
Enactment of the Servicer Law

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With the promulgation of the servicer law, there will be some American servicers entering the Japanese market in this area as well as Japanese companies launching into the servicer business. However, the mere emergence of servicers does not mean an immediate solution of the bad debt problem. The business faces some challenges including how to improve the servicer law, enhance the servicer functions of the Japanese version of RTC (the Resolution & Collection Bank), establish a cooperative system with private sector servicers and further build up the environment for final disposition of bad debts.

The promulgation of the Servicer Law on October 16, 1998 has made it possible to establish the private sector servicer business in Japan. Some companies have already announced their plans to establish servicer companies, while the Nippon Credit Bank and the Chuo Trust and Banking have reached a basic agreement to cooperate in setting up a servicer company.

Against this background of growing interests in the servicer business in expectation of the increasing securitization and faster disposition of bad debts, this report will review the future role of the servicer business in Japan.

1. What is a Servicer?

Japan's adoption of the servicer system was made in consideration of the fact that servicers played a significant role in dealing with bad debts in the United States in the early 1990s. American financial servicers are specialized in many cases in controlling and collecting loan credits in such schemes as securitization of housing mortgages, securitization of commercial mortgaged loans, and securitization of bad debts. In contrast, the firms known as servicers in Japan are often specialized in controlling and collecting loan credits and accounts receivable. In the following chapter, we will see how the servicer is defined in Japan's servicer law.

2. The Promulgated Servicer Law

It has been decided that the servicer law, which was enacted during the 143rd Diet session (Japanese parliament), should be enforced by April 16, 1999. A closer look at the servicer law shows that the servicer business in Japan is not always intended for securitization, but that it is merely a means to allow the private sector to handle control and collection work for

financial institutions' loan credits and money lenders' lease credits, actions which were previously permitted only to lawyers.

1) Purposes and Characteristics of the Enactment of the Servicer Law

The law has been established to promote disposition of bad debts and liquidation and securitization of credits. It allows, as an exception to the Attorneys-at-Law Act, private sector servicer companies to engage in control and collection of specified money credit, and aims to secure proper management of the business by applying necessary rules (Article 1).

A notable point in the law is that in consideration of the fact that antisocial forces such as gangsters and forced occupiers were deeply involved in the area of credit collection, a cooperative framework among the Minister of Justice, the Commissioner General of the National Police Agency and the Japan Federation of Bar Associations has been established to exclude the entry of such antisocial forces into the credit control and collection business (see "2) (2) Necessary Conditions for Licensing").

In other words, the spirit of the law is to ensure the adequacy in credit collection and take consideration in protecting the debtors' human rights while pursuing the efficiency of credit collection.

However, the initial purpose of helping the liquidation and securitization of land and credit to contribute extensively to the stabilization of the financial system, as envisaged by the ruling party, has become less forceful from the viewpoint of reinforcing the role of servicers in the liquidation and securitization process. This is because the ruling party accepted, as a result of consultation with the oppositions in enacting the law, the oppositions' demand to limit the role to promote bad debt disposition which is the problem of the greatest urgency. The dilution of the purpose of the legislation has had a substantial impact on the scope of the credit to be handled.

2) Definition of the Servicer

The servicer is defined in Clause 2, Article 2 of the servicer law. This clause is stipulated in conformity with Articles 72 and 73 of the Attorneys-at-Law Act,^{*1} and the servicer law permits acts that had been prohibited under the Attorneys-at-Law Act.

(1) Kinds of the Credit Handled

The credit to be handled by the servicer is defined as "specified money credit" which is limited to the following kinds (Clause 1, Article 2).

*1 Article 72 of the Attorneys-at-Law Act

Persons who are not lawyers are not permitted to handle legal matters including expert opinion, representation, arbitration, or composition, in regard to lawsuits and non-lawsuits as well as petitions of objection against administrative agencies, including appeal for examination, exception, and appeal for reexamination for the purpose of getting remuneration, or engage in mediation for these matters, unless otherwise stipulated in this law.

Article 73 of the Attorneys-at-Law Act

No one is permitted to engage in a business of exerting the rights transferred from others, by such means as lawsuit, arbitration, composition and others.

