# ALLOWING JAPANESE BANKS TO ENGAGE IN SECURITIZATION: POTENTIAL BENEFITS, REGULATORY OBSTACLES, AND THEORIES FOR REFORM

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## 1. INTRODUCTION

The United States has experienced remarkable growth in the securitization[1] of financial assets by pooling assets and creating secondary markets for so-called asset-backed securities ("ABS").[2] At the end of 1992, the total value of securitized assets exceeded

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[1] Securitization may be defined broadly as the repackaging of illiquid assets and their associated cash flows into marketable securities. On securitization generally, see TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES (1991) (a comprehensive treatise on the history, legal issues, theories, and structures of securitization); SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 1991) (a practitioner's guide) [hereinafter Kravitt]; Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991) (setting forth the background and basic principles of asset securitization, as well as recent legal and regulatory developments in the field). Frankel discusses two other forms of securitization: commercial paper (the substitution of securities for loans) and loan participations (the sale of portions of large loans). *See* FRANKEL, *supra*, §§ 2.2-2.3. This Comment focuses on securitization by pooling, rather than by commercial paper or loan participation, because pooling has a larger potential market in Japan and more relevance to the Japanese capital market and banks. *See* David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 379-83 (1990). Also, commercial paper and loan participation transactions are much more developed in Japan. *See, e.g.*, Hideki Kanda & Michael Kawachi, *Securitization in Japan*, JCR FIN. DIG., Nov. 1993, at 1; Litt et al., *supra*, at 423-28. For varying definitions of securitization, see Shenker & Colletta, *supra*, at 1373-75; Robert B. Titus, *Asset Securitization: Marvel of the Marketplace, But Should We Be Uneasy?*, 73 B.U. L. REV. 271, 272-73 (1993) (book review).

[2] Asset-backed securities are the end products of the securitization process and are sold to and traded among investors, usually of the institutional variety. Each ABS is based on a pool of assets, the cash flows of which pass through to the ABS.



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an estimated one trillion dollars.[3] Securitization has provided borrowers with lower interest rates, investors with greater liquidity, banks with lower funding costs, and the economy with a lower cost of capital.[4]

In Japan, however, the ABS market is heavily restricted and regulated. In particular, regulation has prevented Japanese banks from restructuring their nonperforming loans[5] and effectively has hindered Japanese companies seeking an alternative source of capital. Also, restrictions on trading have proved troublesome for non-Japanese issuers of ABS seeking access to the Japanese capital market.[6]

In light of continuing developments in Japan, this Comment focuses on the theories underlying securitization and the potential application of these theories to Japan's highly regulated financial industry. This Comment argues that a more fully developed ABS market is necessary both for the future profitability of the Japanese banking industry and for effective financing for Japanese nonbank companies, and that such a market requires nothing less than significant reform of securities and banking regulation.

Section 2 outlines the basic principles and benefits of securitization and discusses the potential for an ABS market in Japan. Section 3 provides a brief overview of the historical development of asset securitization in Japan and describes some sample transactions. Section 4 examines and analyzes Japanese securities and banking regulations, the major obstacles to a fully developed ABS market, as well as other impediments. Section 5 briefly discusses some theories for reform and deregulation that might promote the market for ABS in Japan. Section 6 concludes that gradual yet significant reform of financial regulation is necessary for the future growth of securitization in Japan. This growth, in turn, should benefit the well-being of Japanese banks and their

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[3] *See* Michael T. Kawachi, *The New Law of Asset Securitization in Japan*, 17 U. PUGET SOUND L. REV. 587, 590 (1994)

[4] *See* discussion *infra* section 2.2.

[5] *See Poor-performing Loans, Low Demand Stifle Money Flow, Economic Revival: Financial Sector Ills Graver than Bank Ledgers Indicate*, NIKKEI WKLY., Nov. 28, 1994, at 1 [hereinafter *Poor-performing Loans*].

[6] In recent U.S.-Japan trade talks regarding the financial services industry, the United States urged Japan to open up a domestic ABS market to allow U.S. ABS issuers access to the Japanese securities markets. *See Treasury Seeking Early Resolution in Japan Financial Services Talks*, 64 Banking Rep. (BNA) 48 (Jan. 2, 1995) [hereinafter *Treasury Seeking Early Resolution*].

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corporate clients.

## 2. OVERVIEW OF SECURITIZATION

### *2.1. Development in the United States and Europe*

The securitization of financial assets originated in the U.S. residential mortgage industry as a financing tool developed by the Federal National Mortgage Association ("FNMA"), the Government National Mortgage Association ("GNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC").[7] Since the 1970s, these federal agencies have bought qualifying home mortgages from lenders, pooled the mortgages, issued securities (each of which is backed by a mortgage pool), resold the securities in the capital markets, and provided guarantees of the timely payment of interest and principal on the securities.[8] The market for these so-called mortgage-backed securities ("MBS") currently remains the largest for securitized assets both in the United States and in the world, totalling over 900 billion dollars.[9] The MBS market has substantially integrated the U.S. real estate credit markets with national and international capital markets,[10] including the Japanese capital market.[11]

Moreover, the securitization of mortgages has served as a model for the securitization of a variety of other financial assets by both the government and the private sector. Government sponsored pools include student loans, through the Student Loan Marketing Association, and farm loans, through Farm Credit Banks.[12] The private sector has securitized assets such as automobile loans, home equity loans, leases, credit card and trade receivables, and loans made or held by the U.S. federal govern-

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[7] *See, e.g.*, Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1267-71 (1991). FNMA, GNMA, and FHLMC are all quasi-governmental agencies designed to increase the availability of funding for purchases of residential real estate in the United States. *See id.*; *see also* Shenker & Colletta, *supra* note 1, at 1380-88 (providing a history of quasi-securitization transactions before the emergence of mortgage-backed securities).

[8] *See* Schill, *supra* note 7, at 1268-70.

[9] *See* FRANKEL, *supra* note 1, § 2.4.5.

[10] *See* Schill, *supra* note 7, at 1270.

[11] Certain MBS have a significant presence in Japan. *See infra* notes 86-87 and accompanying text.

[12] *See* FRANKEL, *supra* note 1, § 2.4.3.

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ment.[13] Both the amount and variety of securitized loans have increased dramatically.[14]

The general process of asset securitization follows the pooling method of the MBS model, whereby one or more intermediaries between the borrowers and the ABS investors, such as banks, repackage the assets, usually loans, into securities that are issued.[15] Meanwhile, the government (the original lender), banks, or insurance companies provide the "credit enhancement," which lowers the risks to investors through guarantees or collateral.[16] Market intermediaries develop secondary markets for the securities through issuance and trading.[17] Only through this intermediation process, including both pooling and credit enhancement, can a secondary market be created for ABS.

Technological advances in computer data processing also have enabled the growth of asset securitization by facilitating the evaluation of loans, interstate lending, trading, and the creation of new ABS.[18] Moreover, telecommunication technologies have integrated the world's financial markets by allowing "trading virtually without borders."[19] Globalization of the capital markets has spawned the issuance and trading of ABS between countries, especially in European markets.[20] It also has made securitization easier in countries such as Japan.[21]

Overseas placement of ABS backed by U.S. assets has been widespread. In contrast, securitization of domestic assets has been developed and completed in Canada and in almost all of the European Union nations, though all are on a much smaller scale

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[13] *See id.* §§ 1.3, 2.4.4.

[14] *See id.* § 1.3.

[15] *See id.* §§ 1.2, 2.5.1.

[16] *Id.*

[17] *See id.*

[18] *See* Yoichi Miyazawa, *Financial System Reform in Japan: Separation of Banking and Securities Business*, *in* INTERNATIONAL SECURITIES MARKETS 1991 233, 240-41, (PLI Corp. Law & Practice Course Handbook Series No. 743, 1991); Schill, *supra* note 7, at 1271; Kazuhito Ikeo, *Banks Failing to Take Advantage of New Business Opportunities: Outdated Accounting Practices, Reluctance to Change Cloud Diversification Prospects*, NIKKEI WKLY., Oct. 31, 1994, at 7.

[19] Miyazawa, *supra* note 18, at 241.

