

# The Recent Developments in Securitization in Japan

## – Centering on the SPC Law –

*Motomi Hashimoto*

*The Diet passed SPC Laws regarding the enhancement of the securitization of specified assets by special purpose companies (SPCs) as well as laws to establish relevant legal systems and ensure reforms necessary to facilitate investment by general investors in such securities, which are related to the Financial System Reform Laws.*

*The laws were promulgated on June 15, 1998 and will become effective on September 1, 1998.*

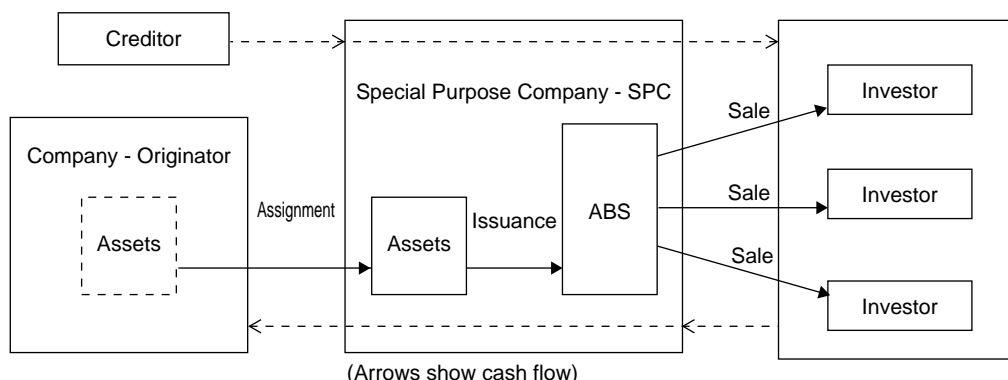
## 1. The Need for the New Securitization Law

### 1) New Securitization and Systemic Obstacles

#### (1) What is the Securitization ?

Securitization<sup>1</sup> means that a company assigns its financial receivables and real estate to an assignee company, and the SPC divides them up into small lots to sell to investors (Figure 1). The company which implements this mechanism is called an “originator”, and the assignee company is known as a “special purpose company” (SPC<sup>2</sup>). The SPC uses the assets as collateral to issue securities (Asset-Backed Securities: ABSs), and sells them to investors in small lots.

**Figure 1. Conceptual Scheme for Securitization**



Source: NRI

- 1 “Securitization”, which is a term used in the specified receivable as set law under the jurisdiction of the MITI(Ministry of International Trade and Industry), to make it distinguishable from “securitization” and is used in connection with securities transactions under the jurisdiction of the Ministry of Finance.
- 2 The assignee of assets can be a company, a trust, or an association. Under the scheme that covers all this, the SPC is often expressed as an SPV (special purpose vehicle).

Securitization ensures the following advantages.

- The originator can treat its assets on an off-balance sheet basis and raise new funds.
- It becomes possible to expand business without increasing assets.
- It is finance based on asset risk, not on corporate risk. It can assure higher rating than the company that holds it, by complementing credit for assets or financial institutions, helping reduce finance cost.
- Off-balance sheet transactions, which are used in most cases, ensure a cut in capital cost without increasing equity capital.

## **(2) Recent Securitization in Japan**

Securitization in Japan has been carried out through various schemes such as mortgage-backed securities, housing loan credit trusts, housing-backed certificates, securitized general loans (including loan participation), and enhanced securitized leasing and credit card receivables in small-lot vehicles.

Since the start of securitization of financing receivables by leasing companies and credit card companies in June 1993 pursuant to the Law for the Regulation of Business Relation to Specified Receivables (*Tokusai-ho*) established in 1992, the scale of securitization of leasing and credit card receivables is increasing.<sup>3</sup> Initially, there were three approved structures for securitization of specified financial receivables; assignment, participation and trust. Since April 1996, the asset-backed securities structure has also been approved.<sup>4</sup>

## **(3) Obstacles under the Current Law**

The following are obstacles in securitization under the current law.

