion preferred-stock offering which was quickly consumed by investors eager to earn the 9.4% yield. *See* Gregory Zuckerman & Craig Karmin, *U.S. Investors Scoop Up Offer by Sumitomo*, WALL ST. J., Feb. 9, 1998, at C1. Other Japanese banks are expected to follow Sumitomo's lead. *See id.* One New York practitioner involved in the Japanese market believes that these visits to the capital markets suggest that "Japanese banks do not want the strings attached to accepting government money, and are willing to pay 400 bp [basis points] over U.S. Treasuries for that luxury." Telephone Interview with Paul D. Leake, Partner at Weil, Gotshal & Manges LLP in New York (Feb. 6, 1998). In addition, some Japanese banks are securitizing performing loans through collateralized loan obligation (CLO) transactions in the international capital markets. *Id.*

237. *See* Howard C. Gelbtuch & Takashi Kataoka, *Real Estate Securitization Gaining Favor in France & Japan*, REAL ESTATE ISSUES, Aug. 1997, at 1, 1-7 (describing the benefits of the SPC vehicle).

238. REITs, or Real Estate Investment Trusts, were formed in the 1960s as "vehicles to hold or finance real estate and to offer tax advantages to investors." Richard Marchitelli & James R. MacCrate, *REITS and the Private Market: Are Comparisons Meaningful?*, REAL ESTATE ISSUES, Aug. 1996, at 7, 7-10 (explaining the origin and benefits of the REIT structure). The growth of the REIT market has been phenomenal in the United States and is expected to continue. *See* J. Linn Allen, *Zell Leads, Rides Real Estate Revolution*, CHI. TRIB., Sept. 7, 1997, at N1.

239. *See Top Lender Survey*, National Real Estate Investor, Oct. 1997, *available in* LEXIS, News Library, Mags File (quoting Ethan Penner of Nomura Asset Capital, who maintains that liquidity in the United States real estate market improved as a result of increased capital market use of real-estate backed securities); *MOF Considers Securitization*, *supra* note 189; *cf.* 1 FRANKEL, *supra* note 114, § 3.3.3 (noting that "[l]iquidity can entice investors to trade rather than invest long-term for income.").

240. *See* Allen, *supra* note 237; Steve Bailey & Steve Syre, *Beacon Deal Seen Reflecting Shift in Boston Real Estate, Industry*, BOSTON GLOBE, Sept. 16, 1997, at D1 ("Scale will allow economies of operation and provide the kind of liquidity that will attract new investors.").

The stock market should also benefit from increases in ABS issuances backed by former *jusen* assets.[241] One theory is that the securitization of low-quality assets would obviate the need for banks to issue new shares to strengthen their capital base.[242] New issues result in the dilution of existing shares, causing stock prices to fall. Furthermore, Japan's credit crunch has forced some companies to sell portions of their equity holdings,[243] producing downward pressure on stock prices. However, if banks issue ABS securities instead of selling stocks to earn the capital required by MOF and Basle Accord guidelines then the stock market should experience less downward pressure on prices.

B. Securitization of Jusen Assets is Feasible: Criteria Necessary For Securitization

If a cost-benefit analysis reveals that securitization would be a promising financial alternative for *jusen* assets, the next step is to analyze the feasibility of such a structure. The factors that are crucial to this inquiry fall into three basic categories: 1) the quality of the originator; 2) the quality of the obligors; and 3) the nature of the assets.

1. *Quality of the Originator.* Since ABS are usually rated triple-A with an ability to withstand as much as a five-fold rise in default rates, investors have historically been most concerned with the collateral behind and the structure of a deal.[244] However, there are a number of reasons why the quality of the originator should be given equal if not greater weight in an investor's analysis.[245]

The originator or issuer of the ABS plays a key role in servicing the asset pools. Accordingly, the investors rely heavily on the originator of the securitized assets to channel the cash flows from the assets to the SPV or directly to the security holders. The issuer must convince the ABS market as well as the rating agencies of its commitment and ability to make the assets perform. Since debt

241. *See MOF Considers Securitization*, *supra* note 189 (claiming that asset securitization would be a stabilizing force in the Japanese stock market).