[20] *See* Shenker & Colletta, *supra* note 1, at 1422.

[21] *See* Litt et al., *supra* note 1, at 374.

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than in the United States.[22]

Growth outside of the United States has been slow due to the relative lack of experience with secured transactions, the complicated nature of securitization, and the restrictive regulatory environments.[23] Nonetheless, foreign asset securitizations are expected to grow in number and in size as banks begin to comply with the international risk-based capital framework of the Basle Accord capital adequacy guidelines.[24] Additional catalysts of foreign asset securitization include economic and legal changes which will both push financial institutions to become better capitalized and less leveraged and compel companies to seek alternative sources of capital.[25]

In Japan, the growth of domestic securitization most likely will not match its rapid growth in the United States. The success of securitization in the United States occurred through a favorable, almost accidental, combination of legal, regulatory, tax, and accounting conditions. This combination included: lenient accounting treatment of sales of receivables with recourse, permission to issue wider types of securities, governmental promotion (especially in the case of MBS), "regulatory taxes" imposed on banks and thrifts for deposits,[26] and compliance costs of maintaining capital.[27] Japan's financial environment lacks most, if not all, of these conditions.

Nonetheless, shrinking profitability from traditional lending induced U.S. banks and thrifts to consider alternative methods of

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[22] *See* ASSET SECURITIZATION: INTERNATIONAL FINANCIAL AND LEGAL PERSPECTIVES (Joseph J. Norton & Paul R. Spellman eds., 1991) (discussing securitization in the United States, the United Kingdom, and Western European countries); SECURITIZATION: AN INTERNATIONAL GUIDE (Patrick Stewart ed., 1993) (discussing securitization in the United States, Canada, the United Kingdom, Germany, and Japan); *see also* Shenker & Colletta, *supra* note 1, at 1421-26.

[23] *See* Kawachi, *supra* note 3, at 590.

[24] According to the capital standards of the Basle Accord, banks undertaking international business must maintain a capital-to-assets ratio of eight percent. *See* Committee on Banking Regulations and Supervisory Practices, Final International Risk-Based Capital Standards Adopted by the Basle Committee on Banking Regulations (1988), *reprinted in* 51 Banking Rep. (BNA) 143, 149 (July 1988); *see also* Shenker & Colletta, *supra* note 1, at 1414-15, 1421.

[25] *See* Shenker & Colletta, *supra* note 1, at 1421-23.

[26] *See infra* note 60 and accompanying text.

[27] *See* SECURITIZATION: AN INTERNATIONAL GUIDE, *supra* note 22, at 3; Kawachi, *supra* note 3, at 590; Shenker & Colletta, *supra* note 1, at 1391-92.

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financing, including securitization.[28] In the same vein, Japanese banks will harbor greater demand for the ability to securitize their loans as their lending profits are squeezed.[29] Banking practices are likely to be the most important factor in determining the future growth of securitization in Japan.

### 2.2. *Benefits of Securitization and Demand for an ABS Market in Japan*

Despite the high transaction costs of securitization,[30] it provides numerous benefits to borrowers, investors, financial intermediaries, and the financial economy as a whole.[31] The most significant advantages of securitizing are: (1) for borrowers, lower borrowing costs in the form of easier access to credit and lower interest rates;[32] (2) for investors, a wider variety of securities and the ability to diversify;[33] (3) for intermediaries, a lower cost of funding through diversification, more efficient management of interest rate risk, prepayment risk, credit risk, and market risk,[34] as well as better capitalization;[35] and (4) for the economy, a lower cost of capital and a more efficient financial system.[36]

The benefits to intermediaries are especially important and

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[28] *See* Shenker & Colletta, *supra* note 1, at 1388-92.

[29] *See* discussion *infra* section 2.2.1.

[30] The transaction costs of securitizing assets are high because of the process of intermediation. That is, the income-producing assets and their associated risks are unbundled and then allocated to banks and other financial institutions who are better at bearing or diversifying away the risks. *See* Kravitt, *supra* note 1, § 3.01.

[31] *See generally* FRANKEL, *supra* note 1, §§ 3.0-5.0 (discussing the positive effect of securitization on the economy and the financial system, financial intermediaries, and borrowers and investors); JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 12-23 (1988) (discussing the net benefits of securitization).

[32] *See* FRANKEL, *supra* note 1, §§ 5.2-5.4; ROSENTHAL & OCAMPO, *supra* note 31, at 12-13.

[33] *See* FRANKEL, *supra* note 1, §§ 5.10.1-5.10.2; ROSENTHAL & OCAMPO, *supra* note 31, at 13.

[34] *See* FRANKEL, *supra* note 1, §§ 2.4.6, 4.3-4.5; ROSENTHAL & OCAMPO, *supra* note 31, at 13-17; Shenker & Colletta, *supra* note 1, at 1393-95.

[35] *See* Shenker & Colletta, *supra* note 1, at 1395-96.

[36] Greater efficiency results from the intermediation process, which allocates interest rate, prepayment, credit, and market risks to the lowest-cost risk bearers, and provides greater liquidity by using markets rather than traditional lending. *See* FRANKEL, *supra* note 1, §§ 3.1-3.3.5.

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relevant to Japan's current financial industry. In particular, the potential benefits enjoyed by originators, the generators of securitizable receivables such as loans, have special import for Japanese banks. The following sections of this Comment describe these benefits, their application to the problems and needs of the Japanese banking industry, and the resulting demand for more liberalized securitization in Japan.

#### *2.2.1. Restructuring Bad Debt and Enhancing Financial Ratios*

Securitization allows the originator to remove the securitized assets and associated liabilities from its balance sheet. Cash received through the disposition of assets[37] can be used to pay off liabilities so that the originator's balance sheet shows fewer assets and liabilities than it would with a straight debt offering.[38] As a result, the originator will appear financially stronger when evaluated by various accounting measures, including return on assets, return on equity, and capital-to-assets ratio.[39]

The importance of the ability to remove assets and liabilities from the balance sheet is twofold. First, with stronger financial ratios, originators can achieve a lower cost of funding for other business activities.[40] Second, securitization makes it easier for banks to comply with capital requirements such as the Basle Accord capital adequacy guidelines.[41] Both of these features are attractive to Japanese banks, especially to those plagued with bad debt.[42] Instead of continuing to resort to write-offs and reserves,[43] banks can recover their credit-creation capacity by

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[37] From an accounting perspective, the disposition is treated as a sale to a nonconsolidated entity. *See* Kenneth P. Morrison, *The Securitization Phenomenon*, *in* SECURITIZATION: AN INTERNATIONAL GUIDE 3, 4-5 (Patrick Stewart ed., 1993).

[38] *See id.*

[39] *See generally* Walid A. Chammah, *An Overview of Securitization*, *in* ASSET SECURITIZATION 1, 7-11 (Joseph J. Norton & Paul R. Spellman eds., 1991) (reviewing the benefits of securitization).

[40] *See* Kravitt, *supra* note 1, at 3. For the effect on the cost of capital, see Chammah, *supra* note 39, at 12.

[41] *See* Shenker & Colletta, *supra* note 1, at 1395-96; *infra* note 48 and accompanying text.

[42] *See Poor-performing Loans*, *supra* note 5, at 1.

[43] Currently, Japanese banks have only two ways of removing bad loans from their balance sheets. They can either write them off or sell them to the

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liquidating their nonperforming loans or by liquidating real estate held as collateral against nonperforming loans.[44] One commentator notes that Japanese banks are "preparing to shed hundreds of billions of dollars in bad real estate loans, employing securitization and individual-asset sales as their primary tools."[45]

The Japanese Ministry of Finance ("MOF") has acknowledged securitization as a potential solution to Japanese banks' nonperforming loans, estimated at $414.16 billion,[46] which are mostly attributed to the decline in the Japanese real estate market.[47] The Japanese government also has recognized that securitization can assist banks in complying with the Basle Accord capital adequacy guidelines.[48] The MOF has changed some regulations to help banks comply with Basle Accord capital adequacy guidelines by easing restrictions on the issuance of convertible bonds, on the market for subordinated loans, and on the market for securitized loans.[49] Nonetheless, actual transactions involving

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Co-operative Credit Purchasing Company ("CCPC"). The banks lend to the CCPC and must absorb any losses later incurred by the CCPC in disposing of collateral. *See Mitsubishi Bank Securitizes Bad Loans*, FIN. REG. REP., July/Aug. 1995.

