Comparative Analysis of U.S. and Japanese Lenders in U.S. Real Estate Workouts: What Have Japanese Lenders Learned?

by

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B.E. Architecture and Building Engineering
Tokyo Institute of Technology, 1988

Submitted to the Department of Architecture in partial fulfillment of the requirements for the degree of Master of Science in Real Estate Development at the Massachusetts Institute of Technology

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ABSTRACT

Japanese started investing in U.S. real estate in the early 1980s when the Japanese real estate market was a difficult environment to invest in. Japanese investors (perhaps naively) found the U.S. real estate prices inexpensive and tended to overpay. In most cases, These investors kept a close relationship with their Japanese banks; they borrowed from the Japanese banks in dollars and sometimes the Japanese banks introduced them to deals. In 1993, Japanese investors went into a stage of divestment, and then accelerated disposition of troubled real estate because of the need to repatriate capital to Japan to support their core business, which were struggling because of the slow economy in Japan.

What determines Japanese behavior in U.S. real estate workouts? Key issues lie in the business culture and practices in Japan. Keeping a continuing "relationship" plays an critical role in Japanese business world, and most of Japanese firms maintain a very tight relationship with their so-called "main" bank, which enables banks to lend more money without incurring higher risks. Land is viewed as a commodity with inherent value in Japan as opposed to being viewed as simply a call option on future development. In addition, real estate is a highly illiquid asset because of the high tax rate on capital gains and advance reporting requirements for real estate transaction.

Japanese banks’ U.S. operations are subject to both the U.S. and Japanese regulation. In U.S. real estate workouts, Japanese banks chose restructuring as a first choice, aiming at maximum recovery because, unlike U.S. banks, they were not under the pressure of writedowns or disposition of troubled assets. After a few year grace period, Japanese banks finally started selling assets one by one, and wish to clean up the mess while their business in Japan is strong enough to sustain the huge deferred write-offs.

As a new strategy in the U.S. real estate, Japanese banks may go into other real estate lending area, such as REITs or large listed real estate companies. They will inevitably behave more like U.S. banks to survive the severe market and price competition. In order for Japanese banks to utilize experience gained through the U.S. real estate workouts in Japan, two objectives must be achieved; enhancing the liquidity of real estate, and establishing clear guidance with regard to the tax treatment of their losses from asset disposition. Securitization and valuation method based on future cashflows should be studied and heavy capital gains tax must be reduced, to induce new capital into real estate. Strong political leadership is required to achieve these objectives in the process of solving serious problems.

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I. Introduction - Analysis of Past and Present Condition of Japanese Investments in U.S. Real Estate

A. Why did the Japanese invest in U.S. real estate?

1. Overheated investment markets in Japan

The Japanese started investing in U.S. real estate in the early 1980s when the Japanese investment markets were overheated and an extremely difficult environment to invest in, especially for small investors. The Nikkei, the Japanese stock market, had increased by nearly 240% from 1984 through 1989 and other investments, such as savings, did not give total returns that investors were looking for. Some investors had already heavily invested in stocks. However, rapid asset appreciation made current investment returns on real estate extremely low and there were not enough real estate deals which made economic sense. Around 1987, free and clear (unlevered) returns on new office buildings in Tokyo declined to 2%. Given a lack of investment opportunities in Japan, some investors started to look overseas.¹

According to Mitsui Fudosan, a leading Japanese developer, when it offered for sale the equity interest in its brand-new office building in Tokyo in June 1990, 51 shares were issued and all the shares were sold within one week. Based on a building size of 30,500 sq.ft (interests were for the 2-7th Floor), investors paid over $1,700 per sq. ft of building floor (see the Table I-1). Although this building

was not in a prime location, investors rushed to buy shares. This is partly because Mitsui was a credible developer and investors were willing to pay a premium price for its ability to manage property, but also partly because it was a rare opportunity to invest in real estate in Tokyo. No similar benchmarks are available as most other asset investment was in vacant land.

| Table I-1. Initial Offering of Equity Participation in an Office Building in Tokyo |
| ($1=Y110) | allocation | price Yen | $ price/m² | $ price/sq.ft |
| building 48.71m² | 73,536,235 | 1,509,674 | 1,275 |
| land 8.12m² | 26,463,765 | 3,259,084 |
| total 100,000,000 | 2,052,967* | 1,734* |

*price per square foot of building area

2. **Familiarity with the U.S.**

Japanese investors were risk-averse and preferred easy entry and exit. From the viewpoint of country (political) risk, the U.S. has always been considered one of the safest countries for investment among Japanese investors. In addition to being considered safe, the U.S. market offered easy access to relatively higher yielding investments such as U.S. treasury securities and commercial real estate. For most of Japanese investors, the U.S. was the most familiar foreign country.

3. **Inexpensive U.S. real estate prices**

Although real estate prices were rising both in the U.S. and Japan, U.S. real
estate prices seemed extremely inexpensive when compared to those in Japan. Many Japanese investors naturally tended to compare their U.S. investments to similar ones in Japan and some investors made their decisions solely on yen-denominated prices. As mentioned in paragraph 1., the overall Japanese market was overheated, and for many small Japanese investors, real estate investments were beyond their investment targets. These investors did not use American standards for evaluation. Rather, Japanese investors were willing to accept relatively low current returns as measured against American standards, largely because current returns on similar investments in Japan were so low. The appreciation of the Yen also played a major role in determining whether to invest in the U.S., as Yen denominated U.S. real estate prices seemed to offer relatively “better deals” to Japanese investors.

4. **Severe lending competition among Japanese banks**

Japanese banks were competing severely to increase assets. They were eager to expand their loan businesses with established clients. As discussed later, under the main bank system, relationships with certain clients were already established and it was difficult to change each banks’ loan share to a certain client in the domestic market. To counter this limitation, banks sought to increase their overseas loans as they believed they faced less competition abroad and their relationships with established clients were not as fixed as within Japan. Banks encouraged their clients to invest in U.S. real estate and to borrow the necessary funds from them. Some banks cooperated with U.S. brokers and introduced their clients to various real estate deals.
Driven by severe competition for market share, banks also eased credit and started to deal with less qualified speculative investment companies. Banks believed that at a minimum, the borrower’s real estate holdings in Japan would more than adequately cover any potential losses in the U.S.

B. How did the Japanese structure their investments in U.S. real estate?

1. Financial arrangements

According to survey conducted by Mizuto and Toyoshima,² 36 out of 37 Japanese investors responded that they rely on local currency funding, and 30 out of those 33 investors preferred funding from Japanese-related financial institutions. Thus, most Japanese investors borrowed in U.S. dollars from Japanese lenders. Although some investors raised funds on a non-recourse basis through their U.S. operations, lenders usually required some form of guarantee from the parent company in Japan. Even if lenders did not require guarantees from parent companies, investors could not simply walk away when projects got in trouble because of their strong relationships with the banks.

2. Mystery of Yen denominated low cost of capital

The nominal cost of Yen capital was extremely low for Japanese investors because of the lower cost, and higher utilization, of debt in Japan. As discussed in chapter III-D, borrowers could comfortably maintain a higher level of leverage because problems of asymmetric information were significantly mitigated by an

unusually close relationship with their main banks. The cost of debt was so low that in 1987 large, well-capitalized Japanese companies could borrow in Yen at rates around 5% when the dollar denominated risk free (U.S. Treasury) rate was 8%. While it was possible to finance U.S. investments with low cost yen-denominated debt, investors did not do so because of the substantial currency risk. For example, if 10-year U.S. government bonds (denominated in dollars) were yielding 8% and an equivalent Japanese bond was yielding only 4% (denominated in Yen), such pricing would indicate that the market expects the dollar to decline in value relative to the yen sufficiently so that over the term of the bonds the yield will be equal. That is, if a Japanese company finances U.S. investments in Yen denominated debt, interest payments may be low but the Yen denominated value of the project will decline because of the depreciation of dollar against Yen. Therefore, the availability of such “cheap” foreign debt did not stimulate U.S. acquisitions; indeed, one only need look to the lack of U.S. companies financing their U.S. operations with yen denominated debt.