### **(a) The Cost of Establishing SPCs**

The establishment of an SPC is subject to the joint stock company regulations under the Commercial Code, and this requires the expenditure of over ¥10 million as well as the burden of arranging the company management mechanism including the appointment of directors and auditors. As there are taxes on the SPC as well as capital and personnel costs, this tends to exceed profits.

### **(b) Procedures Necessary for Assignment of Financial Receivables**

Assignment of financial receivables usually requires the certain notification to the debtor. When many debtors are involved, the notification takes much time and involves great cost. The public notice system is available only to the assignment from specified business operators to the specified receivables assignee under the provisions of the *Tokusai-ho*.

---

3 According to a survey by MITI's Trade Credit Office, securitization realized in 1997 (April-December) amounted to 627 cases, 100% up from the previous year, and the funds raised increased sharply by 4.4 times to ¥1,656.9 billion. (SFI Bulletin No.17, Structured Finance Institute of Japan.)

4 Likewise, according to a survey by MITI's Trade Credit Office, the trust structure accounted for about 80% of the total securitized assets, followed by the assignment structure, the asset-backed securities structure and the partnership structure.

## 2) Suggestions for Legislation of Securitization of Financial Receivables

Many measures and suggestions have been made from various quarters to promote securitization, such as finance receivables and real estate. The means for extensive securitization include the relaxing of regulations under the current Civil Law and the adoption of preferential tax treatment. (Table 1).

From the viewpoint of revitalizing the capital market, it is urgently necessary to dispose of bad loans and transact collateral property held by financial institutions. The LDP's extraordinary economic measures council announced a fourth additional economic package on February 20, 1998. According to the package, SPC Laws were promulgated on June 15, 1998.

**Table 1. Suggestions for Enhancing Securitization made by Many Quarters**

Time	Suggested by	Suggestions
March 1997	Mortgaged Property-Related Liaison Council	<p><b>“The Comprehensive Mortgaged Property Securitization Package”</b></p> <p>The package aims to securitize real estate, while endeavoring to improve income collateral from the mortgaged property. The suggested specific measure is to implement a “mortgaged property securitization package”. The coverage of financial receivables, which are the object of trust beneficial interest regarded as securities under the Securities and Exchange Law, should expand to include housing loan claims, and banks and securities firms should be allowed to handle these types of claims.</p>
May 1997	Assignment of Financial Receivables Study Group (a private group of the chief of the Civil Affairs Bureau of the Ministry of Justice)	<p><b>“Report of the Assignment of Financial Receivables Legal System Study Group”</b></p> <p>The report notes that the requirements for the assignment claimable against the third party demanded by the Civil Code hampers assignment of finance receivables by corporations, and suggests that a registration system should be established as new requirements in enhancing the securitization.</p>
June 1997	The Financial System Research Committee	<p><b>“Reforms of Japan's Financial System - contribution to a viable Japanese economy”</b></p> <p>The business environment should be prepared for securitization by the use of ABS because it is expected to develop in the future to respond to the diversifying means of corporate financing, offer attractive investment vehicles and provide helpful means to disperse risks and control ALM.</p>
November 1997	Government	<p><b>“Emergency Economic Package for the 21st Century”</b></p> <p>The Government intends to present to the next ordinary session of the Diet bills regarding SPCs intended to securitize real estate and financial receivables as well as a special bill to simplify the requirements for the assignment of financial receivables and prompt securitization of financial receivables. Their purposes are to improve the vehicles of financial institutions' risk control and offer attractive investment means to investors by allowing banks and insurance companies to handle certain types of ABS designed to securitize financial receivables.</p>
February 1998	LDP	<p><b>“Emergency National Economic Package (4th)”</b></p> <p>The LDP includes securitization of real estate in the measures for enhancing land transaction, which is one of the 7 major economic measures, and indicated specific measures for amendment and promotion of relative laws.</p>

## 2. Outline of the SPC Law

The purpose of the SPC Law to enhance securitization is to prepare a framework to enhance the securitization of certain assets such as financial receivables and real estate through the SPC, protect investors and facilitate investment in such securities by general investors.