[44] Commercial banks, including those in Japan, have already used securitization techniques to repackage Third World debt. *See* Andrew C. Quale, Jr., *LDC Debt-Reduction Techniques: Debt/Equity and Debt Collateralization Transactions — Legal and Accounting Implications for US Banks*, *in* ASSET SECURITIZATION 388, 412-20 (Joseph J. Norton & Paul R. Spellman eds., 1991); Alfred J. Puchala, Jr., *Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 137, 151 n.41 (1989) (discussing an unsuccessful effort by Japanese banks in 1987 to connect Third World debt to preferred stock). *But see* David W. Leebron, *First Things First: A Comment on Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 173 (1989) (critiquing these securitization techniques).

[45] *How the Bank Cleanup Will Work in Japan*, LIQUIDATION ALERT, Jan. 31, 1994, *available in* WESTLAW, ALLNEWS database.

[46] *See Japanese Panel to Consider Approval of Market for Asset-Backed Securities*, WALL ST. J., Aug. 25, 1995, at A5F [hereinafter *Japanese Panel*].

[47] *See Japan Official Suggests Securitization of Property Loans*, DOW JONES INT'L NEWS, Oct. 30, 1995, *available in* WESTLAW, ALLNEWS PLUS database (stating that securitization may help *jusen*, special-purpose companies often confronted by non-performing housing loans); *Japanese Panel*, *supra* note 46, at A5F.

[48] *See Proposals for International Convergence of Capital Measurement and Capital Standards*, Bank for International Settlements, Committee on Banking Regulations & Supervisory Practices (Dec. 1987), *reprinted in* 27 I.L.M. 530 (1988).

[49] *See* Duncan E. Alford, *Basle Committee International Capital Adequacy Standards: Analysis and Implications for the Banking Industry*, 10 DICK. J. INT'L

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the securitization of corporate loans remain rare.[50]

*2.2.2. Alternative Efficient Means of Funding*

Asset securitization is an alternative efficient means of funding because it reduces the originator's cost of funding in several ways. First, securitization leads to a higher credit rating for the ABS than the originator itself possesses.[51] There are several means of achieving this benefit. Special purpose vehicles[52] buy the assets to be securitized from the originator, pool them, and then issue the ABS. As a result, an investor buying the ABS looks to the cash flow from the assets rather than the credit of the originator to achieve nonrecourse financing.[53] Stronger assets can be separated from weaker assets, allowing the creation of a pool of higher quality assets upon which financing can be obtained.[54] Intermediaries also may provide credit enhancement through guarantees and collateral.[55]

Second, originators have the flexibility of choosing among alternative securitization structures. Two examples are the pass-through structure and the revolving pool structure. Pass-through structures, which pay principal out to investors when it is collected on the underlying assets, allow "match funding,"[56] the perfect or near-perfect matching of assets with liabilities. This

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L. 189, 207-09 (1992) (discussing the implementation of Basle Accord regulations in Japan); Toby S. Myerson & Andrew E. Feldman, *Recent Developments in the Japanese Financial Markets, in* INTERNATIONAL SECURITIES MARKETS 1991 263, 270-77 (PLI Corp. Law & Practice Course Handbook Series No. 743, 1991). The MOF also has allowed leasing and credit companies to securitize their receivables, provided the ABS are issued and sold overseas. *See infra* note 101 and accompanying text.

[50] *See* discussion *infra* section 3.3.

[51] *See* Morrison, *supra* note 37, at 5.

[52] Special purpose vehicles also are referred to as special purpose trusts or special purpose companies. *See* Steven L. Schwarcz, *Structuring and Legal Issues of Asset Securitization in the United States, in* ASSET SECURITIZATION 16, 17 (Joseph J. Norton & Paul R. Spellman eds., 1991).

[53] *See id.* at 17-18.

[54] *See* Kravitt, *supra* note 1, at 3.

[55] *See id.*

[56] As a result of the pass-through structure, "[s]ubstantial increases or decreases in prepayment behaviour will not cause a mismatch with the asset funding." Chammah, *supra* note 39, at 13.

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permits better management of resources.[57] Revolving pool structures, in which a pool's assets regularly turn over, allow the originator to raise long-term financing with short-term assets.[58]

Third, securitization allows originators, especially banks, to avoid certain legal and regulatory restrictions.[59] For example, borrowers are not subject to the restrictive financial and operational covenants imposed by lenders in traditional debt financings. In the United States, depository institutions have used securitization to avoid "regulatory taxes" associated with deposit-taking,[60] as well as some of the costs of maintaining capital in compliance with regulatory requirements such as minimum capital requirements.[61]

Finally, securitization shifts the risk of catastrophic loss from the originator to the investors, so that the originator's potential loss is limited to its "retained interest, with the investors taking the risk of loss on the remainder."[62] Although investors assume the risk of catastrophic loss on the remainder, credit enhancement in most rated transactions lowers this risk.[63]

To realize the beneficial effects discussed above, a Japanese company seeking an alternative means of raising capital may consider securitization because it permits the company to finance its assets or receivables without putting its credit at risk. The company, in other words, can achieve nonrecourse financing.[64] In addition, the risks inherent in securitization, such as default and prepayment risks, can be mitigated through pooling and diversification in addition to credit enhancement.[65]

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[57] *See* Kravitt, *supra* note 1, at 3; Morrison, *supra* note 37, at 5. The originator still receives a steady stream of income because it can service the loans on behalf of the investors. *See* Shenker & Colletta, *supra* note 1, at 1392.

[58] *See* Morrison, *supra* note 37, at 5.

[59] *See id.*

[60] These "regulatory taxes" are deposit insurance premiums and reserve requirements under the Federal Reserve Board's Regulation D. *See* Reserve Requirements of Depository Institutions, 12 C.F.R. §§ 204.1-.132 (1991).

[61] *See* Shenker & Colletta, *supra* note 1, at 1391-92.

[62] Morrison, *supra* note 37, at 5.

[63] *See id.*

[64] *See* Shenker & Colletta, *supra* note 1, at 1425.

[65] *See Japan Asset-backed Securities to Aid Corporate Funding: Report*, DOW JONES INT'L NEWS, Feb. 1, 1996, *available in* WESTLAW, ALLNEWS PLUS database [hereinafter *Asahi Report*] (noting that "statistical analysis can provide information on the history of bad corporate debts" in order to reduce risk).

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Japanese financing companies which engage in leasing, automobile financing, and credit card financing are especially good candidates for securitization because they can sell their receivables to raise funds instead of relying solely on bank loans with rising interest rates.[66] Some of these financing companies, however, may be hesitant to engage in asset-backed securitization because they do not want to endanger relations with their lenders by repaying loans with capital derived from issuing ABS.[67] Nevertheless, deregulation of the Japanese ABS market likely will stimulate financing innovations and, in turn, the Japanese capital market.[68]

### *2.2.3. Better Banking*

As an alternative financing tool, securitization will become more valuable as the Japanese capital market puts a premium on corporate "de-leveraging," or reduction of liabilities.[69] There is already evidence that Japanese companies are minimizing capital investment in order to reduce their liabilities.[70]

The emphasis on de-leveraging is especially relevant to Japanese banks which, plagued with underperforming loans, have become more cautious about those corporations to whom they will extend loans with collateral.[71] The result is a shrinking market for traditional bank lending. Indeed, there is a continuing shift away from bank loans toward market securities. Both investors and companies are turning away from traditional bank lending because of outdated products and unfavorable interest

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[66] *See* Robert Steiner, *Japan to Allow Overseas Sales of Asset Bonds*, WALL ST. J., Sept. 19, 1994, at A11.

[67] *See id.* Financing companies also have been reluctant to issue corporate bonds. One observer explains that "[l]oan growth is so slow now that banks want to keep their lending to that industry strong." *Id.* (quoting Alicia Ogawa, an analyst with Salomon Brothers Asia Ltd.)