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3 Lawrence Bacow, Understanding Foreign Investment in U.S. Real Estate, MIT Center for Real Estate Working Paper #12, November 1987, p. 9-12
C. Overall trends in investment activities

1. How much did Japanese investors invest overall?

![Bar chart showing investment trends from 1985 to 1993.](image)

Figure I-1. Japanese Investment in U.S. Real Estate
source: E&Y Kenneth Leventhal Real Estate Group

From 1985 to 1993, the Japanese invested $77.3 billion in U.S. real estate. At the peak they invested $16.5 billion, but Japanese investment fell to $710 million in 1993. After 1993, the Japanese entered a stage of divestment.
2. Characteristics of Japanese Investments

Japanese paid top dollar for trophy office buildings, four-star hotels, championship golf courses and high-end condominiums.

They heavily invested in California, Hawaii and New York.
D. Why did the Japanese real estate investments fail?

1. Exporting expectations

From World War II until the early 1990s, real estate in major Japanese cities had never decreased in value; rather, investors enjoyed substantial capital gains after only moderate periods of time, e.g., 10 years. Therefore, Japanese investors tended to pay little attention to annual current income or yield and relied instead on optimistic future expectations. As long as the initial price was within budget constraints, that investment was deemed to make economic sense. They exported these expectations to their investments in U.S. real estate.

2. Overpricing projects

While exporting expectations, they also applied the same evaluation criteria (e.g., current return on investment thresholds and expectations of substantial capital gains) to determine the price of U.S. property. This is one of the major reasons why Japanese overpaid for their purchases in the U.S.

3. Crash in U.S. real estate market and recession

As the Japanese never experienced a decline in their real estate market, they tended to overlook the cyclical movement of the U.S. real estate market. The crash in the U.S. real estate market was the result of overbuilding in early the 1980s; this will be discussed in detail in chapter 2. As most Japanese investors had initially overpaid for their U.S. investments from a U.S. standard, a significant decline in rental income hurt their long-term financial position. Many of these investments were upper-end single family developments, golf
courses, luxury condominiums, and deluxe hotels, all of which had limited appeal to the general market.

E. Trends in divestment from 1993 through 1995

In 1993, Japanese investment went into a stage of divestment. In 1993, Japanese had disposed of or restructured $17.5 billion of assets, while their new investments totaled only $710 million. In 1994, their divestment activities continued and they had now disposed of $6.4 billion of assets. During 1995, Japanese owners and lenders divest another $8.9 billion worth of properties. Their divestment activities are illustrated in Figure 1.4:

Figure 1-4. Divestment Activities in 1993 - 1995
source: E&Y Kenneth Leventhal Real Estate Group

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F. Major reasons for divestment

1. Need to repatriate capital to Japan

In 1990, Japan’s economic environment changed dramatically. Commercial land prices significantly decreased after 1990 as a combined result of several factors, including the Bank of Japan’s (BOJ) tighter monetary policy, the Ministry of Finance’s (MOF) real estate lending restrictions, and banks’ lending behavior under the Bank of International Settlements (BIS) capital requirements (to be discussed in chapter IV, section E). With the collapse of the Japanese stock market, the net worth of Japanese investors declined sharply. Some investors could no longer sustain their investments and were forced to dispose of assets. Since 1990, Japan’s economy has been in its longest slump in postwar history. Although it is believed to be showing signs of recovery, the Japanese economy continues to have serious problems. One of the largest groups among Japanese investors, construction companies, are consistently facing difficulties because of the weak economy. Significant government spending on infrastructure has been unable to offset the decline in private sector construction activity.

Companies which previously invested in the U.S. real estate have changed their strategies toward business diversification, and have begun to allocate money and resources to their core business or toward growing markets in such areas as Asia.

2. Change in pricing expectations

Surveys performed by E&Y Kenneth Leventhal show in 1993 and 1994, a period
when sales of commercial real estate in the U.S. were gradually increasing, most Japanese owners and lenders remained out of the market. In 1995, however, many became active sellers. With the recovery of U.S. real estate markets, those properties sold in 1995 returned approximately 60% of original acquisition costs as compared to only 56% in 1994 and 50% in 1993. Although U.S. property values have recovered, they are still below the peak values of the late 1980’s real estate boom, when the majority of Japanese investors and lenders entered the U.S. market. Thus, Japanese investors should not expect to recover 100% of their original investment. The stigma of selling assets for less than the original acquisition price has diminished, however, as Japanese investors realistically lowered their recovery expectations.

G. Current five-year outlook of Japanese investment in U.S. real estate

Divestment activities will continue over the next few years, and it will take a long time for Japanese investors to come back into the U.S. real estate market. Moreover, real estate problems in Japan must be solved as potential investors view this type of investment as “very risky.” Balance sheets of Japanese investors have been severely hurt by the collapse of real estate markets and their net worth is far below the peak of the bubble economy when they entered the U.S. real estate market. As discussed below, they have, however, learned how to better deal with investments in U.S. real estate in their portfolios.
II. How U.S. Lenders Dealt With Their Problems

A. What happened in the U.S. real estate market in the 1980s

1. How the commercial real estate boom occurred

An excess of commercial space could arise because of too much new building or because of an unexpected falloff in the demand for space. The latter happened in Texas and other Southwestern states, where declining oil prices produced a dramatic reversal of the economy in the mid 1980s. But while unexpected declines in demand contributed to high nationwide commercial real estate vacancy rates, much of the blame lies with overbuilding. Construction of commercial buildings ballooned in the first half of the 1980s. In just two years between 1983 and 1985, the constant dollar value of commercial construction increased 50 percent. Why did this happen? The following issues played significant roles.

a) Demand fundamentals

While rates of new construction were low in the late 1970s, employment growth was booming. As shown in Table II-1., employment was especially strong in those sectors that occupy commercial space: finance, insurance and real estate;

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services; and wholesale and retail trade. As a result, the 1980s started with a substantial pent-up demand for commercial space. In the office market, vacancy rates averaged only 4 percent in 1980.

The recessions of 1980 and 1981-1982 sent overall employment plummeting. However, the impact of the recessions was very uneven because manufacturing bore the brunt. Services and finance, insurance and real estate held up relatively well during these recessions and then grew strongly as the economy recovered.

Thus, industries which occupy commercial space fared much better in the early 1980s than the overall economy.

There were spaces available in the market which were previously occupied by manufacturing tenants. However, the facilities suitable to manufacturers were not ideally suited or designed for the needs of financial or service industries.

Accordingly, surplus space in declining industries was of limited value to those that were expanding.

<table>
<thead>
<tr>
<th>Table II-1. Percent changes in US employment in the 1970s and 1980s</th>
</tr>
</thead>
<tbody>
<tr>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>Total employment</td>
</tr>
<tr>
<td>Commercial tenant industries:</td>
</tr>
<tr>
<td>wholesale and retail trade</td>
</tr>
<tr>
<td>finance, insurance and real estate</td>
</tr>
<tr>
<td>services</td>
</tr>
<tr>
<td>Other</td>
</tr>
</tbody>
</table>

source: U.S. Department of Commerce
b) Changes in the tax code

Commercial construction also received an impetus from the Economic Recovery Tax Act of 1981 (ERTA). A major goal of ERTA was to stimulate investment. High rates of inflation in the late 1970s had reduced the present value of then-existing statutory depreciation deductions. ERTA attempted to offset this by reducing asset's depreciable lives and by permitting more accelerated depreciation schedules. Depreciable lives were shortened from about 40 years to 15 years. In the late 1970s, the inflation rate was high and all investment capital sought inflation-hedging assets.