Specifically, the SPC Law aims to (1) establish the SPC system engaged in improving the securitization of specific assets, and (2) promote investment in securities to be issued in response to the securitization enhancement of specific assets and protect investors. Special tax treatments are taken for the SPC Related Law.

The SPC Laws were promulgated on June 15, 1998, and are scheduled to become effective on September 1, 1998.

### 1) How to Reduce the Cost of Establishing SPCs

#### *(1) What is Covered by the SPC Law*

“Securitization enhancement of specific asset” means to acquire specific assets with money to be gained by issuing asset-backed securities, and carry out (1) the servicing of debt in the case of specified commercial papers (specified CPs) or specified bonds, and (2) distribution of profit or acquisition for the purpose of redemption, or distribution of residual assets in the case of preferred securities, with money to be gained by managing and disposing the said specified assets (including beneficiary interest of trust in the case of trust of the said specified asset). (Article 2 of SPC Law)

“Specified assets” means real estate, nominative financial receivables and beneficiary interest of trust of these two. The SPCs can issue preferred securities, specified bonds and specified CPs. The issue of specified bonds requires the establishment of a specified bond management company as is the case with a joint stock company. This requirement is exempted when the amount exceeds ¥100 million.

#### *(2) Establishment of SPCs*

##### (a) The New Formality for the SPCs

The SPC law defines the SPCs as legal entities different from joint stock companies and limited liability companies, and has less rigid requirements for its establishment and corporate organization. The SPC’s requirements for the minimum capital and the number of directors are reduced, and it is exempted from limitation to the non-assignability of the equity holding and issue of bonds that are limited in the case of a limited liability company. This allows an SPC to be on the same scale as a limited liability company and to raise funds in the same way as a joint stock company.

The SPC has requirements regarding a general member meeting, directors (more than one), auditors (more than one) and accounting auditor, as is the same case with a joint stock company.

##### (b) Procedure for establishing an SPC

The promoter of an SPC is required to prepare the articles of incorporation, specifying its purpose, trade name, amount of specified capital, asset securitization plan and the term of existence or reasons for dissolution (Article 18 of SPC Law). The asset securitization plan

should define basic matters regarding the securitization of specified assets and state the following points (Article 5 of SPC Law).

### **Contents of Asset Securitization Plan**

- (1) The term of the plan and the required items regarding the terms of the plan.
- (2) Matters regarding asset-backed securities
  - Preferred securities: matters regarding total amount, contents and issue, and matters regarding disposition.
  - Specified bonds: total amount, contents and issuance, and matters regarding redemption
  - Specified CPs: matters regarding maximum amount and issuance, and matters regarding redemption
- (3) Matters regarding acquisition of specified assets
- (4) Matters regarding management and disposal of specified assets, and the fiduciary of that business
- (5) Securitization implementation plan

SPC's capital should be composed of specific capital (more than ¥3 million) and preferred capital (when preferred securities are issued). The requirements of asset subscription and preincorporated subscription are exempted when they are stipulated in the asset securitization plan. (Clause 3-3, Article 18)

The SPCs have no system for legal reserves, and profit distribution is limited to the balance of net assets minus total capital and specified equity holding. When the term of business exceeds a year, the company can provide an interim dividend if it is stipulated in its articles of incorporation.

## **(2) Administrative Regulations**

### **(a) Registration**

The SPCs cannot engage in asset securitization business unless they present an application describing the asset securitization plan to the Prime Minister<sup>5</sup> and get their registration accepted. When an SPC terminates the plan, it must its termination to the Prime Minister.

When it engages in the securitization business under another plan for securitization, it is required to receive renewed registration (Articles 10 and 11).