[68] *See Asahi Report*, *supra* note 65.

[69] Shenker & Colletta, *supra* note 1, at 1425. The Japanese Ministry of Construction has suggested that securitization be used as a method of long-term financing of public development projects. *See id.* at 1425 n.288 and accompanying text.

[70] *See Poor-performing Loans*, *supra* note 5, at 1 (noting that in June 1994, outstanding loans and discounts by all Japanese banks "posted the first year-on-year monthly decrease since the end of [World War II] and have been on the decline since").

[71] *See id.*

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rates.[72]

As leveraging and traditional banking products are further disfavored, the profitability of Japanese banks is expected to shrink.[73] Shrinking profitability may serve as a powerful inducement for banks to engage in securitization, as it did for U.S. banks and thrifts in the 1980s.[74] Although the Japanese regulatory environment is not nearly as conducive to securitization as is the environment in the United States,[75] the corporate sector's rising demand for securitization as an alternative financing tool makes it increasingly important for banks to be able to participate meaningfully.

#### *2.2.4. Foreign and Domestic Access to the Japanese Capital Market*

Securitization generally permits access to a more diverse investor population beyond traditional equity markets and third-party lenders.[76] For example, investment grade ratings of ABS, which may have a higher rating than the originator itself,[77] permit access to other sources of financing, such as money market funds, insurance companies, and other investors restricted to securities of minimal investment grades.[78]

By granting foreign investors access to its capital market, Japan could further increase its population of investors. Foreign issuers of ABS believe that they can maximize the global liquidity of their securities if given the opportunity to participate in the large Japanese capital market.[79] Nonetheless, the Japanese have

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[72] *See* Colin P. A. Jones, Note, *Japanese Banking Reform: A Legal Analysis of Recent Developments*, 3 DUKE J. COMP. & INT'L L. 387, 406 (1993).

[73] Japanese banks have begun looking to the U.S. market because "the earnings environment remains severe at home." Ryosuke Harada, *Japanese Banks See Bright Spots in America: Lending Competition Tough But Volume Grows; Securitization and Derivatives Opening Up*, NIKKEI WKLY., Sept. 19, 1994, at 21. Japanese banks have had to pay a premium on commercial paper because of the increased risk and volatility in the banking industry. *See CapMAC May Securitize Up to $1B in Japanese CP*, ASSET SALES REP., Dec. 18, 1995, at 1.

[74] *See supra* note 28 and accompanying text.

[75] *See* discussion *supra* section 2.1.

[76] *See* Morrison, *supra* note 37, at 5.

[77] *See supra* notes 51-55 and accompanying text.

[78] *See* Chammah, *supra* note 39, at 13; Morrison, *supra* note 37, at 5.

[79] *See* Shenker & Colletta, *supra* note 1, at 1425.

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restricted foreign involvement in its ABS market, a course of action which has been the subject of contention in trade negotiations between the United States and Japan.[80] U.S. representatives have urged Japanese officials to open up the Japanese domestic ABS market to promote the "freedom to innovate" in the area of underwriting.[81]

Potential ABS issuers and traders in Japan also have much to gain from allowing domestic investors greater access to their market.[82] Japanese securities regulation, however, has permitted only finance companies and nonbank securities firms to engage in the issuing and trading of ABS and similar commodities, and then only in a limited fashion.[83] Although banks may sell portions of their commercial loans to institutional investors,[84] they have been hesitant to do so. Consequently, true bank loan securitizations are still far from being a reality.[85] As a result, the market for securitized bank loans has been stymied by restrictions on issuance, transfers, and trading. Reform and deregulation may eliminate such restrictions and, in turn, assist banks that stand to benefit considerably from greater liquidity and marketability in the domestic market.

## 3. DEVELOPMENT OF SECURITIZATION IN JAPAN

### *3.1. Trading of U.S. ABS in Japan*

Mortgage-backed securities have been traded in the Japanese capital market almost since their inception, but those securities are based predominantly on U.S. assets. One type of U.S. MBS, the collateralized mortgage obligation ("CMO"), has a significant

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[80] *See Japan/U.S./Financial Services 2: Results by Clinton Visit*, CAPITAL MARKETS REP., Jan. 21, 1996, *available in* WESTLAW, CMRFP database; *Treasury Seeking Early Resolution*, *supra* note 6, at 48.

[81] *Treasury Seeking Early Resolution*, *supra* note 6, at 48. The growth of the Japanese ABS market would be lucrative for Wall Street investment banks, which have developed the most expertise in securitization. *See Japanese Panel*, *supra* note 46, at A5F; Steiner, *supra* note 66, at A11.

[82] *See* Miyazawa, *supra* note 18, at 243.

[83] *See* discussion *infra* section 3.3.

[84] *See* Myerson & Feldman, *supra* note 49, at 270.

[85] *See* discussion *infra* section 3.3.

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market in Japan.[86] In 1990, popular mortgage funds based on U.S. mortgage-backed certificates also entered the Japanese market.[87]

In September 1990, the MOF approved an ABS backed by Citibank credit card receivables for trading and distribution in Japan.[88] The approval, given more than a year after the original request, was rationalized by finding that the "issue was sufficiently similar to a 'security' and that it could be sold by Japanese securities houses."[89] Even though other U.S. companies have sought similar offerings in Japan, the MOF has been reluctant to authorize additional trading of securities backed by U.S. assets.[90]

### *3.2. Securitization by Japanese Nonbanks*

The first attempt at establishing a domestic securitization occurred in 1990, when the Japan National Railways Settlement Corporation financed real estate assets owned by its parent company, a privatized rail monopoly, with a loan that was convertible into an interest in real estate assets.[91] This structure was chosen to raise capital without sparking real estate speculation.[92]

Since then, transactions involving domestic assets have been limited to the following: (1) securitization of commercial mortgages,[93] (2) the use of commercial paper,[94] (3) securitization

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[86] *See* Henry A. Fernandez, *Globalization of Mortgage-Backed Securities*, 1987 COLUM. BUS. L. REV. 357, 361 (1987). The CMO is divided into several classes, or "tranches," varying with the maturities of the underlying loans. Short-term CMO holders are entitled to principal payments and prepayments before the longer-term CMO holders. *See* Schill, *supra* note 7, at 1270. In a global CMO issue, the first and last tranches usually are sold in the United States, the middle tranches in Europe, and the ten-year tranch in Japan. *See* Fernandez, *supra*, at 361.

[87] *See* C. Jeffrey Char, *Reforming Japan's Securities Markets: The Loss Compensation Scandal*, 10 INT'L TAX & BUS. LAW. 173, 205 n.155 (1993). Foreign exchange risk in trading these mortgage funds is completely covered by hedging in foreign exchange futures. *See id.*

[88] *See* Myerson & Feldman, *supra* note 49, at 270-71.

[89] *Id.* at 271.

[90] *See id.*

[91] *See id.*; Shenker & Colletta, *supra* note 1, at 1425 n.289.

[92] *See* Myerson & Feldman, *supra* note 49, at 271.

[93] *See* Kanda & Kawachi, *supra* note 1, at 1.

[94] *See* Litt et al., *supra* note 1, at 375 (describing the characteristics of commercial paper).

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of residential mortgage certificates and trusts,[95] and (4) bank loan participations.[96] Dissatisfied with the highly restrictive regulations at home, Japanese nonbank companies also have issued ABS in the U.S. and European markets.[97]

In 1992, Japan enacted the Specified Claims Law ("SCL") which allowed the limited securitization of leases and credit card claims beginning in June 1993.[98] Under this legislation, Japanese lease and credit card companies can pool and securitize their claims under the supervision of the Ministry of International Trade and Industry ("MITI") and issue ABS with the MOF's permission.[99] It was not until September 1994 that the MOF authorized the general sale of ABS based on such claims.[100] The MOF required that ABS be sold to non-Japanese investors, prohibited resale to Japanese banks until after a 90-day lock period, and banned resale to Japanese investors.[101]

Together, the SCL and the MOF authorization have enabled the first securitizations of domestic assets. In October 1994, Nippon Shinpan, a Japanese consumer finance company, issued an auto-loan-backed security using a revolving structure.[102] In December 1994, Japan Leasing, which leases industrial and computer equipment, issued notes backed by Japanese equipment lease receivables in the United States "to enhance liquidity while diversifying funding."[103] While both transactions were watersheds for Japanese companies, the companies sold ABS primarily

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[95] *See* Miyazawa, *supra* note 18, at 241-42.

