Toshihiko Fukui: Toward the reform of corporate finance in Japan

Keynote speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the JSLA Symposium on "New Corporate Finance to Revitalize Japan", Tokyo, 17 November 2003.

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Introduction

I am honored to have the opportunity to address this symposium sponsored by the *Nihon Keizai Shimbun* and the Japan Syndication and Loan-trading Association (JSLA). In the brief three years since its founding in January 2001, the JSLA has contributed greatly to establishing the infrastructure for the syndicated loan market: not only devising a standard form of sales contracts for loan assets and promoting its wider adoption, but also working toward better disclosure of information relating to loan assets trading. On behalf of the Bank, I would like to express, at the outset, our sincere admiration for the JSLA's energetic efforts in this regard.

In constructing a revitalized and dynamic economic system in Japan, I believe that it is increasingly important to direct our efforts towards reform of the framework for corporate financing, just as the JSLA has done to date. Today, I would like to share with you my thoughts on reforming the system governing corporate financing in Japan.

I. Role of corporate financing

Let me start by discussing the fundamental role of corporate financing within the economy from a purely theoretical standpoint.

We can classify a vast number of decisions taken daily at companies into two broad categories: those that relate to operations, including production, sales, and investment; and others relating to the company's financing decisions such as procurement of debt and equity. Let us take a completely hypothetical example, where no friction exists in economic activities, no asymmetry of information is found between sellers and buyers or between borrowers and lenders, and no one even has to worry about the threat of bankruptcy. In such a world, companies should devote themselves purely to the production and sale of attractive products and services, and there would be no active decisions to be made regarding financing. In other words, the company's financing activities would simply and passively follow the development of its business.

In reality, however, we face various uncertainties. In particular, there are always significant informational asymmetries between borrowers and lenders, and these force borrowers to make appropriate decisions on financing as well as operational decisions. In deciding their optimal capital and liability structures, firms need to consider the idiosyncratic risk profiles associated with their particular businesses. A firm operating a high-risk business should have a sufficient capital base. If liabilities were high relative to capital, it would be difficult for the firm to maintain an appropriate degree of liquidity in the face of market concerns about the materialization of risk, and the firm's ability to continue operations would come into question. Furthermore, the awareness of the risks involved in a firm's business operations varies depending on the stage of development at which the firm finds itself. A start-up firm that lacks sufficient creditworthiness is required to maintain a proportionately higher capital base. Similarly, the optimal composition of capital and liabilities also varies with the macro business cycle. When recession brings the possibility of bankruptcy to the forefront of firms' minds, they should respond by strengthening their capital bases.

While narrowing the information gap, we must also ensure the smooth flow of funds between borrowers and lenders, that is, between firms and banks/investors. To this end, corporate financing should not simply involve the unilateral determination of the levels of debt and equity by one party, but should be a process which allows players on both supply and demand sides adequate input into the determination of optimal financing and fund management arrangements.

The key to this process is the ability to assess the risk and return involved in a given transaction accurately and efficiently. A fund provider which is highly competent in this area can earn more profits. On the other hand, if a fund-raising firm lacks the ability to judge how to combine different means of financing, including new financing facilities, so as to minimize both the costs of financing and the possibility of bankruptcy, it becomes difficult for the firm to maintain efficiency and stability when managing its business. This is an ability that requires expertise, and as a result, banks, securities companies, institutional investors, credit-rating agencies, and firms' finance divisions all have crucial roles to play.

Accurate assessment of risk and return is vital not only at the microeconomic but also at the macroeconomic level. If many companies raise funds to finance investments whose returns are low relative to the degree of risk involved, macroeconomic productivity and the economic growth rate will decline in line with the reduced rate of return on the savings. The same can be said if sufficient funds are not provided for investments that are expected to yield high returns but which carry only modest risks. Both of these phenomena have been evident in Japan's economy and financial markets since the emergence of the asset price bubble and its subsequent collapse.

II. New corporate governance

I would now like to look briefly at the past history of corporate financing in Japan, in order to identify what reforms are necessary to revitalize the Japanese economy.

As is often pointed out, until relatively recently corporate financing in Japan was dominated by fund provision under the main bank system. Banks extended loans not based on their evaluations of individual operations or projects, but based on their evaluations of individual borrower firms. In determining the eligibility of corporate borrowers, banks were less interested in diligently assessing the state of cash flow than in gauging the extent of the real estate holdings that could be offered as collateral. They focused on the long-term and comprehensive profitability of overall transactions with each borrower, rather than the profitability of each loan transaction. Within this framework, main banks accumulated extensive information about borrower firms, and decisions about the granting or rolling-over of loans were based on this information. The main bank's decision then acted as a signal which other banks typically followed. From the viewpoint of corporate governance, the main bank was not only, clearly, a major creditor of the borrowing firm, it was often also one of its shareholders. In a sense, therefore, banks, and in particular the main bank as the most important stakeholder, acted to discipline corporate activities.

