Liquidity Enhancement and Securitization of Loan Assets and Disposition of Bad Loans

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Since the beginning of 1998, disposition of banks' bad loans has been accelerated through such means as bulk sale and securitization. The introduction of bulk sale has attracted greater attention to whether it can help the methods of price setting and evaluation based on market disciplines, such as DIV and due diligence, take root in Japan. While legal arrangements are proceeding toward the startup of a securitization market with the enactment of the SPC bill and the servicer bill, difficulties about bad loan disposition through securitization have been pointed out. This report will review the traditional loan assets liquidity enhancement method and the bulk sale approach, and discuss the limitation of bad loan securitization and requisites for its dissemination.

1. Liquidity Enhancement of Loan Assets as Relative Trading

1) Inducement to Loan Assets Liquidity Enhancement [*1]

The issue of banks' bad loans comes in essence from the devaluation of loan assets and the erosion of equity capital caused in the process of disposing of devalued properties. In order to increase equity capital or improve the equity capital ratio, banks have taken one of two methods. The first is to increase the numerator (value) through direct expansion of capital base by issuing subordinated loans or subordinated bonds, and the second is to decrease the denominator (value) through liquidity enhancement of loan assets.

In the first half of the 1990s, banks focused their efforts on increasing the numerator by adopting subordinated loans or issuing subordinated bonds and preference stocks.

In the subsequent years, however, although lagging far behind, they began to realize the economic value of loan assets liquidity enhancement partly because of the increasing amount of bad loans and the declining margin for subordinated bond issue (Table 1). The introduction of the "prompt corrective measures" in April 1998 has caused bank managers to pay greater attention to the capital adequacy ratio and subsequently to liquidity enhancement and securitization of their loan assets in their operations.

*1 Views differ as to definitions of liquidity enhancement and securitization. This report defines liquidity enhancement as an act on the part of a bank to decrease its loan assets held in the form of collateral by transferring relative loan assets to a specific third party (the conventional method), and securitization as an act to disperse risks by selling the risks of relative loan assets to an unspecified number of investors.

Table 1 Breakdown of the Capital Adequacy Ratio of City Banks

(Unit: trillion yen)

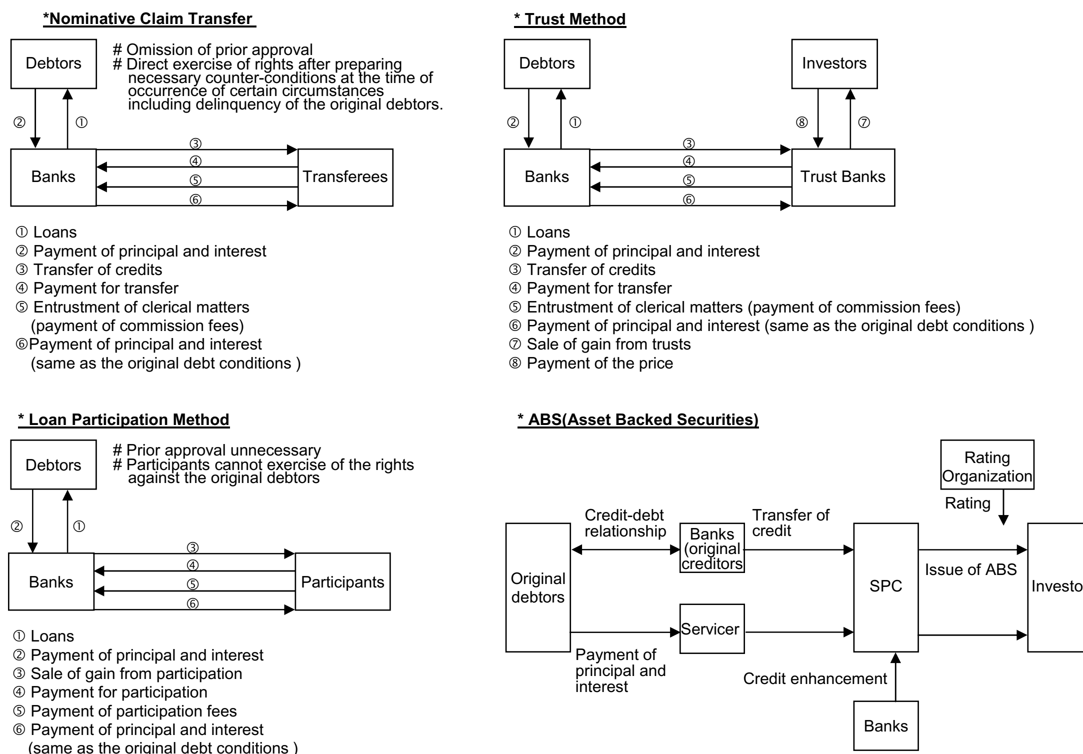
	March 1990	March 1997	March 1998
Tier 1	14.55	15.50	14.03
Tier 2	13.51	14.71	13.57
Latent gain from securities	12.77	2.56	0.50
Subordinated debts	0.00	11.11	11.22
Reserves, etc.	0.74	1.05	1.85