The ERTA actually favored real estate over other forms of investment, as commercial building could sustain higher leverage than most other investments and the greater use of debt conferred additional tax advantages in the form of tax-deferring losses. Commercial properties offered particularly attractive opportunities to shelter income, as they could be financed largely by debt, depreciated at accelerated rates to shelter ordinary income, and then sold for a capital gain to others who hoped to repeat the process. The fact that properties could be resold and depreciated several times increased the impact of ERTA's depreciation provisions and provided incentive to invest in real estate. Internal Revenue Service data show a sharp rise in limited partnership investment in real estate following ERTA. In October 1979, the nation's property market also became subject to a new federal bankruptcy statute. This law motivated lenders to require the use of remote single-purpose borrowers so as to insulate themselves from bankruptcies that would result when real estate or corporate borrowers had difficulty with other assets. Additionally, creditworthy corporate
borrowers were further motivated to accept the use of abundant nonrecourse debt as an effective ethical stop loss in the holding in real estate assets. The use of such nonrecourse debt became a major stimulus to the speculative fever that pushed real estate market prices in the mid 1980s.

The boom in real estate tax shelters led Congress to scale back the depreciation rules allowed for real estate in 1984. Then, the Tax Reform Act of 1986 eradicated virtually all tax provisions favorable to commercial real estate investment by individuals. Depreciation schedules for structures were lengthened, and the ability to shelter other income from current taxation via real estate tax losses, permanently phased-out. It was clear that the ERTA was a measure that added gasoline to an existing fire (real estate investment as a hedge against inflation) and the Tax Reform Act of 1986 proved to be a powerful depressant.

c) Credit availability

The financial deregulation of the early 1980s is also thought to have fueled investment in commercial real estate, by making financing more readily available. The Depository Institutions Deregulation and Monetary Control Act of 1980 began to phase-out interest ceilings on deposits of banks and thrift institutions and broadened the lending powers of federally chartered thrifts. But while the ability to offer higher interest rates enabled banks and thrifts to compete more effectively for deposits with money market funds and other financial intermediaries, it also increased the cost of funds and created pressure to generate higher rates of return on their investments. Their desire to survive
caused them to attempt to improve, through asset allocation to real estate in an inflationary time, the acknowledged higher-risk and return lending practices forced on them by their comparative disadvantages.

Banks' shift into commercial real estate is frequently attributed to their unfavorable experience in other lending areas. The early 1980s saw first loans to less developed nations and then energy loans sour. At the same time, banks were encountering competition in lending to their traditional large corporate customers from the commercial paper market, finance companies, and foreign sources. But the movement into commercial real estate was not simply a retreat from other areas. Real estate investments were seen as offering extremely attractive returns by everyone from academics, to the general public, to the banks.

d) The appeal of real estate

In the late 1970s and early 1980s a number of articles appeared in scholarly journals comparing returns generated by real estate with those from common stocks, bonds, and government securities. In general, those findings were quite favorable to real estate. These results were qualified by acknowledgment that the returns to real estate involved many assumptions. It seemed that the approximations used in many of these studies understated the risks (cashflow and asset value variability) associated with real estate. In a number of cases, returns were calculated using appraised values rather than actual transactions. This approach has been criticized for smoothing out returns on the grounds that appraisals are based on long-run values rather than short-run market figures.
The slowdown in inflation after 1982 resulted in a similar slowing in the growth of construction costs. At the beginning of the decade there existed strong demand for commercial space and various incentives for investment created by tax changes and financial deregulation, and commercial real estate values might have continued to rise rapidly in the early 1980s. If construction costs are rising more slowly than prices, more construction will take place until the increased supply dampens the rise in values. With attitudes shaped by the 1970s, however, investors did not recognize this fact. The key issue here is the unlinking of property value from its utility, by the pressures brought on by long-term investors seeking an effective hedge against inflation. Property began to be produced for the demand of investors, not the ultimate users.

e) Commercial construction cycles

As is the nature of the long-term market movement, construction of commercial buildings is inherently cyclical. Lags are critical problems. Construction lags create an inherent tendency towards periodic overbuilding. The supply of space is supposed to be more elastic over time, therefore an increase in the demand for space initially generates only a small response. Rents rise above the level that will result when additional supply is forthcoming. If developers and lenders react to these temporarily high rents without much consideration of forthcoming supply, they will build too much and rents will be driven below what they would otherwise have been in the long run.

How do market participants react to short-term marginal rents? In assessing property value, appraisers use current leases to estimate the current level of
rents and then project these into the future based on recent trends. During periods of rising rents, marginal rents are higher than average rents and projecting a continuation of past trends will eventually lead to a tendency to overbuilding. In a period of declining rents, the opposite is true.

Lenders' attitudes toward real estate loans also contribute to over-shooting by prolonging either construction build-up or its reverse. All other things being equal, construction levels tend to be higher if lenders' past experience with real estate loans was positive. This suggests that following a period in which conditions favored new construction and lenders achieved good results, lenders may remain receptive to real estate lending even if the underlying economic conditions and investment incentives have changed.
2. **Did commercial real estate lending cause the banking crisis in U.S.?**

According to the study conducted by Federal Reserve, by between 1982 and 1993, the percentage of bank assets invested in commercial real estate nearly doubled.

![Graph showing percentage of bank assets invested](image)

**Figure II-1. Percentage of Bank Assets Invested as of Year Ends 1981 - 1993**

Source: Federal Reserve

Commercial bank failures throughout this period reached their highest levels since the 1930s. During the forty year period from 1941 through 1980, no more than sixteen commercial banks failed in any single year. By contrast, during the 1982 - 1993 period there were at least forty failures each year, and during the 1985 - 1992 period there were at least 100 bank failures each year. Not until 1993, when only forty one banks were closed, did the number of failures drop to pre-

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In their study, Cole and Fenn examined the relationship between commercial real estate lending and bank failure proceeds from 1981 to 1993. They explored several specific and subtle questions about the causal relationship between commercial real estate concentrations and bank failures. In particular, they constructed a model, using a statistical procedure known as "logistic regression," and tested whether the commercial real estate loan concentration variables and the non-real estate control variables had statistically significant influences on the probability that a bank would fail in a given year during 1985 - 1992 period.

According to their analysis, three points were apparent: 1) commercial real estate is a significant factor in explaining banks failures only from 1987 through

Figure II-2. Number of Bank Failures 1985-1993
source: Federal Reserve
1992; 2) construction lending is more significant than permanent financing in predicting banks failures, and the relationship is strongest between failures and construction loans booked during the 1983 - 1985 period when a great deal of commercial real estate development was driven by tax benefits that the 1986 Tax Reform Act subsequently reduced or eliminated. This suggests that only certain high-risk types of real estate lending were associated with bank failure; and 3) throughout the entire period, other balance sheet and income statement measures that indicate a bank’s preference for risk-taking was also strongly associated with banking failure.

These results suggest that risky commercial property lending, while clearly a proximate cause of many bank failures, is not the underlying cause. Systemic institutional problems as described by the theory of moral hazard may better explain the fundamental cause of the banking crisis of 1985 - 1992.

B. Traditional methods

In the early 1990s the flood of defaults on loans, bankruptcies and restructurings overwhelmed the real estate industry and workouts became business as usual. Traditionally, lenders have used one of two methods to manage troubled loans: 7

1. Restructurings/Loan modification

Restructuring involving renegotiation of the underlying loan transaction in order to reduce or defer the obligations of the borrower, such as collateral

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modification (e.g., direct active assignment of rents), borrower change (e.g.,
joint venture with lender or change of general partner of limited partnership),
and new loans. There are several reasons why a lender might choose to
restructure a loan rather than foreclose or sell its interest. The lender may not
have sufficient capital or loss reserves to bear significant write-downs. The
owner may be a better property manager than the lender. Before GAAP
changed in 1993, in some cases restructured loans were treated as performing
loans, e.g., no writedowns required. New treatment required for fiscal years
beginning after December 15, 1994 that restructured loans had to be valued at
the fair market value of the collateral or, if such fair market value could not be
determined, by discounting expected future cash flows at the effective contract
interest rate. Most lenders were forced to recognize write-downs and this
method lost its advantage.

2. **Foreclosure and sale**

The primary advantage of a foreclosure is that the lender gains control of the
management of the property and future sale of the property. If the borrower is
cooperative, the borrower may voluntarily give the lender a deed in lieu of
foreclosure. However, an uncooperative borrower may file for bankruptcy or
assert lender liability claims against the lender. Foreclosure is a time consuming
and costly process.