During the years of high economic growth and rising real estate prices the main bank system had its own underlying rationality. Indeed, Japan could not have achieved high economic growth under the system if it had not been rational.

However, the system has gradually become incompatible with the changing economic environment. This change was already evident even before the emergence of the asset price bubble, and it has been further confirmed since the bubble's collapse. Yet, there does not yet appear to be a consensus explanation of the reasons behind the malfunctioning of the system. In contrast to the period of high economic growth and its ensuing afterglow, economic globalization has forced firms to take up the challenge of high risk businesses and projects. I believe that a new framework for corporate financing is required in order to control such risks. Banks' assessments of borrowers' profitability become less well-defined if they cling to the conventional criteria of “long-term and comprehensive profitability.” They can no longer compete with other financial services providers that offer highly specialized, cutting-edge financial services.

I should remind you, however, that I am not insisting on a simple shift from bank-dependent financing to capital-market-dependent financing. We will not be able to identify an optimal system for corporate financing by perfunctorily repeating such questions as: “Which is more desirable, financing mainly from banks or from capital markets?” For business projects to contribute to economic growth, there has to be someone collecting and analyzing data about these projects, and assessing the risks involved and the likely rates of return. No matter how we change the overall structure of the financial system, we will always require somebody to perform this fundamental role. What is called for at present is a complete revamping of the ways in which information on risk and return is gathered and dealt with, as an integral part of building a new system of corporate governance to replace the main bank system.

Japan is not the only country that is searching for alternative forms of corporate governance. In the past, U.S. firms were seen as providing the role model for corporate governance. However, in the wake of a series of incidents such as the failure of Enron, they too appear to be entering a new phase of corporate governance. As a result there is no particular textbook model that we can apply to for guidance regarding corporate governance, and we must work hard to produce an original one.

III. Recent developments in corporate finance

Over the past few years there have been a number of new developments in the area of corporate finance in Japan that seem to signal further changes in the future.

First, firms have been reducing their levels of debt. This has been a major trend since the 1990s.

The corporate sector has registered a net surplus since fiscal 1998, with savings exceeding investment, and the outstanding amount of loans extended to firms by banks has decreased on a net basis since 1994. The straightforward reasons for these debt reductions have been firms' need to get rid of the excess debts built up during the asset price bubble in the late 1980s, and also the increasing difficulty of finding new investment opportunities in the years of economic downturn. More fundamentally, both firms and banks have become increasingly aware of the need to optimize their capital and liability structures to adapt to changes in the economic environment. For firms this involves carefully assessing the risks and returns associated with projects, as well as recognizing the need to achieve an optimal structure in terms of their relative holdings of capital and interest-bearing liabilities. Meanwhile, banks are striving to enhance their risk management by taking better note of their capital situations, and to set interest rates that reflect the credit risks associated with individual borrowers so as to improve the profitability of lending.

Second, banks are rushing to unwind their cross-shareholdings.

The amount outstanding of stocks held by banks fell by 48 percent, that is, by 21 trillion yen, over the past two years. This is not of course to say that there are no circumstances under which banks should hold stocks. However, cross-shareholdings may have a serious and unpredictable impact on banks' business given their limited capital bases. In this sense, banks' reductions of cross-shareholdings represent an attempt to restore themselves to financial soundness. At the same time, I believe that, having freed their capital from stock price volatility, they will be able to increase their extension of loans to firms.

Third, many banks have been starting to measure the economic value of loans, particularly nonperforming loans (NPLs).

For example, banks made use of the discounted cash flow (DCF) method in their fiscal 2002 financial statements and made subsequent increases in provisioning. Improvements of this nature in the evaluation of NPLs enable them to be traded on markets more easily, thus helping expedite banks' disposals of their NPLs. They also encourage corporate restructuring funds and other institutions to increase their purchases of NPLs, speeding up the process of corporate revitalization.

Fourth, new credit markets, led by the markets for syndicated loans, asset-backed securities (ABSs), and credit derivatives, are growing rapidly.

The arrangement of syndicated loans totaled about 11 trillion yen in 2002, marking a sharp increase from around 3 trillion yen in 1999, while over the same period ABSs also rose significantly, to slightly less than 5 trillion yen from roughly 2 trillion yen. Such instruments aid the smooth transfer of funds and risks through markets. For example, a new risk management method is being adopted for ABSs which involves diversification of risk by pooling individual loan assets. Banks are also actively working on new lending products, such as small-value business loans and non-recourse loans.