* Figures for March 1990 show the result of recalculation of published data based on the BIS standard. Subordinated debts in Tier 2 are estimated after deducting latent gain and reserves.
* Others are calculated from the figures disclosed by banks.
Source: Nomura Research Institute

2) Models of liquidity Enhancement of Loan Assets

Methods of liquidity enhancement of loan assets are roughly classified into three: nominative claim transfer, loan participation and trust (Figure 1).

Figure 1 Typical Schemes for Liquidity Enhancement of Loan Assets



Source: Nomura Research Institute

The general loan assets transfer system was adopted in 1990 as a means to meet the BIS capital adequacy requirements. The nominative claim transfer method is characterized by the fact that the creditor (transferor) can avoid credit risks against the debtor by transferring its credit-debt relationship to the investor (transferee).

Loan participation, which was introduced in 1995, represents a bilateral contract between the creditor and the investor (participant) without the debtor's prior consent. Unlike the nominative claim transfer method, this method requires no legal transfer of the credit-debt relationship. However, it entitles the creditor to the same accounting treatment as the nominative claim method, making it easier to secure economic effectiveness than by credit transfer.

The trust method calls for transfer of loan assets to a trust bank, which sells the right of beneficiary to investors and uses this price in paying for the transferred credits. The trust method is divided into the direct trust approach in which credits are directly transferred to the trust bank, and the indirect trust approach in which credit is first transferred to business corporations and others which set up their monetary credit trust.

3) Economic Values of Liquidity Enhancement of Loan Assets

Liquidity enhancement of loan assets has at least two economic values. First comes from an off-balance effect, and ensures an improvement in the capital adequacy ratio and ROA through the reduction of the balance sheet. The money generated by assets reduction can be provided as new loans to companies, which can use it to cope with the credit crunch being caused by the tightened lending policy of banks. The second value comes from an effective means to raise funds. However, no advantage from funds raising can be fully enjoyed without relying on sale of normal loans. If bad loans are sold, devalued assets will inevitably cause erosion of the selling price, and this sale will incur the posting of a large amount of loss. Sale of such bad loans is thus a subordinated option for banks with inferior capital base or managers still unprepared for losses. Those who want to maintain their trading relations with debtors are hesitant to sell loan assets to a third party, and thus have limited their trading to the cases of raising funds by selling normal loans temporarily straddling accounting terms. In consequence, the transferee (participant) has played a role not so much of a purchaser of loan assets in its investor behavior, as of a cooperator with the transferor by providing financing.

4) Problems in operation

Until loan participation was adopted, liquidity enhancement of general loan assets relied on the nominative claim transfer method or the trust method. However, the market did not expand for three reasons. First, in the case of defaulting, the debtor in the nominative claim transfer method was hesitant to have the right exercised by the transferee (a new creditor). Second, a bank as the transferor (creditor) was reluctant to negotiate for the transfer of loan assets even at the cost of a good trading relationship, or could not ignore the cost (fees collectable at fixed date) involved in countervailing a third party. Third, the transferee was hesitant to take credit risks on both sides of debtor and creditor, regarding the transfer of loan assets equipped with no adequate countervailing conditions against a third party. [*2]

In 1991 "the silent method" which requires no prior consent was authorized, but it failed to expand its own market because the transferee's problem of how to avoid credit risks remained unsolved.