Even if the foreclosure is completed successfully, a lender may become subject to
liability under the environmental law. Also after foreclosure, the lender will
incur costs associated with the ownership and operation of the property.
Under bank regulations, a bank can hold a foreclosed property for a maximum of 10 years. Pursuant to such regulations, banks must eventually dispose of foreclosed properties. Thus, a bank may not enjoy the full benefit of any future increase in value.

C. New techniques

U.S. banks have had incentives to dispose of or write-off their troubled real estate assets:

- stock price increases: by the Fall 1991, the stock market hated real estate;

Banks which divest of real estate loans subsequently enjoyed higher earnings multiples

- loan-loss reserves, capital reserves are reduced

- regulatory pressure to write down is reduced

- credit ratings can be stabilized and funding costs can be reduced

- losses realized may be used to offset income in future years for tax purposes

U.S. banks introduced four new techniques: 1) the sale of individual troubled assets; 2) the bulk sale of troubled assets to a third party; 3) the sale of assets to special purpose company; and 4) the securitization of troubled assets. These techniques will be discussed later in section 2. of this chapter.

1. Preconditions for new techniques

Several factors contributed to the development and use by U.S. lenders of each of the four techniques. These include 1) seasoning of the market through government participation in early transactions, 2) introducing new accounting
and tax rules, 3) the emergence of new equity and debt investors, and 4) the absence of governmental policies that inhibit the use of those techniques.

a) The RTC’s experience

One of the most important factors was the experience gained by investors, investment banks, rating agencies and others through participation in the transactions sponsored by the Resolution Trust Corporation (the RTC).

The RTC is a U.S. government owned corporation which was created by Congress in 1989 to manage the disposition of assets of failed savings and loans. The RTC finished its job by the end of 1995. Since 1989, the RTC had disposed assets of approximately 680 institutions which included performing and non-performing loans, as well as vacant lands and empty or partially completed office buildings and other commercial properties.

The most common methods used by the RTC had been bulk sales and securitizations. As investors and market participants were not accustomed to such transactions, early deals sponsored by the RTC featured significant government support, such as loans to purchasers or guarantees to protect investors from misrepresentation.

Many investment bankers, property managers and other advisors engaged by the RTC to assist with the RTC’s sale activities gained experience which they used to assist other lenders in selling their assets.

b) Emergence of new equity and debt investors

Traditional providers of funds to the real estate market were generally less
willing to invest in or lend to these troubled real estate assets. Many of the new
investors were seeking high yields either from cashflow generated by the real
estate or from profits to be made upon the resale of a troubled loan or foreclosed
property after the debt had been restructured. Those third-party investors have
no borrower relationship to protect in the restructuring negotiations, so they can
pursue workouts aggressively. These dispassionate investors appear to have
had greater confidence in the future potential of troubled real estate assets
bought at significant discounts and restructured.

c) Favorable tax treatment to investors

Provisions of the U.S. Internal Revenue Code which are favorable to investors
were also essential. A tax efficient structure, such as REIT, was available to
investors. A REIT is an entity which is not subject to Federal income tax on its
earnings if it meets certain requirements; only the shareholders of the REIT pay
taxes on their dividends and capital gains. The U.S. Internal Revenue Code of
1986 authorized the real estate mortgage investment conduit (REMIC), a tax
efficient vehicle, as issuer of these securities. These vehicles will be discussed in
2.d) in this chapter.

d) Clear guidance regarding tax treatment of lenders’ losses on asset
disposition

Disposition of problem loans was facilitated if losses from sale reduced the taxes
payable by the lender on other incomes. For federal tax purposes, commercial
banks account for total and partial losses on their portfolios of loans under either
the direct charge-off or the reserve method. A commercial bank with assets over $500M must use the direct charge-off method.

Under the direct charge-off method, the banks must establish the total or partial worthlessness of a particular loan before it is allowed as a bad debt deduction. This reduces the bank's basis in the loan for the purposes of determining gain or loss upon a later sale of the loan. The recovery of an amount which was previously deducted must be reported as taxable income.

Under the reserve method, the bank maintains a balance in a bad debt reserve account for loan losses and is allowed a deduction for a reasonable addition to the reserve for the year. The recovery from sale of the their loan will generally be added to the bad debt reserve account, and reported as a either deduction or addition to the reserve for the current year.

e) No governmental impediment on introduction of new techniques

While there are certain legal and regulatory requirements which must be satisfied by the banks, none of the four previously mentioned techniques is prohibited. In fact, regulators have taken action to facilitate the use of securitization and to remove or reduce existing restrictions.

2. New techniques

a) Sale of individual troubled assets

In this case the purchase price may be a substantial discount from the outstanding principal amount of the loan. A key advantage of a sale of a troubled loan compared to other techniques is that it enables the lender to
dispose of a non-performing loan without the time and expense of negotiating
with the borrower, or obtaining title to the real estate and selling the property.
Some investors have more expertise in workouts and restructuring than the
original lender. Many lenders believe that they can sell individual assets at
higher prices than might be realized from the sale of a portfolio of assets.

b) Bulk sale of troubled assets to a third party

A bulk sale involves the sale of a portfolio of foreclosed real estate and/or
mortgage loans to a single buyer. Three typical methods are utilized for bulk
sales: 1) negotiated, private sales, 2) "outcry" auctions and 3) sealed bid
auctions. Among them, the sealed bid auction is quite popular as it offers more
privacy and control to the seller.

Bulk sales have several advantages. They permit a lender to use personnel to
sell many properties at one time and thus reduce transaction costs per property.
Undesirable properties may be sold by including them in a portfolio with
attractive properties. Many portfolios are structured to facilitate a securitization
by the buyer by including a large, diversified pool of properties. Also, some
bulk sales are sufficiently large that they have a had an immediate favorable
impact on the asset quality ratio of the seller, which in turn has had a favorable
impact on the stock price and credit ratings of some sellers.
Some lenders have not made bulk sales because they believe that the slower
process of restructuring and foreclosing followed by individual sales, achieves
higher overall recovery. Significant losses may be taken in a bulk sale, and a
bank may need to raise additional capital to offset the loss.
c) Sale to special purpose corporation ("bad bank", etc.)

A lender with a portfolio of nonperforming loans or foreclosed properties may enter into a transaction with an entity which is formed solely for the purposes of purchasing the assets, making collections and liquidating assets. These entities have traditionally been known as "bad-banks", "bad non-banks" or "collecting entities," because their purpose is to collect and dispose of "bad" assets.

A variety of forms may be used for the collecting entity, depending on the seller's objectives and the source of funding for the new entity. The new entity may be established as a joint venture between the seller and a third party investor.

d) Securitization of troubled assets

The RTC was the pioneer in the securitization of commercial real estate loans.

The RTC started securitization in 1991, and its success helped to create a market for securitization. Participants in RTC transactions gained expertise and started to help other sellers liquidate their troubled assets.

Securitization is the process by which a single asset or a pool of assets is "sold," through the issuance of securities backed by the pool of assets. The certificates evidencing such securities are rated by one or more rating agencies, and can often receive a higher rating than that of the seller.

Commercial Mortgage Backed Securities (CMBS) are usually issued either as pass-through certificates, evidencing an ownership interest in the pool of assets, or as a debt obligation secured by the pool of assets. Issuance of CMBS was started by the RTC and followed by REITs, insurance companies, portfolio
buyers and conduit programs.

Banks usually do not securitize their own troubled loans. This may be in part because transaction costs are high, and because considerable time and effort is required to structure a securitization. For accounting and regulatory reasons,\(^8\) securitization by a bank must be carefully structured to achieve the desired goal of removing assets from the bank’s balance sheet. For example, FAS No. 77 establishes the standards for determining whether a transaction is a sale for accounting purposes. If a transaction does not comply with this standard, it will be treated as a financing. Thus, it may be more efficient for banks to sell their troubled assets to third party investors.

3. **Cases of disposition (Grant Street Bank)**

Grant Street Bank was created by Mellon Bank in 1988 as a liquidating bank which would not accept deposits. The Grant Street transaction was significant because it was the first time that a bad bank was created independent of a bank failure or merger.