- a. Loan credits held by financial institutions, credit banks, labor credit associations and Central Cooperative Bank for Agriculture and Forestry as prescribed by the deposit insurance law.
- b. Specified credit, that is, lease credit, specified by the "law concerning regulations on the business related to credit, etc."^{*2}
- c. Property-mortgaged loan credit held by money lenders prescribed in Clause 2, Article 2 of the "law regarding regulations on the money lending business".
- d. Loan credits held by the financial institutions listed in a. above.^{*3}
- e. Credits based on the guarantee contract that guarantees the credits of the preceding items.
- f. Reimbursement credits held by the credit guarantee association, etc.
- g. That which is specified by the government ordinance as being similar to the money credits listed in the preceding items.

These provisions limit the credits to be handled by the servicer to money credits. This limitation has caused a possibility, for instance, that the credits held by general contractors and financial institutions affiliated with securities companies may not be covered. This would narrow the servicer's area of operations.

(2) Licensing Conditions

Licensing conditions are specified from the viewpoint of excluding antisocial elements such as gangsters as follows (Clauses 1-8, Article 5).

- a. The servicer should be a joint-stock company with a capital of over ¥500 million.^{*4}
- b. The servicer's managing directors engaged in regular duties should include more than one lawyer.
- c. The servicer should be a joint-stock company with no possibility of having gangsters engaged in its business or using them as assistants.
- d. The servicer should be a joint-stock company with no gangsters in its board of directors.

The Minister of Justice is required as the licensor (Article 3) to hear the view of the Commissioner General of the National Police Agency as to the qualifications in term of the conditions specified in Article 5 (Clause 1, Article 6), and make his/her decision on licensing on the basis of this view.

As one condition for licensing, directors must include more than one lawyer (Clause 4, Article 5, b above), and it is also stipulated that the Minister of Justice should refer to the opinion of the Japan Federation of Bar Associations as to the qualifications of the lawyer in

*2 Lease credit is included in this classification for the purpose of promoting liquidation of credit, etc. by considering the fact that liquidation and securitization are being promoted under the specified credit law, but all lease credits are not included. For instance, credits for lump-sum payment for credit cards are excluded from the definition of the specified credit law. If its inclusion is necessary, it should be stipulated separately by government ordinance.

*3 Loan credits purchased by the solution and collection organization and the joint credit purchase organization from the financial institutions prescribed in a. above.

*4 This is a joint-stock company established pursuant to the Japanese law, and no offices of foreign corporations are permitted, in the form of their Japan offices, to enter this market.

question (Clause 2, Article 6).

It is intended in this way to exclude antisocial forces and ensure the appropriateness of the servicer business through mutual contact and cooperation between the Justice Minister, the Commissioner General of the National Policy Agency and the Japan Federation of Bar Associations.

3) Scope of the Servicer Business

With regard to the servicer's authorized limit of powers, Clause 1, Article 11 stipulates that when the servicer engages, entrusted by the trustor, in control and collection, it can be a party to the lawsuit. It also stipulates that the servicer can make its lawyer follow suit for a certain judicial action (Clause 2, Article 11).

The servicer performs its business entrusted by others, and this nature requires the servicer to be specialized (dedicated) in its business and not in a side business. However, the servicer may engage in such businesses as control and collection of specified money credits with no risks of lawsuit, as well as certain incidental businesses prescribed by the government ordinance.

It can also engage in other businesses with the approval of the Justice Minister (Article 12). Clause 1, Article 12 defines the servicer as "a business for control or collection of specified money credit and not a servicer intended for control and collection of credits". This stipulation is intended to rule out fears that the control and collection of normal credits may not be possible in connection with the obligation of specialization, because the stipulation by Clause 2, Article 2 stipulates that the credit control and collection business includes the content that this infringes on the Attorneys-at-Law Act.

Clause 2 does not specify incidental businesses, leaving them to be specified separately by the government ordinance. Whether the businesses such as real-estate trading, leasing/lending and investment, of which there has been strong demand for inclusion as incidental businesses, will be permitted remains to be seen.

4) Supervision and Penal Provisions

It is stipulated that the Minister of Justice may conduct investigation, if deemed necessary, to ensure proper management of the servicer business (Article 22) and issue operational improvement order (Article 23) and cancellation of the license (Article 24). In canceling licenses, the Justice Minister may refer to the opinion of the Commissioner General of the National Policy Agency.

What should be kept in mind is the effort to encourage self-purification for the development of a healthy servicer business through strict observance of the supervision and penal rules.