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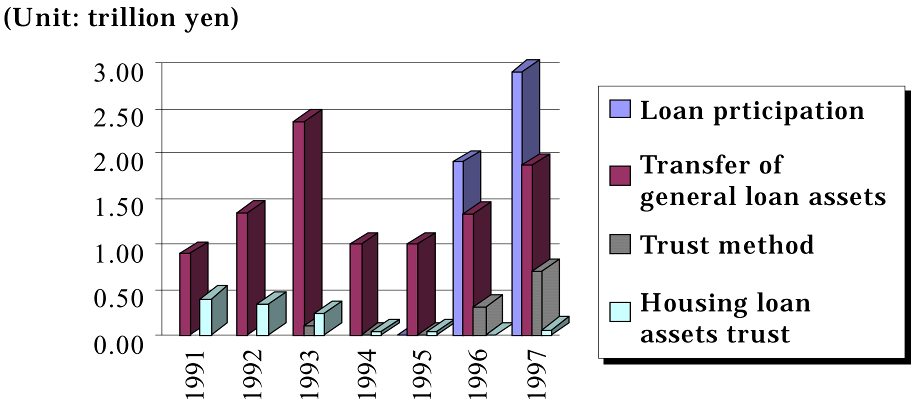
*2 An example is the risk offset with credit held by the original debtor against the original creditor.

It was through the enactment of "the law concerning special exceptions to the civil law on countervailing requirements procedure for credit transfer" (credit transfer law) in October 1998 that the method was made easier to adopt through simplification of the third-party countervailing requirements procedure. [*3]

Figure 2 Records of Loan Asset Liquidity Enhancement by Financial Institutions (on a term-end accounting basis)



* Data are from the Nikkei Bonds and Debentures Information (Koshasai Joho), and the Financial (Kinyu) Facsimile Newspaper.
* Data for FY1995 are unavailable and the previous year's data are used in its place.
Source: Nomura Research Institute

The loan participation method has been adopted after solving the problems with the nominative claim transfer method. A participant is required by the loan participation contract with the creditor to purchase the right to receive principal and interest, and pay the price and fees for participation. As the participant has no right to exercise the right against the creditor, there is no need to prepare the countervailing conditions against the third party. As the loan participation method has less operational difficulties than the nominative claim transfer method, it played a leading role in expanding the market at the initial stage (Figure 2). However, loan participation is still not free from a countervailing risk between the debtor and the creditor, and thus it cannot exclude the risks on both sides of the parties as is the case with the nominative claim transfer method.

2. Introduction of a New Method of Loan Assets Liquidity Enhancement and its Implications

1) Adoption of Bulk Sale

Initial liquidity enhancement of loan assets formed a marginal relative trading relationship with friendly financial institutions as investors. As it had to center on normal credits and

*3 Under the credit transfer law, registration by a corporation of the transfer of loan assets eliminates the need of notification that fixed-date acquisition should be the countervailing conditions against a third party.

was not fully free from the creditor's credit risks, it could not be effective as the method applicable to the disposal of bad loans.

In March 1997 Tokyo-Mitsubishi Bank collectively sold bad loans worth about ¥5 billion by the bulk sale method which is used for disposing of bad loans in the United States. This step triggered a wave of sales of bad loans in bulk sale in Japan.[*4] (Table 2)

Table 2 Recent Examples of Bulk Sale

Time	Seller	Buyer	Scale of Sale
March 1997	Tokyo-Mitsubishi Bk	Cargill	¥5 billion
	Tokyo-Mitsubishi Bk	Goldman Sachs	¥12.5 billion
March 1998	Sumitomo Bk	Goldman Sachs	¥40 billion
	Crown Leasing	Bankers Trust, etc.	¥280 billion
	Tokyo-Mitsubishi Bk	Loan Star Opportunity Fund	¥20 billion
	Sanwa Bk	Merrill Lynch, etc.	¥150 billion
	Sakura Bk	Merrill Lynch, etc.	N.A.
	Mitsui Trust & Banking	Secured Capital	¥130 billion
	Sumitomo Bk	N.A.	¥100 billion

Source: Compiled by Nomura Research Institute from various reports.

2) Effects of Bulk Sale

Banks can expect two advantages from bulk sale of their bad loans. First, their risks on individual bad loans can be dispersed through bulk sale. By the bulk sale method, it is possible to sell various mortgaged properties, which are difficult to liquidate individually, such as those that are subordinated or without surplus and those whose interests are too complicated to adjust, all in combination with various loan assets. It can thus reduce relative cost [*5] and ensure final disposition of bad loans. [*6]

Second, bulk sale has a tax advantage. Loan assets in bulk sale are entitled to non-tax depreciation by posting them as loss from sale of credits. Formerly banks were required to prove that credits in question were uncollectible, but it was extremely difficult for them to establish the adequacy and necessity of the depreciable value. In 1997, the Ministry of Finance discontinued the bad loan depreciation proving system, leaving the depreciation of bad loans to banks' discretion. Now the disposed loan assets through bulk sale are treated as

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*4 Band loans disposed of by bulk sale amounted to ¥3 trillion in the second half of 1997 and ¥2 trillion in the first half of 1998 (Nihon Keizai Shinbun, Oct. 19, 1998)

*5 This is the cost for holding individual loan assets. Usually it takes two or three years to sell loan assets through auction. In the case of bulk sale, losses at the time of sale may expand temporarily but are often lower than the cost for holding them over a few years.