IV. Future direction of corporate finance

These recent developments I have mentioned basically indicate that we are heading in a desirable direction.

At the same time, however, it is true that there are still many challenges ahead. For instance, banks often say that business relationships with customers tend to make risk-based pricing of lending rates easier said than done. Japanese firms often rely heavily on relatively low and fixed-rate loans from banks for much of their external funding, and these loans are often regarded as "quasi-equity." From the point of view of firms, pricing interest rates to reflect risk is rather like suddenly turning equity into debt, and it is scarcely surprising that they show resistance to the idea.

Those working at the frontlines of corporate finance have different perspectives on these issues. Loan officers at banks that have a long history with their customers find it difficult to reach agreement on the specifics of adopting risk-based rates. This is because, although customers may be able to understand the need for such risk-based rates in an abstract sense, alternative capital markets, such as markets for corporate bonds, have not yet been fully developed, and this makes it harder to discuss specific rates. On the other hand, institutional investors find it difficult to invest in corporate bonds because the amount issued is still small and insufficient. This is often attributed to the extremely low interest rates charged on bank lending. Meanwhile, firms, especially small and medium-sized firms with low creditworthiness, point to difficulties experienced even in borrowing from banks, let alone in issuing corporate bonds. Each party, therefore, has a different perspective, and, from their various standpoints, all seem to me to make sense. Solving these kinds of interrelated problems is somewhat like trying to determine which came first, the chicken or the egg.

Nevertheless, this does not absolve us from doing everything we can in order to deal with the problem. In this regard, corporate financing based upon an accurate evaluation of risk and return is all important. Although the term may still be somewhat new, what we are talking about here is the establishment of a “credit culture.” It is this that I believe to be the crucial issue facing Japanese corporate finance today.

Although not perhaps comprehensive solutions, from a strategic viewpoint I would like to emphasize the significance of the following two points.

First, it is vital to establish an infrastructure to facilitate the use of information.

Corporate financial information, such as details about products and transactions, need to be disclosed appropriately and efficiently so that providers of funds can understand accurately the risk and return of particular projects. The establishment of the JSLA's criteria for the disclosure of loan asset information is one example of such efforts. Databases of firms' financial information enable processing of such data and make investors' risk management more efficient. Data on trade volume and the size of financial markets are also useful. Information vendors are planning to provide information relevant to the secondary markets for NPLs.

Bank loans have been the dominant means of corporate financing in Japan. Under the main bank system, borrower information has been shared only between the borrower and its main bank, and neither party has been especially averse to this arrangement. It is always difficult to change such established practices. For this reason, persistent efforts will be required not only to establish an infrastructure to facilitate the use of information, but also to convince market participants to change their thinking on this matter.

Second, the revitalization of credit markets using cutting-edge financial engineering techniques is indispensable.

We see technological innovation in many industries but it is particularly rapid in the financial sector. A variety of statistical methods have been introduced which use information such as accounting data and bankruptcy ratios to obtain quantitative estimates of credit risk and also to evaluate the overall risk inherent in particular portfolios. These techniques have facilitated the rapid development of markets for syndicated loans, ABSs, and small-value business loans based on scoring models, as well as markets for non-recourse loans and credit derivatives. When arranging ABSs, these techniques enable the classification of cash flows from pooled assets into tranches, such as senior, mezzanine, and equity, reflecting different degrees of risks, enabling investors to select the tranche best suited to their individual risk preferences.

V. Expectations for syndicated loan market

Next, I would like to focus on syndicated loans in the context of reforming corporate finance in Japan. Syndicated loans are considered sophisticated because they incorporate devices for both producing and managing information efficiently. I believe that the development of this market will play a leading role in the reform of corporate finance in Japan, and is likely to accelerate the establishment of a “credit culture.” There are two features of this market that are worth specific mention.

First, contracts make clear stipulations regarding the relationships between borrowers and banks, and between agent banks and participating banks. They also stipulate precisely the obligations of contracting parties and the compensation to which they will be entitled. For example, the contract between a borrower and its bank includes covenants that establish certain conditions on profitability and asset quality to which the borrower agrees to be subject. Such covenants allow borrowers more operational freedom, since they can prevent unnecessary intervention of banks. On the other hand, they also allow lenders to take necessary measures quickly when the borrower becomes unable to fulfill its obligations under the covenant. In the United States, where the syndicated loan market is firmly established, covenants are seen performing a triggering role: when borrowers experience difficulties in honoring the terms of their covenants, this prompts discussions with their banks and the implementation of recovery measures. A separate set of contracts for syndicated loans is also signed between agent banks and participating banks. Under these contracts, agent banks are responsible for disclosing information on the borrower and monitoring its observance of the covenant, a service for which they receive a compensatory commission. This gives agent banks incentives to monitor borrowers' financial situations accurately.