In this transaction, Mellon Bank and other affiliates sold to Grant Street $640 million of non-performing loans, foreclosed properties and other repossessed assets. Grant Street financed the purchase with $128 million cash equity paid by Mellon Bank and the proceeds from the sale of $513 million high yield notes by Drexel Burnham Lambert. In addition, $35 million common stock was distributed to shareholders of Mellon Bank as a dividend, $90 million of senior

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preferred stock was distributed to Mellon Bank and $2 million of junior preferred stock was distributed to the directors of Grant Street.

The bad bank strategy has certain obstacles. Assets must be sold at fair market value, and the recognition of losses by the seller institution is likely to be painful. In this transaction, Mellon took an additional write down of about 35% on property that had already been substantially written down before consummating the sale to Grant Street. Transaction costs are high as Mellon was reported to spend $166 million in expenses. Finally, the bad banks incurred the cost and inconvenience of regulation as a bank. Thus, the bad bank is a viable option only for a strong sponsor.

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A. Importance of Relationships

1. Business as a byproduct

"Relationship" means different things to U.S. and Japanese businessmen.\textsuperscript{10} For U.S. businessmen, a relationship is a byproduct of a transaction and the deal itself is more important. For Japanese businessmen, however, a good relationship must be built between the parties before a transaction will occur. In Japan, a transaction is a byproduct of the opportunities created by the existence of a relationship. Japanese businessmen are reluctant to do business with individuals or corporations which they are not familiar with, even if the prospective deal is attractive.

2. Significance of relationship in workouts

When problems occur, Japanese may be unable to restructure a deal because they focus on the likely effect on broader corporate relationships. Americans, on the other hand, usually seek an efficient, but more narrowly-defined, solution. In decision-making, Japanese consider potential losses which may be caused by hurting corporate relationships and try to seek a solution which maximizes total utility. In maintaining long-term relationship, Japanese may choose to bear certain losses from the deal, and will receive certain benefit from the possible

future deals in return. In addition, parties involved in the deal may consider that they developed a tighter relationship. For Americans, this may not seem to be the best solution to achieve the highest recovery; but this is often the best decision for the continuing relationship.

Once this corporate relationship is severely injured, it is very difficult to cure.

Last year one of the biggest electrical appliances supplier, Matsushita (Panasonic) and Daiei, the biggest retailer in Japan announced that, after a 32-year holdout, they would begin to transact. Over three decades ago, Matsushita decided that it did not want to have its products sold at significant discounts as Matsushita had to protect its own retailers' and service network. Its founder, Konosuke Matsushita, decided to stop doing business with Daiei. Negotiations collapsed and their corporate relationship was injured. It took over 30 years to cure this damaged relationship. Because the power of Daiei as a selling channel became too large to ignore and Konosuke Matsushita passed away, Matsushita changed its mind.

B. The price of failure

The price of failure is different to both Japanese and American executives. In American business society the forgiving grace of a “no harm-no foul” mentality is shared. Japanese corporate executives, however, tend to closely relate their values to the performance of their companies and therefore company failure is felt and shared by most executives. In fact, if a Japanese executive’s project fails, he usually receives no second chance for recovery. He will not find any other employers to revalidate his personal worth. Japanese executives, therefore, tend
to be very conservative as they know they typically do not have another chance once they fail. This also explains why Japanese are slow to react and why they are reluctant to take risks by challenging new things. This conservative approach has very slowly begun to change among the younger generation, but it is still difficult for middle aged managers to accept.

C. Complex decision-making process

The decision-making process is somewhat complex and not readily apparent in Japan. Personal communication and informal consensus prior to the board meeting play critical roles in decision-making in Japanese corporations. This process is rather slow and time-consuming. Proposals submitted to the board have already been discussed and consented to informally, but the final decision is made by the board. If this informal communication is not carefully considered, it is highly possible the entire process becomes derailed.

D. Strong relationship between companies and banks

Very long and close relationships exist between companies and banks. Usually a Japanese company has a so-called “main bank” and that bank monitors the firm’s business activities and has a great influence over its decision-making. Problems of asymmetric information and conflicts of interest between borrowers and lenders are less for main banks and, therefore, main banks feel comfortable lending more money without incurring disproportionately higher risks.
E. Different view of the value of Land

1. Land as a commodity with inherent value

By extending an option pricing theory to real estate, a piece of land can be viewed as a call option with a strike price equal to construction costs. The only difference is this call option does not expire. This means land value is a derivative function of developed property.

This outlook is not common in Japan. To the Japanese, a piece of land is itself a valuable commodity. Historically, Japanese banks valued a vacant piece of land more as a collateral because they believed it was easier to sell when needed. The secondary market for buildings (and land) is smaller than that for vacant land and usually buyers prefer vacant land for development.

2. Different land valuation method

The land valuation method is different in Japan. For commercial real estate, property is usually not valued using an appropriate capitalization rate. Land is not viewed as a residual of the building. In the case of an office building, land and building are evaluated separately and then the derived value of each is added (additional value). Land is usually evaluated based on the assessed value on the map published by the National Tax Authority (Rosen-Ka).12 The building

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12 Assessed Value: (Rosen-ka)

Each year local offices of National Tax Authority (NTA) issues a map with assessed value for inheritance tax purposes. In the map each road has an assessed value determined by NTA,
value is calculated at replacement cost at that time, adjusted by the building age.
If the building is leased, net operating income is divided by a weighted average rate, based on the separately derived values, of 4.5% for land and 6.0% for building in Tokyo.

3. Real Estate as a non-liquid asset
Japanese investors usually do not view real estate investments as a part of their financial portfolio and, therefore, they do not evaluate these investments in the same manner as they do other income-producing financial assets.
While capital gain from real estate investment is taxed at 28% like other investments in capital markets, real estate taxation in Japan is quite different. For example, when an individual sells a piece of commercial property within 10 years from the date of purchase, it will be taxed separately from other sources of income at a rate of at least 40% of income tax and 12% of resident tax on sales profit. The tax due becomes higher if the sales profit increases. This taxation is aimed at preventing speculation in, and trading of, real estate. Taxation on real estate capital gain is summarized in the Table III-I:

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therefore assessed value of the land which faces a certain road can be derived by using the number from the map.
In addition, the National Land Agency has a Land Appraisal Committee. This committee determines certain points as a benchmark for public appraisal. Each year the committee determines the publicly appraised value(Kouji-ka) for the above mentioned benchmarks as of January 1.
In determining appraised value for land, appraisers consider both Rosen-ka and Kouji-ka adjusted according to the time that has passed after January 1. Kouji-ka is considered a good indicator of transaction prices in the market, but it is determined only once a year. There is thus a built-in time lag.
Table III-1. Taxation on real estate capital gain

<table>
<thead>
<tr>
<th>Seller</th>
<th>Individual</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holding period</td>
<td>X &gt; 10 years</td>
<td>X ≤ 10 years</td>
</tr>
<tr>
<td>Income tax</td>
<td>30%</td>
<td>40%</td>
</tr>
<tr>
<td>Additional tax</td>
<td>none</td>
<td>none</td>
</tr>
<tr>
<td>on capital gain</td>
<td>on land</td>
<td></td>
</tr>
<tr>
<td>Resident tax</td>
<td>9%</td>
<td>12%</td>
</tr>
</tbody>
</table>

source: Kazuo Uno, *Fudousan no Kenri-chousei to Zeimu* (Real estate valuation, interest allocation and taxation)

On the other hand, if a corporate investor sells its stock portfolio, it will be taxed 37.5% of corporate income tax on capital gain and approximately 1% of securities transfer tax on the value of the transferred stock.

In the Tokyo metropolitan area and the 12 other major cities, if the transaction involves land in an urban area bigger than 300m<sup>2</sup>, the seller must report to the governor of the city in advance the name of buyer, location, sales price and use of property and wait for the authorization (usually nearly 6 weeks). These taxation and reporting systems have made real estate virtually illiquid relative to U.S. real estate.

<sup>13</sup> This table shows a summary only. More detailed consideration is required to determine the actual tax amount.