[96] *See* Kanda & Kawachi, *supra* note 1, at 1. Loan participation is the sale of portions of large loans. *See* FRANKEL, *supra* note 1, at 35.

[97] *See* Myerson & Feldman, *supra* note 49, at 271.

[98] *See* Tokutei Saiken Nado ni Kakaru Jigyo ni Kansuru Horitsu [Specified Claims Law], Law No. 77 of 1992 [hereinafter Specified Claims Law]. For details of the law and the securitization structures it contemplates, see Daniel M. Rossner & Yoshiki Shimada, *Japan*, *in* SECURITIZATION: AN INTERNATIONAL GUIDE 15, 17-18 (Patrick Stewart ed., 1993).

[99] *See* Specified Claims Law, *supra* note 98.

[100] *See Japan to Allow Sale of Asset-Backed Securities*, DAILY REP. FOR EXECUTIVES, Sept. 19, 1994, at 179.

[101] *See id.*; Steiner, *supra* note 66, at A11 (noting that leasing and credit companies can repackage their receivables through overseas special purpose companies).

[102] *See Nippon Shinpan Breaks Through with Japan's First ABS*, ASSET SALES REP., Oct. 31, 1994, at 1 [hereinafter *Nippon Shinpan Breaks Through*].

[103] Laura Lorber, *First Japanese Asset-Backed Deal to Debut in U.S. this Week*, BONDWEEK, Dec. 19, 1994, at 1.

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to foreign investors within the confines of the tight resale prohibition, in accordance with the September 1994 MOF restrictions.[104]

### *3.3. Securitization by Japanese Banks*

In 1990, the MOF allowed Japanese banks to sell portions of corporate loans to institutional investors to help such banks comply with Basle Accord capital adequacy guidelines.[105] The structure of these transactions, however, resembles loan participation sales more than true securitization by pooling because the bank's role as intermediaries is limited to selling portions of loans.[106]

This type of loan participation scheme has been utilized infrequently for two reasons.[107] First, continuing restrictions make the loan sales less attractive to institutional investors. For instance, the loan portions have a minimum principal amount of 100 million yen.[108] In addition, investors who have purchased interests in such loans are prohibited by Japanese securities regulations from reselling their interests.[109] Second, Japanese banks are reluctant to alienate their corporate clients.[110] Secured lending laws require banks to provide notice to the debtor before assigning or transferring the associated instruments.[111] Therefore, banks have chosen not to sell off their loans due to their fear of harming existing relationships.[112]

As a result of continuing restrictions in the domestic lending market, more Japanese banks are securitizing their loans and

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[104] *See Japan Leasing to Issue Asset-Backed Bonds in U.S.*, REUTERS, Dec. 20, 1994, *available in* LEXIS, News Library, Curnws File.

[105] *See* Myerson & Feldman, *supra* note 49, at 270.

[106] *See* Shenker & Colletta, *supra* note 1, at 1426 n.290. Japanese "city banks" are currently considering a new loan participation scheme whereby originators would retain their status as creditors and investors would bear the risk of debtor default. *See City Banks Eye New Loan-Securitization Scheme*, JIJI PRESS TICKER SERVICE, Nov. 22, 1994, *available in* LEXIS, News Library, Curnws File.

[107] *See* Myerson & Feldman, *supra* note 49, at 270.

[108] *See id.*

[109] *See id.*; Shenker & Colletta, *supra* note 1, at 1426 n.290.

[110] *See* Myerson & Feldman, *supra* note 49, at 270.

[111] *See id.*

[112] *See id.* One proposal is to eliminate the requirement of providing notice to obligors, because such notice is costly and time consuming. *See id.* at 272.

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issuing long-term securitized products in the United States, which requires licensure by the U.S. Federal Reserve.[113] Alternatively, some Japanese banks operating in the United States have already securitized a variety of U.S. receivables, including auto, consumer, mortgage, and leveraged buy-out loans.[114]

Japanese banks have made some progress toward offering other ABS to Japanese investors. In July 1995, Mitsubishi Bank became the first Japanese bank to issue a security backed by nonperforming assets in Japan.[115] Although cash flows will be generated by the liquidation of real estate collateral held against bad debts,[116] Mitsubishi is required to guarantee seventy percent of the principal.[117] The bonds were placed privately and thus cannot be traded in the public secondary market.[118]

In general, the denial of access to a domestic ABS market constrains the ability of Japanese banks to restructure their loans and reduces banks' effectiveness as lenders. Moreover, the MOF's authorization of loan participation sales is woefully inadequate and has had little impact on banking practices. Although participation in the U.S. ABS market may offer an alternative, it also poses additional transaction costs and provides neither the flexibility nor the liquidity potentially offered by a domestic ABS market.

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[113] *See* Harada, *supra* note 73, at 21. As of September 1994, only three Japanese banks had units licensed to underwrite corporate bonds and stocks. *See id.*

[114] *See* Myerson & Feldman, *supra* note 49, at 271.

[115] *See Mitsubishi Bank to Securitize Non-Performing Assets*, DOW JONES NEWS SERVICE, July 3, 1995, *available in* WESTLAW, ALLNEWS PLUS database (documenting the offer of ¥11.686 billion of zero coupon bonds backed by real property in Tokyo).

[116] *See id.*

[117] *See Mitsubishi Bank Securitizes Bad Loans*, *supra* note 43.

[118] Mitsubishi circumvented the disclosure requirement by utilizing the private placement to institutional investors, primarily comprised of life insurance companies. *See Japan Banks/Loan Securitizations 2: Bonds Privately Placed*, CAPITAL MARKETS REP., Aug. 3, 1995, *available in* WESTLAW, CMRFP database. Selling real-property-backed securities to individual investors may be problematic because of such investors' lack of sophistication in judging the risks and returns of real estate investment. *See* Nobuko Hara, *Japan Banks May Get Scant Help from Loan Securitizations*, CAPITAL MARKETS REP., Aug. 3, 1995, *available in* WESTLAW, CMRFP database.

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## 4. SECURITIES AND BANKING REGULATION AND OTHER IMPEDIMENTS TO A FULLY DEVELOPED ABS MARKET IN JAPAN

### *4.1. The Japanese Version of the Glass-Steagall Act*

The Securities and Exchange Law ("SEL") of 1948[119] regulates the Japanese securities industry, including securities firms, stock exchanges, and securities transactions.[120] Both Japanese banks and securities firms have sought the ability to sell ABS, but Article 65 of the SEL only allows securities firms to do so.[121]

Article 65 prohibits banks from participating "in any of the acts enumerated in each item of Article 2 paragraph 8"[122] of the SEL, which include underwriting and trading securities.[123] Article 65 also limits the scope of activities which securities firms can perform. For example, Japanese brokerage houses are barred from trading bank assets.[124] Article 65 has been referred to as the Japanese version of the Glass-Steagall Act,[125] which articulates the same prohibitions in the United States.

Although legislative reform in 1992, the "Financial Reform Law"[126] has allowed some crossover between banking and securities activities, this crossover is limited.[127] Under the new

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[119] *See* Securities and Exchange Law, Law No. 25 of 1948, *reprinted in Japanese Laws Relating to Securities and Exchange & Foreign Securities Dealer*, IV LAW BULL. (series Japan (EHS) MA 51 (1987)) [hereinafter SEL].

[120] Article 2 of the SEL contains a list of "securities business activities." *Id.* art. 2, ¶ 8. Moreover, securities falling within the SEL are subject to disclosure, antifraud, and insider trading provisions, all of which are intended to protect investors. *See id.*

[121] *See id.* art. 65.

[122] *Id.* art. 65, ¶ 1.