242. *See id.*

243. *See* Abrahams & Tett, *supra* note 16.

244. *See* Gregory Zuckerman, *Asset-Backed Securities Face New Scrutiny*, WALL ST. J., Feb. 18, 1997, at C25.

245. *See id.* (discussing investors' changing emphasis on the issuers of ABS in light of recent issuer defaults).

collection and enforcement requires a unique set of skills not possessed by corporations generally,[246] the originator may increase the attractiveness of its issuance by transferring the servicing function to reliable specialists.[247] Moreover, investors can also rely on back-up servicers to perform such functions in the case of an issuer bankruptcy.[248]

The primary holders of *jusen* debt are large Japanese banks and government-sponsored dissolution agencies. In order to gain the confidence of ABS investors, these entities should join forces with those who specialize in the restructuring and servicing of distressed debt and properties. Nippon Credit Bank has already formed such a partnership with Bankers Trust.[249] An alternative to such joint ventures would be to simply sell off large blocks of the debt to experienced ABS players. Goldman, Sachs, for example, is expected to spend as much as $4 billion to purchase distressed loans from troubled banks.[250]

2. *Quality of the Obligors.* An obligor's delay in making payments (slow pay) or its default on payments (no pay)[251] will directly affect investors' return on their investments. Consequently, the pool must contain a sufficiently large number of assets to create a statistically high probability that the payments will be made on time even if some obligors delay or default.[252] If the required pool size cannot be created statistically to assure payment, liquidity facilities[253] may be used to provide the "fill-in funds" to the issuer to meet its obligations in the event of slow pay. In effect, these facilities make short-term loans to the issuer; however, if simple delays turn into

246. *See id.*

247. *See, e.g.*, Delilah Brummet Flaum & George A. Pecoulas, *Securitizing Health Care Receivables: Legal and Structural Issues*, COM. LENDING REV., Spring 1995, at 45, 49 (explaining the importance of a "sound reputation and an established track record" in selecting a servicer of receivables in the health care industry).

248. *See* Zuckerman, *supra* note 243, at C25 (quoting Tracy van Eck, head of ABS Research at Bear Stearns, "If a bank goes under, a backup servicer is . . . readily available.").

249. *See supra* note 193.

250. *See* Oliver August & Janet Bush, *Goldman Has $4 bn to Spend on Japanese Loan Portfolios*, TIMES (London), Dec. 24, 1997, at 15; Patrick McGeehan, *Japan's Bad Loans Attract Interest of Goldman Sachs*, WALL ST. J., Dec. 23, 1997, at C15 (reporting that the investment bank recently completed major purchases of loans from Bank of Tokyo-Mitsubishi Ltd. and Sumitomo Bank Ltd.).

251. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 5.

252. *See id.*

253. *See supra* note 157.

larger-than-expected defaults, the ultimate risk is borne by the issuer or credit enhancement facility.[254]

With billions of dollars of commercial and private loans, effective pooling of the former *jusen* assets should minimize the effects of obligor defaults, assuring timely payments to investors. Nevertheless, further defaults will occur. The impact of default by these obligors can be reduced by securitizing the nonperforming loans of a large number of borrowers.[255] In creating pools, the issuer should also consider the financial health of the obligors and any defenses to payment that they may claim. After analyzing the various risk levels and payment histories of the particular obligors, specialists can form pools that provide predictable cash flows and attractive risk-reward levels. As long as the return increases with the level of risk, there will be investors willing to buy the ABS.[256]

More significant than the actual (default or slow pay) risk is the ability to accurately predict what the risk will be. If the risk can be accurately predicted, then pricing[257] and credit enhancement can be properly managed and the assets successfully securitized.[258] Government guarantees[259] could also be employed to insulate investors from any substantial devaluation of the bad loan-backed securities that may result from unexpectedly large defaults or changes in the market. The government may look to the long-term benefits of a liquid ABS market, the invigoration of real estate prices, and a final resolution of the *jusen* crisis as justification for absorbing a portion of the costs of these safeguards.