<sup>14</sup> After April 1, 1997, this will be lengthened to 10 years.
IV. How Japanese Lenders Dealt With Their U.S. Borrowers

A. Japanese banks presence in the U.S.

Table IV-1. Top 15 Japanese Banks in the United States as of December 31, 1993

<table>
<thead>
<tr>
<th>(U.S. assets in millions)</th>
<th>Agencies/Brances</th>
<th>Subsidiaries</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Tokyo(^{15})</td>
<td>$21,346</td>
<td>$23,498</td>
<td>$44,844</td>
</tr>
<tr>
<td>Mitsubishi Bank(^{16})</td>
<td>29,843</td>
<td>6,433</td>
<td>36,276</td>
</tr>
<tr>
<td>Sanwa Bank</td>
<td>25,535</td>
<td>7,395</td>
<td>32,929</td>
</tr>
<tr>
<td>Industrial Bank of Japan</td>
<td>21,170</td>
<td>10,881</td>
<td>32,051</td>
</tr>
<tr>
<td>Fuji Bank</td>
<td>29,256</td>
<td>2,288</td>
<td>31,544</td>
</tr>
<tr>
<td>Sumitomo Bank</td>
<td>21,186</td>
<td>5,089</td>
<td>26,275</td>
</tr>
<tr>
<td>Daiichi-Kangyo Bank</td>
<td>23,194</td>
<td>396</td>
<td>23,590</td>
</tr>
<tr>
<td>Long Term Credit Bank of Japan</td>
<td>17,913</td>
<td>1,165</td>
<td>19,077</td>
</tr>
<tr>
<td>Sakura Bank</td>
<td>16,571</td>
<td>1,057</td>
<td>17,627</td>
</tr>
<tr>
<td>Daiwa Bank</td>
<td>11,094</td>
<td>1,359</td>
<td>12,453</td>
</tr>
<tr>
<td>Norinchukin Bank</td>
<td>12,075</td>
<td>0</td>
<td>12,075</td>
</tr>
<tr>
<td>Mitsubishi Trust and Banking</td>
<td>10,922</td>
<td>332</td>
<td>11,254</td>
</tr>
<tr>
<td>Tokai Bank</td>
<td>9,858</td>
<td>1,282</td>
<td>11,140</td>
</tr>
<tr>
<td>Yasuda Trust and Banking</td>
<td>10,020</td>
<td>420</td>
<td>10,440</td>
</tr>
<tr>
<td>Sumitomo Trust and Banking</td>
<td>8,745</td>
<td>331</td>
<td>9,077</td>
</tr>
<tr>
<td>Others as a group</td>
<td>52,442</td>
<td>1,041</td>
<td>53,483</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$321,170</strong></td>
<td><strong>$62,966</strong></td>
<td><strong>$384,135</strong></td>
</tr>
</tbody>
</table>

source: Federal Reserve

\(^{15}\) Bank of Tokyo and Mitsubishi Bank merged on April 1, 1996.

\(^{16}\) New bank, Tokyo Mitsubishi Bank started to consolidate their U.S. operations, but no further information is available for other banks as of April 1, 1996.
1. **Overview**

With a booming stock market, low domestic interest rates, and a strong yen, Japanese banks started to expand aggressively. This aggressive expansion of Japanese banks in the late 1980's included greater penetration of foreign markets, in part because of the opportunities provided by these markets and in part because of Japanese regulatory actions that encouraged the internationalization of Japanese finance. By 1990, Japanese branches and subsidiaries accounted for approximately 8% of all U.S. banking assets and 18% of all commercial and industrial loans to borrowers located in the U.S., which shows considerable growth from the 1987 figures of 5.5% and 11%, respectively. While Japanese banks initially may have expanded U.S. operations in order to serve their Japanese customers opening or expanding operations in the U.S., by the late 1980's they were actively expanding their business with U.S. based customers.

The Japanese share of foreign banking activity in the U.S. peaked in 1990 when Japanese banks accounted for over 60% of U.S. commercial and industrial loans by foreign banking organizations. After this year, the Japanese share declined, a fact not experienced by other foreign banking organizations.

2. **Branches and Agencies**

Japanese banks have branches and agencies which are a part of their banking operations in Japan. Agencies can not accept deposits from customers. In the U.S., branches and agencies are either state or federal chartered, but usually are not members of FDIC. Japanese banks are reluctant to comply with special
reserve obligations against bad loans required by the Federal Reserve Board (FRB), which is more rigorous than those required by MOF. This will be discussed later in section B.

3. **Subsidiaries**

Japanese banks also have subsidiaries, but real estate loans are made at the branch level. Some subsidiaries have participated in loans made by branches, but this is not very common.

B. Jurisdiction over branches and agencies

1. **MOF requirements**

Jurisdiction over the branches and agencies remains somewhat obscured. They are supervised by MOF as a part of the Japanese banking system. In 1995, Daiwa bank disclosed that it had $1.1 billion in losses from its New York trading operations. The losses, accumulated over 11 years, were systematically hidden from U.S. regulators. In response to this violation, the Federal Reserve ordered this bank’s U.S. operations closed or liquidated by February 1996. MOF was criticized for lax supervision of the banks’ overseas operations. MOF requested Japan’s major banks to report on their internal management of their overseas operations. It will also require full audits of all foreign branches of Japanese banks.

2. **Federal Reserve and state banking regulations**

In addition to MOF requirements, branches and agencies are subject to Federal Reserve and state banking regulations as they operate in the U.S. In 1991, the
U.S. Congress passed the Foreign Bank Supervision Enhancement Act (FBSEA) in the wake of the BCCI scandal. The FBSEA established new Federal Reserve Board review and examination standards for foreign banks in the U.S. These review and examination standards require regulators to hold foreign banks to the same standards.

3. **Difference under two regulations**

There are some contradictions to operating under the two different regulations. For example, the Federal Reserve requires the full amount of special reserves against non-performing loans while MOF does not require any specific reserves. Required level of disclosure of non-performing loans is significantly different in the U.S. and Japan. Initiatives regarding to disclosing non-performing loans are taken by the SEC and banking regulators take the same standard for supervision. In Japan no guidance for recognition and disclosure of non-performing loans has been given by MOF or BOJ. NTA instituted a guidance system for treatment of accrued but unpaid interest in 1966. The Federation of Bankers Association of Japan (Zen Gin Kyo) set up a guidance system based on this NTA guidance for definition of non-performing loans and minimum level of disclosure. Therefore, a U.S. branch of a Japanese bank is examined by MOF, BOJ, state/FRB and Audit department from Head Office. Interestingly, among many Japanese banks with operations in the U.S., Tokyo-Mitsubishi bank is the only bank which lists its shares on the New York Stock Exchange.
C. Strategies of Japanese banks in U.S. real estate workouts

1. Restructuring as a first choice

Unlike U.S. banks, Japanese banks were not under regulatory pressure to take direct write-offs for the impaired value of their loans. When the real estate non-performing loans became problematic in the early 1990s, these banks chose to restructure those loans because, at that time, MOF would not let them record any losses from asset disposition.

If the borrower is a Japanese company or subsidiary of Japanese company and the lender maintains a good relationship, the U.S. branch may send the loan back to the head office in Japan after receiving deeded property from the borrower. Loans to Japanese investors are usually made on recourse basis with mortgage over the property or as a part of general corporate loans. If the loan is made to a U.S. subsidiary of a Japanese corporation, a lender asks for a guarantee from the parent company. As mentioned earlier, relationships between corporations are very important, and banks just keep taking care of those loans after restructuring the loan. In the case of loans to non-Japanese borrowers, the lender is less concerned about continuing the relationship, and it may set-up a special purpose company (SPC) to hold troubled real estate assets. The problem with this SPC method is that unlike the U.S., SPCs with multiple assets are not allowed under MOF regulations. Some Japanese lenders have already established SPCs with a single troubled asset, but they find managing many of those small companies costly and inefficient.
2. **Efforts to maximize recovery**

Japanese banks may choose to sell off those troubled assets, but this requires substantial discounts in pricing. Head office management may be reluctant to sell at deep discounts and realize losses if their "budget" for write-offs for the year is already exhausted. Timing of asset disposition is, therefore, carefully managed. Japanese banks aim at maximum recovery and because they have enough staff for their U.S. operations, they choose sales of individual assets. According to a real estate manager of a Japanese bank, it is unlikely that Japanese banks would consider bulk sales at significant discounts.