As the registry of securitization enhancement plans and such implementation plans are open to public inspection, the SPC scheme becomes public information (Article 71).

---

<sup>5</sup> Administration and rights regarding SPC registration, inspection and supervision are left to the Financial Supervising Agency (SPC Related Law, Article 20 and the Financial Supervisory Agency Law Clause 20-2, Article 4.).

(b) Business Regulations

Regulations for the SPC's business include (1) prohibition of other business operations (Article 142), (2) prohibition of issue of more than one type of preferred securities or specified bonds (Article 150), (3) restriction on borrowing (Article 151), (4) restriction on disposal of specified assets (Article 152) and (5) restriction on management of surplus funds (Article 153).

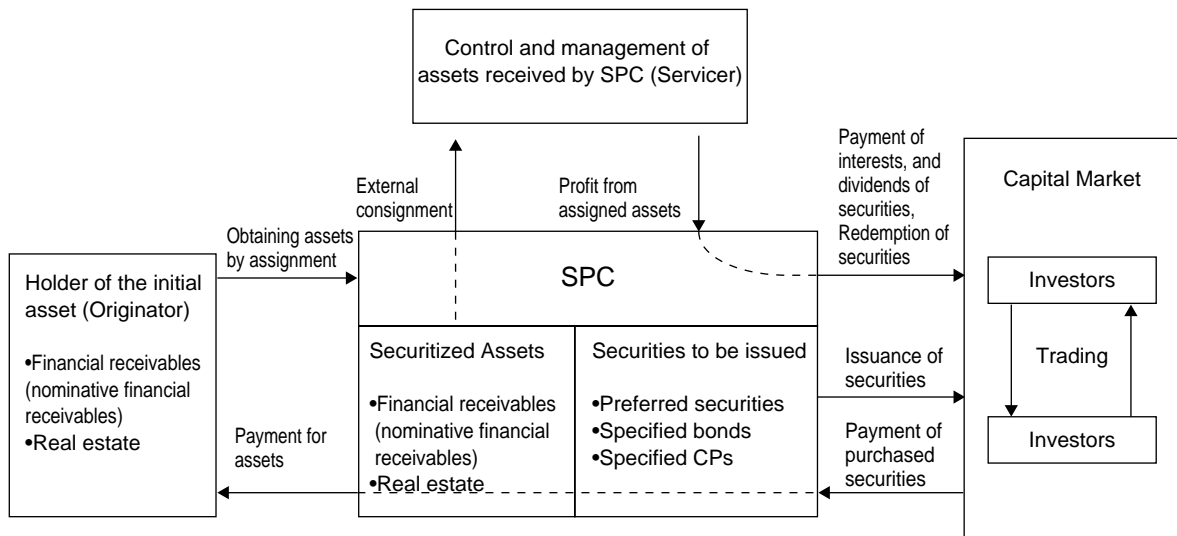
(c) Supervisory Regulations

The SPC is required to prepare and maintain accounting books and documents and present business reports annually to the Prime Minister (Articles 154 and 155). When the Prime Minister judges that the SPC's business has violated, or is feared to violate, laws, he may order an "entry and inspection", an order to correct illegal act, or cancellation of registration (Articles 156-161).

**(3) Investor Protection and Disclosure**

As specified bond and preferred securities issued by the SPC have been designated as securities under the Securities and Exchange Law, disclosure for public offering is required. Details of disclosure will be defined by the ministerial ordinance for disclosure.

**Figure 2. Flow Chart for Securitization Using SPCs Based on the SPC Law**



## **2) Legal Systems concerning SPC Law**

### ***(1) Taxation System***

The amended taxation system (amended March 31, 1998) envisages the following tax reduction measures intended for smooth establishment and management of SPCs.

#### **(a) Taxes on SPCs**

When the SPC has satisfied the following conditions, it can enter under losses such dividends, up to the amount of income, as paid during the fiscal year.