*6 Excepting for individual loan assets and mortgaged properties for which discretionary sale is possible, Japanese banks' disposition of bad loans used to rely solely on indirect depreciation by retaining reserves for future possible loss. By this indirect depreciation, non-performing bad loans remain on the balance sheet, and management costs increase over time. A decline in land price would require posting additional reserves, and a rise in interest rates would affect the profit and loss account.

"loss from sale of credits" for accounting purposes and thus are entitled to non-tax depreciation.

Apart from pricing at below cost, this method helps reduce relative cost compared with individual sale.

Bulk sale also provides investors with at least two advantages. First, it ensures a high-expected return. Investors tend to focus on risk capital of high risk and high return, and their expected return is said to range between 10% and 20%. Second, like the seller, the investor also can enjoy the advantage of risk dispersion. In the case of concentrated investment in one asset, a price collapse at the time of resale may make the deal fail altogether. However, considering possible resale in the future, bulk sale promises a fairly good investment value by ensuring a satisfactory overall return even if only a few out of a hundred assets are actually sold.

3) Implications of Bulk Sale

By using the bulk sale method, a large amount of bad loans can be disposed of simultaneously. However, as these bad loans are sold below cost, its success depends on the bank's financial resources. If a bank's policy were to maximize the return from loan assets and mortgaged properties, it would find little value in bulk sale. Bulk sale is meaningful when the bank gives up the maximization of return and finds it more advantageous to collect the invested funds early by disposing the loan assets even at below cost than continuing to hold the money-losing assets.

More important point about bulk sale are the calculation method of an appropriate price for the claimable assets pool for sale and the concept about calculation procedure, that is, calculation by the DIV (derived investment value) and its due diligence. These are now expected to be practiced in earnest in Japan.

If the establishment of this calculation method and the procedure has an impact on industry practices by the traditional property appraisal method and price setting, making it possible to form indicators in the market, it will make a significant contribution to the securitization of properties and the development of the securitization market in Japan. [*7]

3. Securitization of Bad Loans

1) Price of Bad Loans

Bad loans are those of which collection cannot be realized by the end of the lending term due to the stagnation in the projected cash flow of principal and interest. On the other hand, in the case of bulk sale, the risk capital firm, as the buyer, regards a bank's bad loans as normal or good credits as long as the bad loans can be purchased at a price level that promises

*7 On September 22, 1998, the National Land Agency and the Japanese Association of Real Estate Appraisal released "the items worthy of special note in appraising real estate in the fair appraisal procedure of bad debt mortgage real estate". As the items do not include the way to calculate fair price of bad loans, further study should be made from the viewpoint of price setting based on market discipline.

high yields.

In other words, disposition of bad loans is in essence the process of reducing the book value in order to generate cash flows. The fact that disposition of bad loans has been postponed means that the bank managers involved have been afraid of possible erosion of their equity capital or deficit settlement of their accounts.

The price decided in the traditional way is nothing but a price compromised between the bank and the buyer over discretionary sale of mortgage real estate. By comparison, the price adopted through bulk sale or securitization is an "appropriate" price calculated by DIV and supported by many investors. Disposition of bad loans in Japan has now reached a new stage in the sense that it has generated marketability in the course of price setting.

2) Difficulties in Securitization of Bad Loans

Generally loan assets held by banks have often been "made to order" by customer companies or individuals. Conditions of loans to companies often depend on the degree of customer relations and are not uniform as those for loans to individuals, such as housing loans. In this sense, claimable loans to individuals are thought to be easier to securitize than those to companies. Whoever the creditor may be, an individual is inclined to endeavor to pay back primarily for fear of losing his/her social position for delinquency and other reasons. This attitude will finally help stabilize cash flows.

On the other hand, loans to corporations are often affected by the degree of the creditor's pressure for repayment. The fact that the size of the funds collected depends on the relative relationship between creditor and debtor indicates that a new creditor's passive attitude toward collection and the existence of non-cooperative unwilling debtors can deteriorate cash flows rather than improving. In this sense, the difficulty in securitization of bad loans is often ascribed to the instability of cash flows. However, emphasis should be placed on the intensity of the efforts to collect funds in order to realize stability in cash flows. After all, the success of securitization of bad loans depends in essence on the degree of aggressive collection efforts on the part of the entity in charge of collection.