5) Miscellaneous and Supplementary Rules

A clause for reexamination is added as Supplementary Rule. 7 which stipulates that the

provisions of this law may be reexamined approximately five years after its enforcement taking into consideration of how the law is being executed. This clause is not intended to keep the law in force only for a limited period of time, but to verify whether the credit collection scheme can function adequately by excluding antisocial forces. There is a possibility that conditions for the entry into the market, including the minimum capital requirement, will be eased if the adequacy is ascertained five years after enactment. These rules can be seen as an indication of the attitude to cautiously monitor the development of the servicer business.

3. Foreign and Domestic Companies' Entries into Japan's Servicer Market

Generally American servicers are involved in a broad spectrum of processes including origination, control and collection, brokerage for mortgaged properties and securities investment, including purchases of credits for securitization.

In contrast, Japan's servicers stipulated by the recently enforced servicer law are assigned to the specialized collection service to facilitate bad debt disposition. The important function of this service is to distribute cash flows generated from assets in a stable way in the process of securitization of funds that are gathered from investors by issuing securities with various assets as collateral. It is expected that this service in Japan will expand in the future with the progress in securitization.

Since the start of 1999, many companies in various lines have announced their plans to enter into the promising servicer market in Japan as shown in Table 1. They intend to utilize their expertise in their principal lines, including banking and leasing. Their supervisory authority, the Ministry of Justice, expects 20-30 servicers to start operation.

These companies' attitude toward the servicer business indicates that their approaches differ from each other. For instance, the Nihon Credit Bank and the Chuo Trust & Banking reached a basic agreement to establish a servicer and expressed a policy to aim to be a special servicer working for foreign companies, which have procured land in Japan but have meager knowledge of Japanese laws and regulations. Sumitomo Bank has a policy to purchase bad debts, in lump sum, held by local banks and life insurance companies, and entrust a servicer to be founded within its group with the business of collection of credits. Orix, a major leasing company, is said to be considering launching out into the servicer business specialized in special servicing, due diligence and investment, utilizing its experience in operating a joint servicer company with Bank One of the U.S. Credit companies and consumer finance companies plan to engage in collection of small-lot accounts receivable of department stores and credits held by consumer finance companies. Some other companies intend to enter into the backup servicer business.

Despite such a growing move to enter into the servicer business, actual launching seems difficult because of many hurdles to overcome. Under the recently enforced servicer law, for example, a new servicer has to have a capital of ¥500 million at its startup. With the exception of large banks and big companies, this requirement makes it difficult for medium and small-sized banks and companies to enter into this market. There is also a problem of profitability: in the case of the simple job of collection and control of funds, it would be

unprofitable without receiving bulk orders involving fixed forms of clerical work. Moreover, because of the restriction on foreign companies against entry into the market through their Japan offices, they have to establish their Japan companies in total conformity with the Japanese law. Under the circumstances, foreign companies can incorporate a servicer to engage in the credit collection business, but full-line operation is restricted.

Therefore, if the cost of establishing a servicer is felt to be too much, a realistic step would be to focus on investment business in the forms of credit purchase mostly through bulk sale and arrangement of securitization schemes. These circumstances will require an improvement, at the level of government ordinance, or early reexamination of the servicer law in order to ensure the development of a healthy servicer business and market by relaxing conditions for market entry and encouraging competition between big and small companies, and between domestic and foreign companies.