3. *Nature of the Assets*. In order to entice investors to purchase asset-backed securities, issuers must assure investors that principal

254. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 5.

255. *Cf. supra* notes 136-37 and accompanying text (discussing the risk-reducing benefits of diversification).

256. Implicit here is the assumption that sufficient credit enhancement as well as increased institutional transparency reform would be required before investors would purchase such securities.

257. For a discussion of ABS pricing, see SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 6.

258. *See* Schwarcz, *Alchemy*, *supra* note 21, at 135.

259. Such guarantees would act as subsidies to the ABS market; over the long-run, these subsidies are likely to be far less costly than an entirely government-supported clean-up of the bad loan problem. In reality, however, the government would likely not agree to guarantee specific issuances of "*jusen* securities" unless it had more control over the underlying assets. Such control could be accomplished through government purchases of bank shares. *But see supra* note 236.

and interest will be paid at some predictable rate. This predictability is important to investors from the standpoint of return on investment; it is also necessary to price the securities accurately. If securities are offered without an established time of repayment, their proper value cannot be assessed and investors will not purchase them.

The predictability of cash flows is a function of the type or nature of the receivables and market conditions. If, for example, a credit card company extends credit to a cardholder for a consumer purchase, the obligor will have few defenses to payment since the originator has fully performed its part of the bargain.[260] However, consider the problem if the originator is a franchisor that contracts with a franchisee to provide franchise rights and products in exchange for a fee. In the event of a franchisor bankruptcy, the franchisee will be less likely to continue making payments since the originator will be unable to continue its part of the bargain.[261] Therefore, transactions involving a continuing relationship between the originator and the obligor are more likely to result in defaulting obligors than when the transaction is a separate and completed one such as the credit card scenario.

The *jusen* bad loans are more analogous to the credit card scenario than to the franchise contract. Of the total loans outstanding by the defunct *jusen*, approximately 82% represented loans to businesses and 18% were loans to individuals for private home purchases.[262] Since *jusen* had performed their part of the loan contract in extending credit, defenses to payment should be substantially reduced. Despite the fact that approximately 75% of the total *jusen* lending has been deemed nonperforming,[263] banks and others holding *jusen* debt can still profit by developing or liquidating the collateral securing these loans. By securitizing that collateral or the loans themselves, the holders of these assets will avoid having to wait for the anticipated resurrection of the Japanese real estate

260. This is true irrespective of the solvency of the credit card company.

261. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 21, at 7-9 (discussing the predictability of future payment in executory contracts such as franchise agreements). The bargain includes more than merely the supply of products and services. The essential value supplied by the franchisor to the franchisee is the goodwill associated with the franchise name. When the franchisor files for bankruptcy it spoils the name, goodwill, and, therefore, the value of the franchisee's contract.

262. *See* Aritake, *supra* note 11.

263. *See id.*

market, and will instead reap an earlier harvest with the proceeds of their ABS issuances.

The location of the real estate securing *jusen* bad loans is also a significant factor in the success of this securitization effort. The majority of the collateral is located in Tokyo, Osaka, and other large cities.[264] With the Japanese economy gaining strength, the properties located in these major cities will be the first to benefit from increased liquidity and development in the real estate market. Signs of deregulation coupled with improvement in key economic factors will also facilitate the successful securitization of *jusen* assets.

