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Case Study: Facilitating Securitization in Japan

The Japan Securities Dealers Association (JSDA) announced in March 2009 that its members "shall establish procedures to properly communicate information to their customers, who are investors, regarding details and risks (including risk not communicated in the credit rating) of the underlying assets, etc. of the securitized products they distribute (or following the distribution of said securitized products).[1] This new policy was established as a means to sure-up the sagging securitization market in Japan following the global financial crisis by boosting investor confidence in the quality of the assets the underlay securitized products.

Securitization began in Japan in 1990s as part of the global trend to manage credit risk and tap new sources of investment funds. Growth, however, was initially stymied by a lack of legal framework for securitization. First, perfecting the transfer of assets in Japan was costly. "Perfection of transferring loans and receivable requires notarial certification of individual loans and receivables one by one."[2] A second cost issue was the expense of establishing an SPV. Under Japanese laws the SVP had to maintain a 10 million yen capitalization, have a minimum of three directors and retain an auditor.[3] A third issue was the multiple regulatory bodies that controlled different aspects of the securitization transaction. Perhaps most basic was the question of whether an asset-backed security was "security" under Japanese law.

During the 1990s, a series of laws were enacted in Japan that facilitated the issuance of asset-backed securities. In 1992, the Japanese Securities and Exchange Law (SEL) was amended to allow for the Ministry of Finance to designate asset-backed securities as a security for legal purposes in Japan. By 1997, the "security" designation had been given to residential mortgage trusts and "expanded to include a beneficial interest of at trust in which the trust property is any loan from any financial institution."[4] Also, in 1992 the Ministry of International Trade and Industry (MITI) enacted The Law for the Regulation of Business Relating to Specified Claims (MITI Law) which allowed for the perfection of a transfer without individual notice and approval. The MITI Law thus removed a major barrier to those who wanted to securitize lease receivables, auto receivable and installment credit card obligations. Analogous changes were made to Japan's Civil Code "simplifying the procedures for the perfection of transfers of debt obligations, creating

[1] Working Group on Distribution of Securitized Products, Final Report, March 17, 2009, Japan Securities Dealers Association, Executive Summary.
[2] Securitization in Japan, Hideki Kanda, Duke Journal of Comparative and International Law, Vol. 8:359. p.359
[3] Id. p. 360.
[4] Id. 370.

new opportunities for the securitization of a new range of asset classes."[5] Legislation also addressed the high costs of creating and operating SPVs. The SPC Law reduced the minimum capitalization and number of directors. The law also "specifically allows the SPV to issue ABS…"[6], acquire a variety of different assets and conferred special tax advantages to the entity.

As the legal framework for securitization in Japan was clarified and strengthened, the number and value of securitization transactions increased. Securitized assets in Japan grew from 30 billion yen in 1994[7] to approximately 11 trillion yen in 2006.[8] Japan dominated the Asian securitization market. (Exhibit 1) The assets that have been securitized consist of commercial and residential real estate as well as other asset-backed securities including credit card receivables and other consumer loans. In the early years of securitization in Japan, the technique was used to remove non-performing loans from large Japanese banks' balance sheets. Interest in using securitization in other areas expanded after 2000. In 2002 for example, there was an effort to securitize the revenue stream from a patent for voice synthesizing equipment, a concept encouraged by the government.[9] From 2003 to 2007 residential mortgage-backed securities accounted for the majority of new issues. (Exhibit 2) As shown in Exhibit 3, more than 90 percent of issues have been rated A or higher. The vast majority were AAA rated.

Securitization in Japan has grown rapidly from its inception in 1994; however, in the context of the global market for securitized assets Japan's volume was very small. (See Exhibit 4) Moreover, in Japan itself the value of securitization issues annually was less than 2 percent of bank loans outstanding.[10] In 1998, when the legal barriers to securitization in Japan were being eliminated and the use of securitization was growing rapidly in the United States and Europe, there were expectations that Japan "[t]he world's second largest economy should soon become the second largest asset backed market."[11] The Bank of Japan reiterated the rationale for a robust securitization market in Japan in 2004 stating: "A vibrant securitization market should also encourage a better balancing of risks and returns in financial transactions including lending. This should invigorate Japanese financial institutions as new kinds of business and frontiers in financial technology begin to emerge. Furthermore, the stability of the Japanese financial system should be enhanced with the development of financial intermediary channels that can complement lending by financial institutions."[12]

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[5] Japanese Consumer Loan Securitization: A New Asst Class, Nathoo et al, www.hk-lawyer.com/1999-8/aug99-26.htm

[6] New Developments in Japanese Asset Securitization: Open the Floodgates, Roy B. True, p. 5 of 14.