D. **Reasons for Japanese banks’ slow reaction**

1. **Different strategy from U.S. banks**

As mentioned earlier, Japanese banks did not have to remove troubled real estate assets as quickly as U.S. banks. Unfortunately the recovery of the U.S. real estate market was slower than they expected, and they are now finally disposing of those assets.

2. **No regulatory guidance**

No standard or regulatory guidance is established by MOF/BOJ. Recognition of losses is totally at each banks' discretion with due consideration given to their financial strength; close consultation with National Tax Authority (NTA) is still required. MOF and NTA have not teamed up or otherwise coordinated their oversight, and banks are forced to obtain approval separately from MOF as well as NTA. NTA is a part of MOF, but its task involves collecting tax revenues for
the government.

Tax treatment of losses incurred from non-performing loans is unclear as this system is based on transactions, and necessitates close consultation with the NTA.

3. **Slow reaction by the Japanese stock market**

It has been suggested in several previous studies that loan write-offs are not evaluated favorably by the Japanese stock market. This is one reason that they are not motivated to write-down loans or they tend not to announce such writedowns to the public. Stock prices were also thought not to increase, as those stocks are not as freely traded as in U.S. According to the NRI stock survey report, however, this is not quite true. When most of the major banks announced huge write-offs in December 1995, stock prices went up by 10% on average. The market expected progressive action by banks to deal with non-performing loans. Since then, however, delays in discussion by the Diet and lack of initiative by the government, performance of banking sector stocks has been slowed. As mentioned earlier, most of the banks' shares are held by large corporations or institutional investors, so the stock price is thought to be irrelevant when measuring the performance of the banks. Usually, Japanese banks do not care about their stock prices as much as U.S. banks do. Moreover, no Japanese bank wanted to be the first to disclose bad loans because it believed it might look bad by doing so and hurt its reputation in the market. Today

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many banks in the market have started to take action and have stopped looking around to see what the others are doing. Rather, they are now concentrating on what they must do to achieve their objective: the maximum recovery in real estate workouts.

4. **No RTC experience**

Previously there has never been such a credit crisis in Japan. Most Japanese banks are not familiar with the methods used by U.S. banks. Lack of knowledge may prevent them from efficiently utilizing financial instruments available on Wall Street. Japanese banks are not under pressure to take appropriate write-offs or dispose of assets. They are aiming at maximum recovery so they are less likely to choose bulk sales to Wall Street firms.

5. **Slow decision-making process**

All the decisions are made at the Head Office in Japan after an extremely time-consuming process. It is sometimes difficult to take action in a timely manner. Usually Japanese banks establish a budget (reserve) available for write-offs in each operation after close consultation with the Controllers Department at Head Office. As no regulatory guidance has thus far been given, such an allocation to a reserve account is discretionary to each bank.

6. **Lack of incentive for management/managers**

Management/managers are on a 3-5 year tour of promotion to U.S. operations. It is human nature that these managers would want their tour to be as uneventful as possible because they usually do not receive any credits for
developing new business. "Loan workouts and asset disposition sound good, but not while I am here." The price of failure is especially high at banks as compared to other Japanese corporations. This may seem to U.S. bankers a lack of professionalism, because Japanese bankers are so afraid of making mistakes and rather do nothing. Japanese officers sent from Japan are not motivated to cultivate "professionalism" as they are not rewarded for solving problems; instead they may be punished because a problem means a failure, even before they attempt to solve problems. Top management should motivate all the officers, including senior management, to cultivate professionalism, by rewarding new challenges and successes, rather than punishing failures.

E. Japanese lending behavior and capital requirements

1. Basle accord and risk-adjusted capital ratio

In 1988, the Bank of International Settlements (BIS) established a uniform 8% capital ratio requirement for banks which have overseas operations in order to stabilize the international banking system. This 8% capital ratio should be attained based on risk adjusted value of assets.\(^{18}\)

Capital is defined as the Table IV-2. In calculating risk adjusted assets, cash or government bonds are regarded risk free and thus risk weight for those is 0%. Risk weight for residential mortgages is 50% and other generic assets have a 100% risk weight. Therefore if a bank expands loan assets considerably while its capital remains the same, risk adjusted capital ratio declines.

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### Table IV-2. Definition of risk adjusted capital and risk asset ratio

<table>
<thead>
<tr>
<th>Target</th>
<th>Banks with overseas operation in G-10 countries and Luxembourg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation of risk asset ratio</td>
<td>Risk asset ratio = risk adjusted capital / risk adjusted assets</td>
</tr>
<tr>
<td></td>
<td>Risk adjusted assets include on balance assets and off-balance assets</td>
</tr>
<tr>
<td>Risk adjusted capital</td>
<td>Risk adjusted capital = (Tier 1-A) + Tier 2 - B</td>
</tr>
<tr>
<td></td>
<td>A: goodwill in consolidated financial subsidiaries</td>
</tr>
<tr>
<td></td>
<td>B: investments in non-consolidated financial affiliates</td>
</tr>
<tr>
<td>Tier 1 capital</td>
<td>Common stock</td>
</tr>
<tr>
<td>Included without limits</td>
<td>Non cumulative preferred stock</td>
</tr>
<tr>
<td></td>
<td>Reserves which appear on B/S</td>
</tr>
<tr>
<td>Tier 2 capital</td>
<td>Reserves which do not appear on B/S</td>
</tr>
<tr>
<td>Limited to include up to 100% of Tier 1</td>
<td>Revaluation reserves on real estate for operation</td>
</tr>
<tr>
<td></td>
<td>on security holdings (up to 45%)</td>
</tr>
<tr>
<td></td>
<td>Bad asset reserves up to 1.25% of risk assets</td>
</tr>
<tr>
<td></td>
<td>Debt finance perpetual subordinate debt</td>
</tr>
<tr>
<td></td>
<td>cumulative preferred stock, etc.</td>
</tr>
<tr>
<td></td>
<td>Subordinate debt with maturity up to 50% of Tier 1</td>
</tr>
<tr>
<td>Risk adjusted assets</td>
<td>Risk assets off-balance assets include guarantee,</td>
</tr>
<tr>
<td></td>
<td>= categorized asset * risk weight</td>
</tr>
<tr>
<td></td>
<td>L/C, swaps, etc.</td>
</tr>
</tbody>
</table>

source: Bank of Japan

2. **Change in capital positions**

   Before the introduction of the Basle Accord, maintaining appropriate risk adjusted capital ratio had not been an issue in the Japanese banking industry.

   However, according to a study by the Federal Reserve Bank of Boston,°°

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Japanese lending in the U.S. was affected by the parent bank's capital position. Under the Basle Accord, banks are allowed to include up to 45% of unrealized gain on security holdings in bank capital. Japanese banks' tier 2 capital was sharply reduced with the crash of the Japanese stock market in 1989. Japanese banks responded to the requirement by reducing both lending to, and stock holding of, firms with which they did not anticipate a continuing long-term relationship.

3. **Effect in overseas lending**

While their domestic loan growth continued, U.S. lending by branches declined sharply. It is assumed that the branches of Japanese banks started disposing of real estate assets to meet the risk-based capital ratio requirement. They may also have changed their overseas lending strategy: no longer was bigger better. Unless their capital position in Japan improves dramatically, it is unlikely that they will shift to U.S. lending.
F. What is the next step for Japanese lenders?