One obstacle to securitizing the real estate portfolios of *jusen* is that much of the collateral is small and scattered, making the properties less attractive to commercial developers.[265] Moreover, the track record for such asset conversion is not very good. For example, of the $124 billion worth of bad loans transferred to the Cooperative Credit Purchasing Company in 1993, only $5.4 billion had been sold by September 1996.[266] And in the 17 months before it became the Resolution Collection Bank, Tokyo Kyodou collected only about 10% of the $800 million worth of loans inherited from three failed institutions.[267] Such uncertainty will decrease the predictability of the securities payments and may inhibit ABS sales in the short term. A March 1997 government package easing land regulations, however, may significantly aid in the efforts by banks and others to develop these scattered tracts of land.[268]

Investors and guarantors will also require extensive asset-specific information before making large investments in ABS, especially when such securities are backed by presently nonperforming assets.[269] In an effort to begin providing such

264. *See Steps Eyed to Sell Land Held as Bad Loan Collateral*, Japan Economic Newswire, Oct. 15, 1996, *available in* LEXIS, News Library, Non-US File.

265. *See* Choy, *Marshaling Forces*, *supra* note 18; *Profit in Jusen Loans*, *supra* note 108.

266. *See* Choy, *Marshaling Forces*, *supra* note 18.

267. *See id.*

268. *See Property Liquidity Package Released*, Jiji Press Ticker Serv., Mar. 31, 1997, *available in* LEXIS, News Library, News File.

269. Disclosure of all information relevant to an investment decision is particularly crucial in Japan due to the historic absence of securities laws designed to protect investors from securities fraud. Interview with James D. Cox, Professor of Law at Duke University School of Law, in Durham, N.C. (Feb. 3, 1998). United States securities laws, by comparison, are premised on the notion of "full disclosure" in order to protect investors. *See* JAMES D. COX ET AL., SECURITIES REGULATION 45-60 (1991) (describing American disclosure requirements); *see also Moody's Upbeat on Japan's Real-Estate Securitization*, *supra* note 217 (discussing the

necessary information, the government has said it will create a database on collateral property held by banks.[270] This should precipitate further data collection and comparisons in the real estate market as well as aid originators in their attempts to securitize land and loan assets. Lowering the cost of acquiring such information will facilitate securitization deals.[271] Since the pools of *jusen* assets contain large numbers of small loans, information costs about the quality of the assets will be relatively high.[272] Therefore, in order to price and securitize these pools more easily, the loan contracts may need to be rewritten using more standard and simple terms to provide investors a predictable assessment of the securities' cash flow and maturities.[273]

Market conditions will also affect the precise rate at which investors are paid their principal and interest. For example, if interest rates substantially decline, mortgagees will probably refinance their mortgages at lower rates. This refinancing would jeopardize the future stream of cash flows to the banks at the previously higher interest levels. Substantial prepayments in a pool of mortgages may greatly affect the timing and predictability of payments.[274] However, with interest rates currently at rock-bottom in Japan, there is virtually no risk of prepayment of mortgage loans made by *jusen*.

C. Securitized Jusen Loans Would Be Attractive to Investors

1. *Return, Customization and Diversification.* Opponents of *jusen* securitization have remarked that the Japanese capital markets may lack investors willing to buy debt backed by nonperforming loans.[275] While securities backed by nonperforming assets may be

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need for disclosure of accurate information to allow the market to monitor the underlying real estate assets).

270. *See Property Liquidity Package Released*, *supra* note 268.

271. *See* 1 FRANKEL, *supra* note 114, § 2.7.

272. *See id.* (making this point about pooled loans generally).

273. *See id.* (discussing the benefits of "standard and simple terms"). This, however, could be administratively and economically unfeasible considering the thousands of contracts that may need to be re-written in any given pool of loans. Prospectively, lawyers should write new loan contracts with an eye toward future sales and securitizations.

274. *See supra* text accompanying notes 159-61.

275. *See, e.g.*, *Profit in Jusen Loans*, *supra* note 108 (quoting Yuri Okina, a senior economist at the Japan Research Institute, arguing that securitized debt backed by nonperforming loans will not find an interested audience in Japan).

risky, the reward factor associated with deeply discounted bad loans, coupled with aggressive development of the collateral, could be enormous. The investment philosophy of buying assets during deep depressions in value was widely embraced after the Savings and Loan debacle.[276] The Resolution Trust Corporation (RTC) was enormously successful at selling large blocks of real estate loans and collateral at bargain prices, which entrepreneurial investors turned into big gains.[277] Similarly, *jusen* securitization would offer investors an opportunity to profit as the real estate backing their securities appreciates as a result of development programs and an overall upswing in the Japanese economy.