[7] Development and Current Issues of Japanese Securitization Market, Bank of Japan, Yoshitake Hattori, p.9.

[8] Author estimations from: Nomura Research Institute, Lakyara, Vol. 45, November 2008, Current State of Japan's Securitization Market, Exhibit 1.

[9] Japan moves towards first patent securitization, 22 sep 2002, Managing Intellectual Property, Weekly News.

[10] Hattori, p.8.

[11] True p.1.

[12] Report on the Workshop on Securitization (Summary), Bank of Japan, May 21, 2004, p.1.

Despite the strong rationale for growth in asset-backed securities market, Japan's securitization remained comparatively small. Several reasons explain securitization's small market share. Culture plays an important role. On the consumer side, saving rates in Japan have been among this highest in the world. At the same time, Japanese consumers utilize very little credit for purchases. The combination of these factors limits the need for securitization of credit card debt or even receivables. On the originator side, banks dominate Japanese financial intermediation. Historically the banks have been very conservative, especially after the housing bubble bust in 1989 leading to non-performing loan problems. Beyond the cultural issues, legal and regulatory barriers to securitization still remain. Concerns about what constitutes a true sale, an essential ingredient for bankruptcy remoteness, remain. "The term "true sale" has various meanings, but in a legal context in Japan, it means that even if bankruptcy proceedings…have commenced against the originator…the transfer will not be regarded by an insolvency trustee…as part of the originators estate subject to the proceeding."[13] While there is no absolute test of a true sale, the following factors aid the determination: "the intentions of the parties; the reasonableness of the purchase price; whether the transferor has a right to the asset transferred…; whether the transferor bears the risk of the asset transferred…; whether or not the transferor has a right to repurchase the asset transferred; whether the transfer of the asset is perfected; and whether or not the assets are offset from the transferor's account book."[14] Another bankruptcy remoteness related issue is the risk of the servicer becoming insolvent. The SPV relies on a service provider to collect its obligations. "under Japanese law, cash is considered to be the property of the person who possesses it. If the servicer goes bankrupt while possessing collected money, this money will be subject to the insolvency proceedings of the servicer and may be used to satisfy the obligations of the servicer."[15] Frequent transfer of funds from the servicer to the SPV can mitigate, but not eliminate, this risk. Moreover, until 2005 perfection of transfer of some assets required notification and consent of the individual obligors.

The barriers to securitization enumerated above ironically and fortunately keep the Japanese financial system from falling prey to the subprime crisis. In April of 2008 after the failure of the investment bank Bear Stearns in the United States and the run on Northern Rock Bank in the United Kingdom, Nomura Research Institute reported "the subprime crisis does not appear to be having much impact on Japan's securitization market."[16] The report noted that "…spreads have widened, reflecting investor caution" and went on to suggest "[t]he market is offering advantageous opportunities for investors able to capitalize on them with sophisticated risk management."[17] Although the volume of securitization activity in the first quarter of 2008 was 30% below a year earlier, "Japan's securitization market [was]n't as severely damaged as overseas markets, and there were no reports of mortgage loan defaults spiking, nor, any deterioration in the performance of

[13] Bankruptcy Remoteness and Securitization in Japan, Hajime Ueno and Takuya Shimizu, Asia law Japan Review, January 2007, p.14.
[14] Id. p.15.
[15] Securitization in Japan, Hirokazu Ina, Jones Day, Global Securitization and Structured finance 2008, P. 112.
[16] Lakyara, vol. 35, 10 April 2008, Japanese securitization market trends amid the subprime crisis, Nomura Research Institute Ltd.
[17] Id.

securitization in transactions exposed to residential mortgage loans."[18] By the end of 2008 it was clear that the volume of securitized transactions would fall below 2007 levels and perhaps remain at depressed levels for some time but Japan avoided the systemic failure of the financial system seen in the United States and Europe.