1. Real estate sell-offs by Japanese banks

The following transactions have been conducted by Japanese banks:

<table>
<thead>
<tr>
<th>Name of Banks</th>
<th>Activity</th>
<th>Property/Loan</th>
<th>Loan Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mitsubishi Bank</td>
<td>sold</td>
<td>Hyatt Regency Waikoloa</td>
<td>$180M</td>
</tr>
<tr>
<td>Daiichi-Kangyo Bank</td>
<td>contracted</td>
<td>Ritz Carlton Mauna Lani</td>
<td>&gt;$180M(^20)</td>
</tr>
<tr>
<td>Fuji Bank</td>
<td>contracted</td>
<td>loan for NYC office buildings</td>
<td>&gt;$230M</td>
</tr>
<tr>
<td>Long Term Credit Bank</td>
<td>for sale</td>
<td>Regent Beverly Wilshire</td>
<td></td>
</tr>
<tr>
<td>of Japan</td>
<td></td>
<td>Hotel in California</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Four Seasons Hotel in NYC</td>
<td></td>
</tr>
</tbody>
</table>


2. Current outlook

Japanese banks are currently recording a huge profit from operations in Japan because of the extremely low official discount rate. They wish to clean up the mess on their balance sheets because they are now positioned to sustain huge write-offs without incurring serious financial problems. One Japanese officer stated that the funding cost of banks in Japan will not remain as low as the current level for a long enough period to achieve maximum recovery from non-

\(^{20}\) Construction cost in 1990 is estimated to be $180 million.
performing assets in the U.S. It is highly possible that this consideration will accelerate asset disposition over the next few years while their core operation in Japan remains strong. Also, it is easier for Japanese banks to dispose assets in the U.S. where the market is already established, than dispose troubled real estate assets in Japan.
V. Conclusion

A. What is Japanese banks' strategy for U.S. real estate in the future?

One thing that is clear is that Japanese banks paid a huge tuition fee for the tough lessons they learned. Are they going to stop granting loans for U.S. real estate? The answer is yet to be determined.

As mentioned earlier, most of their U.S. real estate lending was for their Japanese clients. Some of the investors are still waiting for the recovery of the market. Will those who withdrew reinvest in U.S. real estate in the future? Probably not. They withdrew because they had to concentrate on their core business in Japan. Or, they were forced to dispose of their investment by their main banks. Their investment in U.S. real estate is not a part of their core business. On the other hand, there may be some Japanese investors who choose to specialize, or increase their existing position in, U.S. real estate. In this case, they are usually sophisticated and able to raise funds themselves. They often use their credit to reduce their cost of funds. Japanese banks will not increase lending against U.S. real estate for unsophisticated, thinly capitalized, or inexperienced Japanese investors. Nor, are they likely to lend against inferior quality properties in secondary locations.

Like other U.S. banks, Japanese banks have started looking into other areas rather than lending to single asset borrowers. They have learned that lending against single assets is very risky in markets with low growth potential. Most likely, Japanese banks will go into corporate real estate lending, such as to REITs or large real estate firms which list their shares on the New York stock exchange.
They emphasize investment grade credits and multiple exit strategies. They may also look to make permanent loans for well-capitalized, low loan-to-value ratio projects. The problem is the degree of competition in that market. Bidding (pricing) becomes competitive among banks, insurance companies, pension funds, and conduits and spreads go down. Japanese banks have to behave more like U.S. banks in this business area to survive severe market share and price competition. Also, they must provide the same customer service they provide their Japanese clients to build and maintain market share.

What is the strategic plan for Japanese banks to be successful in U.S. real estate markets? It is obvious that Japanese banks should expand business with U.S. customers to survive in the changing market and earn sufficient risk-adjusted profits to meet their target. This critical issue arises: Do the Japanese senior management in the U.S. or head office in Japan really understand that U.S. business practices are very different from those in Japan and, therefore, they cannot simply export their customs when dealing with their U.S. customers? Or, do those managers really wish to expand their business base in the U.S.?

What will happen when the demand for bank loans in Japan improves? The U.S. real estate business is highly competitive, far more competitive than Japanese real estate business; therefore, it is impossible to survive in the U.S. market by ignoring U.S. business practices and rules. Quick response, timely decision-making and thorough understanding of the players and market are critical. However, officers sent from Japan usually stay in the U.S. for only a limited period of time, and by the time they get to know their customers, the latest product developments, and the marketplace, they are transferred back to
Japan: This is not very effective and disrupts the continuity of relationships. It is usual practice for Japanese bankers to move constantly between assignments, usually every two years or so, but this frequent transfer does not work well in the U.S. marketplace. It is not easy to understand the U.S. marketplace and cultivate new business relationships within a short time frame; it takes time. Assignments for a longer period of time to the U.S. operation and greater specialization is suggested to be considered by the human resource managers. It should also be a clearly stated and well-planned long-term goal to be shared among all officers of the branch, from senior management to junior staff, both Japanese and American, to cultivate success and survival in a rapidly changing and competitive market environment. According to interviews with some officers in New York, this is not the case at most Japanese bank branches. Usually the so-called “strategic plan” comes from planning department at the head office and there is no room for discussion by the officers/managers who know the local market and actually work there. If Japanese banks wish to expand their business successfully in the U.S., they should act in accordance with the U.S. business practices and rules, which are different from those with which officers sent from Japan have been familiar.

B. What can Japanese banks learn from their experience gained in U.S. real estate workouts?

The biggest lesson the Japanese banks learned may be that painful surgery - disposing of assets at a discount in a timely manner - is sometimes critical for an incrementally successful real estate outcome. They tend to restructure every
loan and wait for a while to see what happens in the market, expecting it to improve. They have been learning when and how to make decisions to dispose of assets, but communication with the head office still remains a big issue, as U.S. operations do not have enough authority for decision-making. All decisions still need be approved by head office in Japan.

Can Japanese banks apply their experience to solve current real estate problems in Japan? The answer is Yes, but there are so many problems to be solved and necessary changes to be made under current system.

There are three obstacles to utilize new techniques in Japan that U.S. banks employed in solving their problems. First, no regulatory guidance or political decision or governmental assistance has been given so far. The solution for current problems has been discussed in the Diet, but the discussion conducted seems more like a political game. Clear guidance may not be given for a while, another year or so. Lack of this essential part will delay the recovery of the Japanese real estate market. Second, real estate is still illiquid under the current obsolete taxation scheme (extremely high tax rate on capital gain realized from short-term investment), because this high tax is simply levied to exclude investors/speculators aiming at capital gains on land from real estate investments. If capital gain tax takes away most of profit realized from investment, who will want to sell the property? Ultimately, who will invest in real estate? Third, there are no experienced institutional investors for troubled real estate assets within Japan. Japanese investors may say, “We have been severely wounded by investing in sound real estate; why should we consider investing in troubled real estate?” Therefore, it may be necessary to both relax
some regulations to induce foreign capital with more experience in investing in troubled real estate, and change the obsolete and tired system of taxation. Because the real estate market is in crisis and the problems that banking industry is facing are very serious, it is, ironically, a good opportunity to make drastic, but necessary changes within the whole financial system in real estate. All participants in the real estate market now know that land prices do fall and it is too risky to make investment decisions based solely on future capital appreciation, especially in mature markets: Investors, therefore, are advised to seriously consider current returns on investment as part of their investment decision-making.

In the process of solving Japanese real estate problems, two important objectives must be achieved; first, enhancing the liquidity of real estate, and second, establishing clear guidance with respect to the tax treatment of losses incurred by banks from asset disposition. Securitization, such as REITs or CMBS, should be considered with keen interest with the precondition of establishing an appropriate valuation method by discounting future expected cashflows. Current methods commonly used in Japan do not make sense to foreign investors who are looking primarily at cash-based returns. Determining an appropriate discount rate is not an easy task because, for example, lease contracts can be relatively easily terminated by the tenant, in most common case, with six months’ prior notice, and the tenant is granted a right by law to renegotiate its lease under certain circumstances. The risk profile of lease contracts is significantly different in Japan from that in the U.S. In addition, heavy capital gains tax must be reduced for those investors who
invest in troubled real estate if such investors are to be induced to supply new capital into Japanese real estate.

Strong political leadership is required to advance the process toward its goal.

Japan is a country with limited land and real estate is a significant asset of the nation. Discussion must be conducted, free of political gamesmanship, because timely decision-making and execution are essential in solving worsening real estate problems. The Japanese real estate economy will not improve unless the relevant problems are openly identified and workable solutions advanced and executed.
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