As the price of the ABS will be crucial to enticing purchasers, part of the originator's cost savings in structuring the ABS must be passed on to investors in the form of higher interest rates. The appropriate level of interest for the debt instrument will often be a function of the credit rating that it receives.[278] While the major United States rating agencies are frequently employed to rate cross-border or exclusively foreign-based transactions,[279] there are also Japanese agencies which rate ABS transactions in Japan.[280]

In rating an ABS offering, the agencies will need to consider a variety of country-specific, deal-specific, and collateral-specific factors.[281] Such factors may include the bankruptcy-remoteness of the issuer, the likelihood of substantive consolidation, property title issues, the priority of the mortgage securing the indebtedness, liquidity structures, sovereign risk, and the relative strength of the currency (if applicable).[282] The ABS investors will therefore rely upon such ratings to determine the minimum return they will accept.

276. Real estate development of distressed properties was commonly practiced following the S&L debacle by so-called "vulture funds" which allied institutional investors with real-estate specialists. *See id.*

277. *See id.*

278. *See* Schwarcz, *Alchemy*, *supra* note 21, at 136. On rating agencies generally, see Shenker & Colletta, *supra* note 114, at 1399-403; *see also* BIRD, *supra* note 72, at 140 (listing factors considered by rating agencies).

279. *See* S&P CRITERIA, *supra* note 115, at 2, 9 tbl.1. In the twelve-month period ending June 30, 1997, S&P rated 49 asset-backed transactions in Japan and 14 among Thailand, Indonesia, Korea, and Hong Kong. *See id.*

280. Nippon Investors Service and the Japan Bond Research Institute are two domestic rating bodies. *See* Yokota, *supra* note 190 (noting the involvement of Nippon Investors Service in a Fall 1997 securitization by Fuji Bank).

281. *See* S&P CRITERIA, *supra* note 115, at 11 (describing the process by which S&P rates structured finance transactions).

282. *See* Shenker & Colletta, *supra* note 114, at 1402.

In addition to the credit rating's importance in pricing the ABS, it also serves to offer investors confidence in the securities' ability to pay the stated interest rate and to repay principal.

Customized transaction structures also provide a way for creative lawyers and corporations to entice investors.[283] For example, originators with nonperforming assets could make bad loan-linked securities more attractive by offering senior and subordinated debt securities to better match the various risk tolerances of target investors. In this way, more risk-averse investors could purchase senior ABS with lower interest rates and lower risk, while the risk-preferring investors could purchase riskier subordinated issues with the prospect of higher returns. Allocating the risk of asset pools would allow originators to increase potential investors and expand their capital base. Moreover, the recent media attention to Japan's bad loan crisis and the government's efforts to structure a "bailout" will also help to legitimize *jusen* securities.

Securities backed by *jusen* assets may have appeal beyond Japanese investors. American or European investors looking to diversify their portfolios by investing in Japan may be attracted to *jusen* loan-backed instruments because they present a cheaper or safer investment opportunity than the notoriously expensive, volatile, and historically restricted (to foreigners) Japanese stock market.[284] Moreover, as Japan's market for all kinds of ABS expands, foreign corporations that have exhausted their domestic fundraising and liquidity capabilities will benefit from accessing the enormous resources of the Japanese capital markets to raise needed cash and to improve liquidity.[285]

283. *Cf. id.* at 1403 n.167.

> A securitized structure is generally more flexible than other financing structures both at origination, because of the ability to adapt the structure to the particular needs of the borrower and its asset, . . . and in administration, because "bright line" tests established for ongoing operations . . . provide both objective, predictable standards for the borrower and administratively workable standards for the securitized lenders.