Japan was able to avoid the securitization crisis not only because the volume of securitized transactions were comparably small but also because the structure of securitization in Japan. The majority of securitization transactions in Japan were single-layer. The re-securitization of securitized products (e.g. squared and cubed collateralized debt obligations) that was prevalent in the United States and led to an understatement of risk was rare in Japan. The level of standardization of securitization in Japan also mitigated risk. Rather than rely on standards, the relationships between the parties were more based on contractual terms. On the investor side of the transaction, in Japan banks and insurers were the primary customers for the asset-backed securities. Given the conservative nature of these institutions, they were more interested in securities that offered moderate risk with moderate return "not the highly leveraged speculative products that wreaked havoc in the US."[19] Consequently, subprime and securitization related losses of the big Japanese banks have been small. The attitude toward securitization remained largely positive in Japan even as the global financial crisis deepened. Exhibit 4 shows that a majority of investors had not changed their policies toward securitization products even at the end of 2008.

While the direct negative impact of the collapse of the securitization market in Japan has been small, the global financial crisis is taking a toll on the Japanese economy. Japan's GDP fell an annualized 12.7 percent in the fourth quarter of 2008, the worst decline in the country since the 1970s oil crisis as the country's exports plummeted.[20] The IMF has forecast that Japan's economy will shrink more than 5 percent in 2009.[21] The bank of Japan and the private sector recognize the positive role that securitization can play in supporting the Japanese economy. As the financial crisis was deepening in 2008, the Bank of Japan wrote about the importance of securitization: "Basically, these securitized products are being utilized by investors as an investment choice for effectively controlling the risk and return on an investment portfolio. They also could contribute to improving the efficiency of financial markets by providing economic entities requiring funds with a new means of fund-raising."[22]

The Bank identified that the critical requirement for a more robust securitization market was improved ability to identify and manage risk - of the assets, structure of the product, price, marketability, etc. Managing risk in turn requires information. To this end Bank

[18] Japan securitization issuance down 30% this year, Market Watch, April 18, 2008.
[19] Lakyara, Current state of Japan's securitization market, Vol. 45 (28 November 2008), Nomura Research Institute.
[20] News Analysis: Japan dragged into deeper recession amid global financial meltdown, Qi Wie, www.xinhuanet.com.
[21] IMF Now Says Japan's GDP Will Fall Nearly 6% in 2009, Darrel Whitten, March 23, 2009, istockanalyst.com.
[22] Securitized-Product Investment: Risk management Perspectives, Bank of Japan, Repro tans and Research Papers, March 2008, p.1.

working with the other stakeholders encouraged the formation of the Working Group on Distributions of Securitized Products. The Japan Securities Dealers Association (JSDA) as both a trade organization and self-regulatory body took a leadership role establishing rules for information disclosure. The rules cover both public offerings and private placements as well as primary and secondary issues. The information provided is not proscribed. Rather, there is flexibility given the range of securitization structures used in Japan; although, the Standardized Reporting Information Package is a guide.

Whether the actions taken by the financial sector in Japan will bolster the securitization market is yet to be seen. But, in June 2009, the New York Times ran a story with the headline: Securitized Debt Makes a Comeback in Japan. "Securitized debt may have been behind the mortgage crisis, but it still has it uses. Takefuji, one the largest consumer lenders in Japan, aims to raise as much as 100 billion yen, or $1 billion, by securitizing its loan book and borrowing from other institutions…"[23]

[23] Securitized Debt Makes a Comeback in Japan, New York Times, June 3, 2009.

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Discussion Questions

Legal

- How do the requirements for “true sale” in Japan compare with the United States?
- How do the requirements for “perfection” in Japan compare with the United States?
- What regulatory approach could Japan use to mitigate the risk of servicers bankruptcy?
- How does the structure and management of SPVs in Japan compare with those in the United States?

Business

- Is self-regulation of discloser an effective tool for reducing information risk in Japan? In the United States?
- Will transparency of risk alone restore the securitization market in Japan?
- What assets are more attractive to securitize in Japan? How does the list compare with the most attractive assets in the United States?

Public Policy

- What is the role of securitization in a risk-averse financial environment?
- What is the rationale for the Bank of Japan’s efforts to support the securitization market?
- How can the Japanese Securities Dealers Association balance its trade and regulatory functions?