Table 1 Entries into the Servicer Business by Japanese companies

Line	Companies Considering Entry	Planned Servicer Business
Banks	Nihon Credit Bank	The Bank plans to enter into the servicer business by starting a fee business for local banks with little experience in handling bad debts, as well as non-banks during FY 99. It has announced a basic agreement made with Chuo Trust and Banking for joint establishment of a servicer company.
	Sumitomo Bank	The Bank plans to set up a servicer company within the group, which will engage in the control and collection of bad debts of local banks and life insurance companies it has acquired.
	Daiwa Bank	The establishment of a servicer company is under study.
	Sakura Bank	The establishment of a servicer company is under study.
	Yokohama Bank	The establishment of a servicer company is under study.
Leasing	Orix	It plans to establish a servicer company in Japan and enter into the servicer business. With some know-how from its investment in Bank One Mortgage Capital Markets of the U.S., the company will focus on handling of bad debts held by business corporations, and plans to purchase and collect ordinary credits. It also plans to sell collected debts to U.S. investors in the form of loan pool.
Credit and Consumer Finance	Nippon Shinpan	It plans to start back-up services for leasing and automobile loans and will consider entering into the credit control and collection business.
	Kokunai Shinpan	It plans to enter into the servicer business by increasing the capital of a subsidiary, Kokunai Shinpan Service.
	Sanyo Shinpan	It plans to enter into the servicer business by setting up a project team within the company.
	Aplus	It plans to enter into the servicer business for handling personal credits by reshaping a subsidiary, Aplus Shoji. It will also work as an agency for credit collection.
	Aiful	It plans to launch into the backup servicer business that collects leasing credits for bankrupt companies, and intends to engage in credit control by issuing credit transfer notices and controlling data, and in entrusted business from other companies' backup servicers. It will consider an entry into the credit control and collection business.
	Orient	It plans to establish Orico Credit Collection (tentatively named) in April 1999 through capital increase of a subsidiary, Orico Counselor, with its initial business limited to the handling of personal credits of financial institutions, and credits of department stores and mass-sale stores.
Construction	Dia Construction	It is considering an entry into the servicer business for the

Line	Companies Considering Entry	Planned Servicer Business
		collection and appraisal of credits by utilizing the know-how built up in the area of real estate business as a condominium developer. It will use its knowledge on the collection and evaluation of credits regarding real estate as well as trouble solving. It also expects to gather information about land.
Foreign-Affiliated Companies	Kennedy Wilson	It is considering an entry into the Japanese market, though the servicer business will not be its main line in Japan.
	Bankers Trust	It has established a subsidiary specialized in purchasing bad debts of Japanese banks, and is considering an entry into the servicer business when the servicer law is enforced.
	GMAC	It establishes a servicer company in February 1999 to acquire commercial properties which have turned into bad debts and intends to handle securitization of properties by utilizing its know-how about this business in the U.S.

Source: Compiled by Nomura Research Institute based on various press reports.

4. Future Challenges

Considering the significant role played by the American servicer in handling bad debts, the recent enactment of the servicer law in Japan marks a big step forward toward securitization and disposition of bad debts. Currently, attention is focused on to what extent the present regulations on operational procedures will be eased by the government ordinance.

Unfortunately, Japan's servicer law, which is strictly limited to the purpose of promoting bad debt disposition, gives a strong impression of being intended for the exclusion of antisocial forces. As a result, the servicer's original positive functions in trading real estate and arranging for securitization have been weakened almost by half by restrictions on market entry and limits to the business scope. It is hoped that there will be debate on possible amendment of the law and how to reinforce the servicer business even before the law is reexamined in five years time.

It is too simplistic to imagine that the problem of bad debts will be solved immediately with the startup of servicers and an improvement in their functions. It will become possible to establish firms which in the US are known as Special Servicers.

The master servicer's functions will be improved gradually with the expansion of the securities market. However, further efforts should be made to create an environment for the solution of the bad debt problem through securitization.

The servicer business faces two major problems. First is the development of the relationship between the Japanese version of RTC (Resolution Trust Corporation), that is, the Resolution and Collection Bank, and private sector servicers. The Japanese version of RTC will function, as was announced, as an organization for purchasing poor-performing assets in the private sector and is expected to perform its role as a huge servicer. It is undoubtedly necessary to develop an "exit strategy" for final disposition of real estate. For this purpose this organization should improve the servicer functions and promote final disposition of bad assets through a cooperative system with the private sector. Otherwise, it will not be characterized as a Japan Version RTC which will be an entity for creating investment and promoting asset liquidity.

The second problem is how to establish a trading market and achieve full disclosure. There will be no real development of the trading market for real estate and that for loan credits unless conditions for adequate market functioning are prepared in terms of information on bad debts, rights regarding mortgaged property and rents. The foundation for the development of the trading markets for real-estate and loan credits can probably be built by involving the servicer in the processes of gathering, standardization, and disclosure of information on real-estate and loan credits.

In view of spontaneous changes in players in the capital market and the process of natural selection likely in the future, the possibility cannot be ruled out that financial institutions will include servicers, which can be entrusted with collection of credits, in their outsourcing strategy. Some financial institutions, which are changing into investment banks, will find it necessary to utilize the servicer through lending for securitization, while other financial institutions, which are strong in asset control, can transform themselves into major servicers. Depending on its performance, the servicer will perform a significant part in the healthy development of securitization and capital markets.