- The SPC should receive the Prime Minister's registration.
- It should issue securities backed by financial receivables and real estate to a number of investors or unspecified institutional investors (excluding the case of private offering to a limited number of investors).
- It should not engaged in other business activities.
- It pays to investors dividends in the amount more than 90% of income.

The SPC is also exempted from registration/ license taxes. A fixed fee of ¥30,000 is charged for the registration of incorporation and a tax rate of 2.5% (against the ordinary 5%) is imposed for two years on assignment registration for the ownership of real estate to be acquired in accordance with the securitization plan. However, no taxes are imposed for assignment registration for financial receivables.

#### **(b) Taxes on Investors**

Taxes on the SPCs represent a major obstacle to their incorporation. Currently, losses incurred to the SPCs are not passed onto investors.

In the current amendment, the rule of “non-accrual dividends”, or dividend exemption, does not apply to the dividends by investors from the SPCs.

### ***(2) How to Handle Securities issued by SPCs***

To the securities defined by the Securities and Exchange Law will be added specified bonds (Securities and Exchange Law 3-2 of Clause 1, Article 2) and preferred securities (5-3 of Clause 1, Article 2) as issued by SPCs. Banks and other financial institutions (Clause 2-3 of Article 65) are permitted to handle specified bonds and preferred securities as defined by the Government Ordinance (SPC Related Law, Article 9).

Underwriting of specified bonds issued by the SPC (excluding underwriting for the purpose of secondary offering) or offering of specified bonds regarding the said underwriting are included in the attached business of financial institutions.

### ***(3) Relation to the Tokusai-ho***

When the SPC receives by assignment specified financial receivables from a specified business operator as defined in the Tokusai-ho, the SPC is regarded as a specified claimable asset assignee under the Tokusai-ho. In that event, the SPC is subject to the provisions of the Tokusai-ho including the public notice system regarding the assignment of specified financial receivables.

### **3. Relaxation of Requirements for Assignment of Financial Receivables**

The special law of the Civil Code, which is intended to introduce a financial receivables assignment registration system as a requirement for financial receivables assignment by corporations, passed on June 5, 1998.

#### **1) Requirements for Assignment of Financial Receivables**

Nominative financial receivables<sup>6</sup> can be assigned in principle (Clause 2, Article 466 of the Civil Code). When financial receivables are assigned, the assignee should give notice to the debtor or get the creditor's approval, to make the assignment claimable against the third party<sup>7</sup>. The notice or approval as to the third party other than the debtor should be made in the form of a certificate with a fixed date (Article 467 of the Civil Code).

This obligation of notice to the debtor forms a major obstacle to the originator of financial receivables. Thus, there has been a growing demand for relaxation of procedures necessary for the assignment of financial receivables, in order to promote securitization.

#### **2) Exceptions to Assignment of Financial Receivables under the Tokusai-ho**

Securitization of financial receivables was adopted in 1992 as a new means to raise funds by leasing companies and credit card companies. In this method, the requirements for assignment of financial receivables were changed from notice to the debtor to a public notice. This step was highly innovative, but it has some problems, which the law allowed only lease and credit card companies to securitize their financial receivables and inadequate protection of the creditor.

The problem of creditor protection is that when the debtor has the financial receivables against the creditor, the credit and receivables can be offset with each other (Article 468 of the Civil Code), but that without notice of the assignment of financial receivables, the chance of such offsetting will be lost.

#### **3) Flexible Assignment of Financial Receivables by Corporations**

After the enactment of the Tokusai-ho, the Civil Affairs Bureau of the Ministry of Justice, which supervises the basic civil affairs laws such as the Civil Code, established a group to study the legal system for assignment of financial receivables in June 1995 in an attempt to grasp the intentions of the quarters seeking securitization enhancement of financial receivables and to identify problems of the countervailing requirements of the current Civil Code. In accordance with the report prepared by the study group in May 1997, the bill regarding special cases of the Civil Code on countervailing requirements for assignment of financial receivables (hereafter called "Law on Special Provisions of the Civil Code") was legislated. It was passed on June 5, 1998. The legislation will be enacted in June 1999 at the latest. The purpose of the special provisions regarding assignment of financial receivables is to create a new requirements system by means of registration of assignment of financial receivables by corporations and take measures such as arrangements of registration procedure, as a special case regarding requirements for assignment of financial receivables, in order to prompt assignment of financial receivables by corporations.