[123] *See id.* art. 2, ¶ 8.

[124] *See Japanese Panel*, *supra* note 46, at A5F.

[125] Banking Act of 1933 (Glass-Steagall), ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

[126] *See* Kinyu Seido oyobi Shokentorihiki 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].

[127] *See* Alan L. Beller, *Recent Developments in the Japanese Capital Markets*, 6 INSIGHTS 24, 24 (1992); *see also* Brian A. Pomper, Note, *The Japanese Financial Reform of 1993: Will Reform Spark Innovation?*, 28 CORNELL INT'L L.J. 525, 556-62 (1995) (although reform may induce some financial innovation,

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law, for example, banks can form subsidiaries that become licensed securities dealers, but certain activities of the subsidiaries are limited for a transitional period of time.[128] Consequently, the continuing Japanese restrictions separate those with the ability to market and sell ABS, the securities firms, from those with the greatest need to issue ABS, the banks.

### *4.2. Turf War Between the MOF and the MITI*

There is a jurisdictional turf war between the MOF and the MITI. On one side, the MITI regulates nonbanks such as manufacturers and retailers. The MITI has helped leasing and financing companies under its jurisdiction to diversify their financing sources through securitization to lower their dependence on traditional bank borrowing and to gain bargaining power when negotiating loans with banks.[129]

On the other side, the MOF represents and regulates financial institutions, including banks, securities firms, and insurance companies.[130] The MOF has sought to keep securitization within its jurisdiction by restricting nonbanks from bypassing banks and securities firms, and from using securitization structures that are not subject to MOF regulation.[131] This has resulted in an ongoing jurisdictional "turf war" between these two entities which has inhibited structural reform.[132]

Another example of the interministry battle is the SCL.[133]

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implementation remains problematic).

[128] *See* Beller, *supra* note 127, at 24. Notably, the Financial Reform Law does allow banks to engage directly in private placements. *See* Financial Reform Law, *supra* note 126.

[129] *See* Rossner & Shimada, *supra* note 98, at 15; Yoshiko Mori, *Japan Asset-Backed Securities Move Signals Opening*, REUTERS, Oct. 5, 1994, *available in* LEXIS, News Library, Curnws File (discussing the decision to allow leasing and credit companies to market asset-backed securities abroad). These lease and credit companies have been proponents of asset securitization.

[130] *See* Kawachi, *supra* note 3, at 606.

[131] *See* Rossner & Shimada, *supra* note 98, at 15.

[132] *See id.*; Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569, 580 (1991) (describing the MOF's opposition to the MITI's initial proposed legislation to regulate the sponsor of commodity future funds). Politically, each ministry and the industry it regulates form an "insider-outsider" stance so that both resist regulation from "outside" ministries. *See* Kawachi, *supra* note 3, at 605-06.

[133] *See* Kawachi, *supra* note 3, at 606.

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Under the SCL, the MITI must approve a company's plans to securitize. At the same time, designated banks and securities firms that are governed by the MOF are exempt from the licensing requirements of the SCL.[134] The SCL also provides tight restrictions on transfers and its own investor protection rules to restrict the market and protect investors not under the MOF's jurisdiction.[135] Although the MOF recently offered to allow companies to issue ABS domestically through special purpose vehicles, setting up the special purpose vehicles remains problematic, and so the MITI has sought further concessions from the MOF.[136] This ongoing turf war likely will continue to be a significant impediment to the development of securitization in Japan.

### *4.3. SEL's Definition of "Security"*

Instruments outside the SEL's definition of "security" cannot be distributed or traded in Japan, except pursuant to restrictions that significantly limit their marketability and liquidity.[137] The problem is that the SEL has a very narrow definition of "security."[138] This definition excludes trust certificates and other types

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[134] *See id.*

[135] *See id.* The interests can be sold in Japan only after 90 days, and even then only to designated financial institutions. *See Nippon Shinpan Breaks Through*, *supra* note 102, at 1.

[136] *See Japan's MITI To Seek More Finance Liberalization From MOF*, CAPITAL MARKETS REP., Apr. 22, 1996, *available in* WESTLAW, CMRFP database.

[137] *See* SEL, *supra* note 119, art. 2, § 1; *see also* Kawachi, *supra* note 3, at 592-93; Shenker & Colletta, *supra* note 1, at 1424.

[138] Article 2, § 1 of the SEL enumerates rights and instruments that are defined as "securities":

> (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 its business, as designated by MOF regulation; (9) security or certificate issued by a foreign government or 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

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of instruments that would be issued in a typical securitization. As a result, virtually all ABS can neither be distributed by securities firms nor traded on any securities exchanges in Japan.

As of April 1993, however, the Financial Reform Law 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.[139] In spite of this extension, the SEL definition continues to exclude most ABS, including, notably, securities backed by claims on Japanese credit cards or leases, even though these were recently authorized for securitization by the SCL.[140]

Even if Japanese issuers manage to fit an ABS within the SEL definition, public offering requirements limit the amount of leverage such issues can have.[141] This limitation effectively precludes the use of special purpose vehicles[142] in a Japanese public offering.[143] The narrow SEL definition and the restriction on the use of special purpose vehicles effectively preclude trust certificates and special purpose debt issuing, two of the main securitization structures used in the United States.

The continued exclusion of most ABS from the SEL definition of a security illustrates the jurisdictional war between the MOF and the MITI because it prevents the MOF from regulating ABS issued by nonbanks.[144] As a result, both U.S. and Japanese issuers are denied the liquidity necessary for effective securitization.

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transferability and other conditions.

Kawachi, *supra* note 3, at 593 n.37. *See generally* Hideki Kanda, *Yuka Shoken no Gainen* [The Concept of a Security], 152 HOGAKU KYOSHITSU 82 (1993).

[139] *See* Financial Reform Law, *supra* note 126; *see also* Kawachi, *supra* note 3, at 606-07 (discussing the amendments, including the expansion of "deemed" securities); Rossner & Shimada, *supra* note 98, at 16 (providing an analysis of the amendments).

[140] *See supra* note 98 and accompanying text.

[141] *See* Shenker & Colletta, *supra* note 1, at 1424.

[142] On special purpose entities, see *supra* notes 52-54 and accompanying text.

[143] *See* Anti-Monopoly Law of 1947; *see also* Myerson & Feldman, *supra* note 49, at 272; Shenker & Colletta, *supra* note 1, at 1424.

[144] *See* Beller, *supra* note 127, at 24; Kawachi, *supra* note 3, at 605-06 n.56.

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### *4.4. Internal Conflict in the MOF*

The SEL authorizes the MOF to designate new financial instruments as securities.[145] The MOF, however, has rarely done so[146] because such instruments would lie outside the reach of banks which have considerable clout. Designation of a new financial product as a security results in a highly politicized dispute within the MOF between banks, securities firms, and those who support investor protection.[147] Because the MOF has usually sided with Japanese banks by refusing to designate most ABS as tradeable securities, this politicized process has slowed the growth of securitization in Japan.[148]

The MOF also may decide not to designate new financial instruments as securities to respect the MITI's "turf." For example, the MOF is not expected to exercise its power to designate new unit interests issued by nonbanks under the SCL as "securities" because the interests would not be completely within its own jurisdiction, and because the MITI does not want to prevent nonbanks from distributing the unit interests they originate.[149] The unit interests are subject to tight transfer restrictions, so a securities market likely will not develop outside the MOF's jurisdiction.[150]

### *4.5. Analysis of Regulatory Impediments*

As a result of the SEL's restrictive definition and the inter-

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[145] The MOF's authority derives from SEL, *supra* note 119, art. 2(1), ¶ 9. The Financial Reform Law of 1992 expanded the MOF's authority. *See* SEL, *supra* note 119, art. 2(1), ¶ 11, art. 2(2), ¶ 3.

[146] *See* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423, 448 (1994).

[147] *See id.* at 448-49.