3) The Important Role of Servicer

The servicer law, which was promulgated on October 16, 1998, is one of the eight finance-related bills enacted at the latest Diet session, and authorizes business corporations to perform the resolution and collection business that was previously permitted only to lawyers. Now that banks can entrust loan collection to outside servicers, there will be a sharp improvement in the efficiency of collection of bad loans.

The problem of how to stabilize cash flows in the process ofsecuritization of claimable assets depends on whether the servicer can aggressively perform his/her job of resolution and collection. Therefore, the problem in operating the servicer law in the future will be how to provide more incentives to the servicer and how to arrange a scheme for realizing a stable cash flow.

4) Steps to Securitization of Bad Loans

Even if cash flows are stabilized, banks wish to resort to securitization in disposing their bad loans only when the traditional trading through liquidity enhancement reaches saturation (when there are no partners for deals) and they find no solutions except dispersing the risk among an unspecified number of investors. If the banks' equity capital has been eroded by a reduction in the book value as a result of liquidity enhancement or securitization, they would find no inducement in securitization that requires their readiness for further loss. The issue of securitization of bad loans inevitably boils down to whether the banks retain enough financial power to absorb further loss at the time of securitization. In consequence, the money-losing securitization of bad loans as an option for bank management has to be one of marginal operation.

This observation leads us to a conclusion that disposition of bad loans has to follow the step of concentrating on discretionary sale and bulk sale to a third party, and then securitizing only bad loans that can ensure stable cash flows, while maintaining and accumulating capital by endeavoring to reduce cost pressure through the restructuring of bank operations.

4. Outlook

1) Future Trend in Bad Loans Securitization

An attempt to establish the practice of liquidity enhancement and securitization of loan assets from the perspective of disposing bad loans will have limitations in forming a sound securitization market. Liquidity enhancement and securitization of loan assets make it possible to improve the capital adequacy ratio through sale of loan assets and repayment of debts. However, when these approaches are employed in disposing of bad loans, the bank has to be prepared to see its equity capital being eroded as a result of the decline in the book value. There is a school of thought that considers that good loans should also be actively liquidated and securitized to expand equity capital. However, unless bad loans can be disposed of as speedily as good loans are reduced, the outcome will be a deterioration of the loan portfolio. In the end, there will be no other way but to endeavor to improve the financial position by balancing funds raising through sale of good loans with erosion of equity capital through sale of bad loans, while striving to reinforce equity capital by injecting external funds and implementing internal restructuring.

2) Toward a Fully-Fledged Securitization Market

There are two requirements for the start-up of a fully-fledged securitization market. One is the need to make such concepts as DIV and due diligence take root. The willpower of the parties involved in this endeavor will be tested as to how firmly they are determined to change the traditional exclusive industry practices and the relative trading bases. Another is the need of further expansion of the market. If disposition of bad loans is taken into consideration, flexible measures, including the provision of incentives to the servicer, should be taken in executing the servicer law.

In order to promote effective use of the SPC, further studies should be made of how to reduce real estate acquisition taxes at the time of transfer of assets.

3) Impacts on Bank Behavior

With the progress in liquidity enhancement and securitization, there will be changes in bank behavior in the capital market. When companies deal with core banks as well as minor banks, role sharing may expand due to the change in the functions reflecting the heavy and light trading relationship and depending on the progress in liquidity enhancement and securitization. The companies' reduction of their bankers will prompt core banks to increase their outstanding lending, while core banks' reduction of assets will induce minor banks, which want to increase their outstanding lending to companies, to purchase assets. This sequence of relative trading will sooner or later create saturation on the liquidity enhancement market, and then prompt risk dispersion among an unspecified number of investors. The resultant development and expansion of the securitization market will facilitate role sharing among banks.

Banks ranking higher in terms of liquidity enhancement and securitization capabilities will further accumulate know-how on securitization, taking advantage of bad loans, and in the course of implementing lending on the basis of liquidity enhancement and securitization they will more and more come to have the nature of investment banks in terms of loan portfolio. On the other hand, some medium and low ranking banks will choose, as the purchasers of loan assets, to work out strategies as usually developed by institutional investors. Some other banks will expand their asset management business as major servicers by making best use of their traditional function of information creation. In this sense, the efforts presently being made to develop securitization products and securitize bad loans represent constant preparation for the start-up of a full-scale loan sale market centering on loan trading, and may lead to a strategy for survival in the years following the disposition of bad loans.