Id.

284. The success of the Japanese warrant program from 1987-1989, which gave foreign investors the opportunity to invest in the Japanese stock market through purchases of Euroyen securities with attached warrants, may suggest that Japanese ABS would find a wide reception outside of Japan. Interview with Stephen Wallenstein, Visiting Professor at Duke University School of Law, in Durham, N.C. (Feb. 6, 1998).

285. *See* Shenker & Colletta, *supra* note 114, at 1424.

2. *Investor Liquidity*.[286] Free transferability is one of the cornerstones of capital markets. Investors purchase securities with the knowledge that a ready market exists in which to exchange holdings for cash at will. The ability to enter or exit the market freely is generally termed "liquidity;" it greatly affects the pricing of securities in the market.[287] Liquidity is driven by volume. That is, the greater the number of players, the greater likelihood that a potential buyer or seller exists to take the other side of a position.

The Japanese financial system has a history of being illiquid.[288] This illiquidity has generally been the result of tight regulatory restrictions designed to channel virtually all capital transactions through banks or securities companies, ensuring governmental control of all cash flows in and out of Japan.[289] Moreover, due to its recent inception, the ABS market in Japan does not yet possess a high volume of buyers and sellers. This, however, should not deter originators from seeking to issue ABS, nor should it deter prospective investors from purchasing them, the reason being that a large-scale securitization program could itself create the necessary liquidity needed to drive the market.

Liquidity could be created in two ways. First, if Japanese banks, dissolution agencies and nonbank entities issue a substantial number of ABS backed by bad loans and market them to institutional investors, the large volume of these buyers and sellers could create an instantly liquid market for "*jusen* securities."[290] Second, launching a large-scale securitization effort with the support of the government's ministries, such as the MOF and MITI, and employing the financial muscle of large Japanese financial institutions, would signal to the

286. This section addresses investor-liquidity as opposed to issuer-liquidity. Investor liquidity relates to an investor's ability to buy or sell in an open market, whereas issuer liquidity relates to an issuer's ability to generate cash flows sufficient to meet its obligations on the issued securities.

287. *See* RADCLIFFE, *supra* note 136, at 193-97 (discussing the premium associated with relatively illiquid investments); *see also supra* note 167 (defining liquidity).

288. *See* Wells & Thieme, *supra* note 178, at 44 ("[T]he relative illiquid nature of [Japan's] financial system [is] the result of historic regulatory restrictions on private capital investments.").

289. *See id.*

290. While liquidity for the bad loan-backed securities should not be a problem in the short-term, if structures employed in *jusen* securitizations fail to produce the required cash flows to fund the securities over the long-term, the market may experience a shortage of investors willing to buy the securities from those wishing to exit.

world the legal and financial viability of this financial tool in Japan.[291] Foreign issuers of ABS would also benefit from having a market in which to bring their securities, maximizing the global liquidity of their issues.[292]

CONCLUSION

For financial institutions struggling through the current bad loan crisis in Japan, the securitization of nonperforming loans could help to create new and cheaper sources of funds, improve capital-to-asset ratios and credit ratings, and enhance flexibility in dealing with capital requirements. As Japan begins to implement its Big Bang deregulatory measures, more strategic Japanese-foreign alliances are likely to arise and bring with them plans for securitizing Japanese assets, including those of former *jusen*. With the recent flurry of securitization deals in Japan and the rest of Asia, the appetite for innovative financial products is tremendous. Investors would embrace a large-scale ABS issuance that provides both substantial liquidity and new avenues for portfolio diversification in the Japanese capital markets. Rather than calling on Japanese taxpayers to fund the bad loan clean-up, the government should encourage the securitization of nonperforming loans and collateral through legal and regulatory changes.

291. *See Profit in Jusen Loans*, *supra* note 108 (suggesting that a securitization plan for *jusen* debt would help popularize such financing in Japan).

292. *See* Park, *supra* note 89, at 734-35.