[148] *See id.* One commentator notes that the internal conflict at the MOF has contributed to the "systemic hollowing" of the economy. Michael Hirsh, *Why Japan Won't Change*, INSTITUTIONAL INVESTOR, Sept. 1994, at 37, 38. *See generally* David G. Litt, *Work in Progress at the Ministry of Finance: Proposals for Restructuring the Japanese Financial Services Industry*, 12 U. PA. J. INT'L BUS. L. 711, 750-53 (1991) (describing how political conflicts between private parties have impeded reform in the financial services industry).

[149] *See* David A. Sneider, *Recent Developments in Japan's Securities Markets*, *in* INTERNATIONAL SECURITIES MARKETS 1993 345, 385 (PLI Corp. Law & Practice Course Handbook Series No. 798, 1993).

[150] *See id.* at 385-86.

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ministry and intraministry politics, neither Japanese nor U.S. ABS issuers can achieve the liquidity necessary for the intermediation process of securitization.[151] Structural reform of the Japanese bureaucracy may or may not mitigate disputes between and within Japanese ministries.[152]

Given the lobbying by both banks and nonbanks, one politically feasible alternative is to allow both banks and securities firms to handle ABS outside the SEL. This alternative, however, would leave investors without the SEL's protection.[153] On the other hand, if ABS were included under the SEL definition of security to protect investors, banks would be precluded from selling securitized instruments, because the SEL authorizes only licensed securities firms to trade these instruments.[154]

Given the SEL's policy of protecting investors and the rising need for banks to engage in securitization, a third, more palatable alternative is including banks within the group of entities which the SEL allows to issue and trade securities. Simultaneously, the SEL's definition of security should be expanded to include ABS so as to maintain investor protection. This alternative would amount to either repealing or amending Article 65, which has been the subject of much criticism and concern.[155]

### *4.6. Other Impediments to a Fully Developed ABS Market in Japan*

#### *4.6.1. Regulatory Custom*

The legal system in the United States ordinarily does not impose civil or criminal sanctions on entities unless they act in a manner that is clearly prohibited by positive law.[156] Thus, individuals can experiment with new financial techniques unless such techniques are formally barred. In contrast, regulatory silence in Japan is interpreted as prohibition, so that new financial schemes and products must await express regulation or legislation

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[151] The SEL has been less restrictive with securities backed by foreign assets but the slow, case-by-case designation process involving the MOF has frustrated foreign issuers of ABS seeking access to Japan's capital market. *See id.* at 390.

[152] *See* discussion *infra* section 5.1.

[153] *See* Milhaupt, *supra* note 146, at 448-49.

[154] *See* Miyazawa, *supra* note 18, at 241.

[155] *See* discussion *infra* section 5.2.

[156] *See* Geoffrey R. Watson, *Preface*, 17 U. PUGET SOUND L. REV. 503, 512 (1994).

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authorizing their development.[157] As a result, new financial instruments and markets develop only when regulators give the green light, which is a rare occurrence.[158]

This "no-rule-means-prohibition" custom, combined with the lack of directly applicable law, has discouraged financial innovation, because proponents of securitization must often endure prohibitively long waiting periods for approval by the bureaucracy.[159] For example, an issuance under the SCL requires regulatory oversight by both the MITI, which must approve the structure of the transaction, and by the MOF, which must approve the issuance, even if the transaction takes place overseas.[160]

*4.6.2. Legislative Process*

The aim of the legislative process in Japan is to reach a consensus among all of the relevant parties.[161] Rulemaking by consensus has proved to be a tedious process involving much compromise and negotiation.[162] This process is reflected both in the SEL amendments, which originally included broad categories of asset-backed instruments which were deleted because of objections from the MITI, and in the MITI-sponsored SCL, which was significantly narrowed by a compromise with the MOF.[163]

In addition, new rules and legislation, once enacted, rarely face judicial challenge in Japan.[164] As a result of the Japanese legislative process and its binding effect, financial institutions following the "no-rule-means-prohibition" custom have been discouraged from creating and marketing new financial products.[165]

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[157] *See* Kanda, *supra* note 132, at 583.

[158] *See Japanese Panel*, *supra* note 46, at A5F (discussing the possibility of the enactment of laws establishing a market for asset-backed securities).

[159] *See* Kanda, *supra* note 132, at 583.

[160] *See* Kawachi, *supra* note 3, at 604; *Nippon Shinpan Breaks Through*, *supra* note 102, at 1 (describing how Goldman Sachs obtained the MOF's approval for a cross-border transaction more than a year after its original request).

[161] *See* Kawachi, *supra* note 3, at 608.

[162] *See id.*

[163] *See id.*

[164] *See id.* at 607.

[165] *See id.*

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#### *4.6.3. Philosophies in the Japanese Financial Industry*

Prevailing attitudes in the Japanese financial industry may marginally explain the slower growth rate of securitization in Japan. In the U.S. real estate market, the desire for short-term profits has been a factor contributing to the growth of MBS with the same trading features as stocks and bonds.[166] In contrast, Japanese investors view real property as a long-term investment.[167] Similar investment philosophies may be pervasive with respect to other securitizable assets.[168] Nonetheless, in the future, Japanese investment philosophies likely will resemble those of U.S. investors, especially as capital markets become more globalized.

### 5. THEORIES FOR REFORM AND DEREGULATION

#### *5.1. Bureaucratic Reform*

One possibility for reform of the Japanese market entails a structural overhaul of the bureaucracy. This suggestion is based on the theory that the Japanese political infrastructure, rather than the market, controls economic activity and shapes public policy through a "government-business consensus."[169] Structural reform is therefore necessary because a slow-moving bureaucracy inhibits and encumbers the financial services industry.

This theory is more myth than reality.[170] Observers of the financial services industry have painted a different picture of financial regulation, one which is driven by "conflict among powerful private interests and which is accompanied by a bureaucracy that mediates these conflicts."[171] Powerful private institutions, particularly securities firms and banks, have exercised

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[166] *See* Derek A. Wittner, *Japanese Investment in U.S. Real Estate: The Oriental Express*, 17 REAL EST. L.J. 99, 100 (1988).

[167] *See id.*

[168] According to one commentator, regulators' resistance to financial innovations such as ABS has been "anti-intellectual and rooted in nostalgia." Char, *supra* note 87, at 205.

[169] Litt, *supra* note 148, at 753.

[170] *See id.*

[171] *Id.*; *see also* Milhaupt, *supra* note 146, at 424-25 (noting that recent commentators have identified private party input as a significant element in formulation and enforcement of Japanese economic policy).

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their abilities to exact concessions and slow reform.[172]

Bureaucratic reform may or may not accelerate the growth of securitization in Japan. A large enough change, however, may have deleterious effects, such as instability in the financial system caused by market disturbances or dislocations of established industries and businesses.[173] On the other hand, gradual reform of financial regulation within the current political structure "facilitates agreement among the regulated entities."[174]

### *5.2. Bank Deregulation*

A more palatable approach to reform and deregulation is allowing banks to enter the securities business.[175] This approach would be accomplished through repeal of the Japanese version of the Glass-Steagall Act, embodied in Article 65 of the SEL.[176] Repeal of Article 65 would allow banks to engage in trading of ABS, the formation of mutual funds, and cross-shareholding. By engaging in securities activities, banks would be able to diversify their assets, including both loans and stock-holdings, and allocate risks more efficiently among borrowers, investors, and other intermediaries.

The policies underlying Article 65 of the SEL, however, remain important and should be kept in mind when suggesting proposals for implementation. These Article 65 policies include "avoiding conflicts of interest, preventing bank domination of industry, and ensuring the health of banks."[177] Large banks in Japan have considerable influence over corporations; therefore, additional regulations may be necessary to ensure that banks' entry into securities activities does not cause market disturbances.[178] Thus, a more developed ABS market should be achieved through repeal of Article 65 and through new strategically placed regulations that embody the policies underlying Article 65.

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[172] *See* Litt, *supra* note 148, at 753.

[173] *See id.* at 743.

[174] *Id.* at 743-44 (noting that the present prohibition on bank subsidiaries from engaging in retail brokerage is not absolute).

[175] *See generally id.* (examining various proposals to include banks in securities activities).

[176] To date, however, repeal has only been partially successful. *See* Pomper, *supra* note 127, at 557.

[177] Litt, *supra* note 148, at 741.