---

6 The creditor is specified. No preparation of deeds is required for the establishment and execution of the financial receivables.

7 This is the requirement for claimable against the third parties with regard to acquirement or loss of legal relations or interest relations that have become valid.



### ***(1) Financial Receivables Covered***

Financial receivables covered by this special provisions are broadly stipulated as nominative claims (monetary financial receivables) held by corporations (Article 2 of the said law). This was limited to leasing companies and credit card companies under the Tokusai-ho, but the said law covers any corporations regardless of business line and form of incorporation. Financial receivables other than credit claims such as lease and credit are also covered. As the assignor of financial receivables is limited to corporations, there is no special application regarding assignment of claims held by individuals and partnerships. The assignee of financial receivables is not limited to corporations.

### ***(2) New Requirements and Disclosure System***

The financial receivables assignment and registration system was created as the requirements for assignment of financial receivables. The corporation, which has transferred financial receivables, should apply to the legal affairs bureau (registry) designated by the Minister of Justice, jointly with the assignee of the receivables, for registration in order to record in the claim assignment registration file such items as (1) name and head office of the assignor, (2) name and head office of the assignee, (3) reason and date of registration, (4) total amount of transferred receivables, (5) period of claim assignment registration (maximum 50 years in principle) and (6) date of registration (Articles 3 and 5).

Registration of the assignment in the financial receivables file serves as notice in the deeds with fixed date as stipulated in Article 467 of the Civil Code (Article 2). In that event, the fixed date is regarded as the date of registration.

The debtor can countervail the creditor regarding the latter's countervailing receivables until he receives the notice of financial receivables assignment registration.

This serves to solve the problem of discontinuance of the debtor's countervailing.

Under the Tokusai-ho, data concerning assignment of financial receivables were supervised by the MITI. However, under the Law on special provisions of the Civil Code, such data are managed by the registry by processing the financial receivables assignment registration file into magnetic digital data, in order to ensure nationwide access to the data. The registration of assignment of financial receivables is also recorded on the commercial register of corporations (Article 9).

Two methods for disclosure of assignment of financial receivables under the assignment registration system are specified. They are delivery of "the statement of registration items" and delivery of "the certification of registration items". This system serves to protect the debtor's privacy and meets the requirements of disclosure.

### ***(3) Effects of the Law on Special Provisions of Civil Code***

A person who wants to be the assignee of financial receivables may go to a nearby registry and confirm who is the real creditor by inspecting the financial receivables assignment registration file, and does not have to go to the debtor.

## 4. Future Trends

After enactment the SPC Laws, the government and the ruling LDP are preparing measures to promote securitization. On April 22, 1998, the LDP prepared the bill for lifting the ban on the establishment of claims collection agency (servicer) at the Land Transaction Promotion Special Committee, and decided to present the bill to the next session of the Diet. Collection of claims is the lawyers' business, and claim collection by any person other than lawyers is prohibited (Lawyer Law).

The bill allows claim collection only in the case of claims of financial institutions and non-banks. In that event, however, it is required to include lawyers in directors and auditors of the servicer. The LDP also prepared on April 22 "Total Plan for Securitization of Land and Financial Receivables". It is to remove the ban on investment of Postal Savings and Postal Life Insurance Funds in ABSs, established "the extraordinary property-related claims adjustment committee (provisional)" in the Prime Minister's Office, and permitted financial institutions renouncing claims to write off tax free.

It is expected to carry out further drastic reform measures.