[178] *See id.*

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One of the concerns underlying Article 65, the health of banks, has given rise to the criticism that bank deregulation would harm Japanese large banks in the long-run. It is feared that securitization will harm banks because: (1) traditional lending decreases as ABS and commercial paper replace bank loans; (2) banks' shareholding power decreases as banks sell their customers' stocks due to less lending to these customers; and (3) banks' big block shareholding power decreases as securities markets become more liquid and as institutions diversify their stock holdings.[179] Each of these three perceived securitization threats is discussed in detail below.

The first such perceived threat is that "as debt securitizes, commercial paper and bonds replace bank loans, so commercial banks' influence as lender declines."[180] Although in the past banks were cautious of nonbanks' asset sales because they result in less loan demand from their clients, Japanese banks now are supportive of nonbanks' asset sales "because the ABS may provide an answer to banks' bad loan problems in the long-run, although banks are not yet allowed to sell them in the market."[181]

The second threat, declining stock, is not supported by empirical evidence, which suggests that bank ownership of stock remained stable during the 1980s.[182] Both threats can be mitigated by banking reform, such as allowing banks to securitize their loans and trade in ABS. If banks also could act as originators, they would retain influence as "lenders" servicing securitized loans and would still retain a credit-based interest to hold stock in their customers.[183]

The third threat, fewer big blocks for banks, is not supported

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[179] This theory is part of the "evolutionary" argument which states that securitization, diversification, and fragmentation of stock holdings will erode big institutional blocks, so that powerful financial institutions in Japan will eventually resemble U.S. financial institutions. *See* Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1958-62 (1993).

[180] *Id.* at 1959.

[181] Yoshiko Mori, *No Boom Likely for Japanese Asset-Backed Bonds*, REUTERS, Oct. 25, 1994, *available in* LEXIS, News Library, Curnws File.

[182] *See* Roe, *supra* note 179, at 1959. A one percent sell-off by banks between 1977 and 1992 is explained by regulators lowering the maximum bank holding from five to ten percent of outstanding shares of stock. *See id.* at 1959-60 n.94.

[183] *See id.* at 1961.

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by theory.[184] Although debt and stock may "disintermediate" from banks' holdings, they would reappear in the holdings of another affiliated intermediary that combines mutual funds, insurance funds, brokerage stock, or pensions.[185] In addition, there is evidence that stock-based power is greater and more concentrated.[186] Nonetheless, because of the current regulatory regime, banks are restricted in such cross-shareholding;[187] thus, banks might lose their big blocks, especially in the absence of strong nonbank intermediaries.[188] Reform, however, allowing banks to form and trade mutual funds and develop affiliations with other intermediaries will help them maintain their status as big block shareholders.[189] Thus, securitization, if accomplished through thoughtful reform, is likely to help banks rather than hurt them.

### *5.3. Revision of the SEL to Accommodate ABS*

The Fundamental Issues Research Group ("FIRG"), a Japanese advisory subcommittee, has explored the revision of the SEL to accommodate ABS.[190] FIRG has proposed a functional defini-

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[184] *See id.*

[185] *See id.*

[186] *See id.* at 1961 n.100 and accompanying text; *see also* Jones, *supra* note 72, at 406 ("'In recent years, the fund raising of large- and medium-size corporations has shifted from bank loans to the issue of securities.'" (quoting FINANCIAL SYSTEM RESEARCH COUNCIL, ON A NEW JAPANESE FINANCIAL SYSTEM 12 (Federation of Bankers Associations of Japan trans., 1991))); Gerard Baker, *Ripple Effect of Tokyo's Big Bang*, FIN. TIMES, Nov. 24, 1994 (anticipating mergers and consolidation in the Japanese brokerage industry).

[187] *See* Milhaupt, *supra* note 146, at 434-40.

[188] *See* Roe, *supra* note 179, at 1961 (noting that the extent of the disintegration of big blocks depends on the absence of strong non bank intermediaries).

[189] *See id.*

[190] *See* KIHON MONDAI KENKYUKAI, KINYU NO SNOKENKA [The Securitization of Finance] (May 18, 1989), *reprinted in* KINYU ZAISEI JIJO, June 5, 1989 [hereinafter Securitization Report]; SHOKEN TORIHIKI NI KUKARU KIHONTEKI SEIDO NO ARIKATA NI TSUITE 3-4 (May 24, 1991), *reprinted in* KINYU ZAISEI JIJO, June 17, 1991, at 68 [hereinafter FIRG Final Report]. FIRG also proposed a new, clearer definition of "public offering," as well as revisions of the size limits on corporate bond issuance and of the trust and underwriting system. *See id.* at 71-72; Securitization Report, *supra*; *see also* Miyazawa, *supra* note 18, at 255. Also, regulators could eliminate bond registration rules, which make the sale of a bond impossible once it is bought and thereby prevent a domestic secondary bond market. *See* Baker, *supra* note 186,

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tion of "security" which includes both traditional securities and new instruments.[191] The proposal maintains the current list of products treated as securities while adding new instruments such as commercial paper, certificates of deposit, and housing loan trust certificates to the list to clarify their status.[192]

The MOF's concerns about investor protection[193] and market volatility remain important considerations. In addressing these issues, FIRG has made several suggestions. First, FIRG suggests that the SEL should be amended to provide more protection against unfair and manipulative practices in the direct sale of securities because originators are likely to sell ABS directly to investors.[194] Second, FIRG states that due to the complex nature of securitization, disclosure provisions of trust law and securities investment trust law should apply in addition to those of the SEL.[195] Thus, the inclusion of ABS within the domain of the SEL must be accompanied by additional protection for investors. These protections include comprehensive disclosure of the structure of ABS and the legal rights and obligations of the investors, originator, and asset-manager.[196]

### 6. CONCLUSION

There is a pressing need in Japan for a domestic ABS market for both banks and their corporate clients.[197] For the Japanese banking industry, the market demand for securitization is huge.

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at 23. All of these proposals would greatly help the Japanese bond market.

[191] *See* Securitization Report, *supra* note 190, at 65-69; FIRG Final Report, *supra* note 190, at 3-4. FIRG has relied on comparisons to U.S. securities laws. *See* Securitization Report, *supra* note 190, at 65-69. For example, the report borrowed the definition of an "investment contract" from the U.S. Supreme Court decision in Securities & Exch. Comm'n v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946), which defines the term as a "contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Id.*

[192] *See* FIRG Final Report, *supra* note 190, at 3-4. Under this system, a security might partially or completely be exempt from SEL requirements if another regulatory framework with similar investor protection applies.

[193] *See* Mori, *supra* note 129.

[194] *See* FIRG Final Report, *supra* note 190, at 4-6.

[195] *See id.*

[196] *See id.* at 9.

[197] Japan's nonbanks depend on bank loans for 95% of their funding. *See* Mori, *supra* note 181.

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As both poor performing loans and corporate deleveraging threaten the profitability of traditional bank lending, Japanese banks will be inclined to use securitization as an alternative method of financing because it alleviates bad debt and allocates risks more efficiently. After opening up an ABS market, "'the real winner will be the corporate customer,'"[198] in terms of a lower cost of capital.

Securities and banking regulation, the principal reason for Japanese banks' inability to securitize their loans, needs to be reexamined and significantly reformed. The government should repeal the Japanese version of the Glass-Steagall Act, thereby empowering banks to engage in securitization. In addition, the SEL's definition of security should be expanded to include ABS, and antifraud and disclosure requirements should be stepped up to maintain the policy of protecting investors.

Although continuing developments are promising, it remains to be seen whether Japanese banks, securities firms, and nonbanks will overcome the turf wars that have impeded attempts at deregulation. Nonetheless, *gradual* reform of financial regulation, rather than an overhaul of the bureaucracy, is sound both politically and practically because it "facilitates agreement among the regulated entities."[199] Recognition of the underlying political process as one driven by conflicting and powerful private interests is helpful for understanding and suggesting changes in the Japanese financial services industry.

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[198] Baker, *supra* note 186, at 23 (quoting Akira Ogino, managing director of Nomura Securities).

[199] Litt, *supra* note 148, at 744.

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