Second, syndicated loan assets are designed specifically with the secondary market in mind. If borrowers allow lenders to transfer loans to a third party, this will dramatically change the landscape of Japan's financial markets. In the past, there were close and exclusive relationships between borrowers and lender banks, especially the main bank, and borrowers were extremely resistant to the idea of having their loans transferred to a third party. Indeed, they were reluctant even to see changes in the share of their total borrowing that came from banks. This explains the existence of contracts for syndicated loans in Japan that explicitly limit the scope for transferring loans to third parties.

For transactions in the secondary market to take off, syndicated loan assets should be priced in such a way that banks other than the existing lenders, or institutional investors, may purchase them in the market. If this happens, it will allow borrowers and agent banks to consider current market prices for loan assets when fixing the terms governing lending in the primary market. A positive growth cycle in secondary markets can be envisioned with more institutional investors entering the credit market.

Of course, expansion of syndicated loan market alone does not complete the reform of corporate financing in Japan. However, if the transfer of loan assets becomes more widely accepted through the development of a secondary market for syndicated loans, the market liquidity of new vehicles such as ABSs will improve. Moreover, if covenants allow borrowers and agent banks to respond more promptly when firms become financially distressed, the amount of lending and investment that goes to finance low-return projects will gradually decrease, and this should accelerate the shift of economic resources to highly-profitable businesses and industries.

I look forward to seeing the JSLA continue to contribute actively in this area.

VI. The Bank of Japan's initiatives

A. Three pillars of the monetary easing policy

The Bank of Japan is making every possible effort to ensure that the effects of monetary easing permeate the economy more fully, so as to overcome deflation and put the economy back on a sustainable growth path. Let me elaborate on our efforts in this regard.

First, the Bank is providing extremely ample liquidity to financial markets. This so-called quantitative monetary easing acts to ensure the stability of financial markets, thereby firmly supporting economic activity.

Second, the Bank has committed itself to continue this quantitative easing policy. Often termed the "policy duration effect," the effect of this commitment is to stabilize public expectations about the direction of future policy, and to keep relatively long-term interest rates at lower levels. Specifically, the Bank's commitment is to keep the current framework until the annualized growth rate of the consumer price index (CPI) stabilizes above zero percent. At the Monetary Policy Meeting in October, the Bank further clarified its commitment in simple and clear terms.

Third, the Bank is striving to enhance the transmission mechanism of monetary easing. For the effects of quantitative monetary easing to reach every corner of the corporate and household sectors, credit should be extended either by banks and other financial services providers, or through financial markets, not only widely but also effectively. In this regard, the reform of corporate finance is intimately related to the Bank's current conduct of monetary policy. Such reform is also extremely important for the future of Japanese economy because, in the creative and dynamic economy that we envision for the future, I believe that it will be essential that the firms intending to identify new sources of value-added, which are actively undertaking risks, should be able to obtain sufficient support to meet their specific financial needs.

B. Efforts to revitalize credit markets

Based on this thinking, the Bank has stepped up its efforts to revitalize credit markets in Japan.

First, the Bank has provided substantial support for private efforts to improve the functioning of such markets. In addition to the traditional credit markets such as for loans, commercial paper (CP), and corporate bonds, we consider it crucial to promote the development of new credit markets for syndicated loans, ABSs, and credit derivatives. The Bank, in cooperation with the JSLA and a large number of market participants, has continued to support steadily efforts to improve new credit markets, in such areas as devising standard forms for contracts, streamlining transaction practices, as well as collecting market data and publishing statistics. A recent example is the Bank's decision to start publishing statistics on syndicated loans from December 2003, in response to earnest requests from market participants. The Bank has also conducted quantitative and theoretical research using a variety of data to capture movements in financial markets and at financial services providers, and has sought to share professional views with market participants by publishing the results of its analyses.

Second, the Bank has been enhancing the settlement infrastructure for financial markets. The Bank started online operation of its funds transfer system in 1988, and of the transfer system for Japanese government securities (JGS) in 1990. As for CP, corporate bonds, and stocks, the Bank has cooperated with private-sector settlement systems to introduce online settlements as well as simultaneous settlements of securities and funds, the delivery versus payment (DVP) system. The Bank will continue its proactive support for ongoing projects, including the complete online settlement of corporate bonds and stocks.

Third, the Bank has continuously reviewed the effects of its various policy measures and operations, adjusting these in light of prospective changes in financial markets and at financial services providers. In 1999, the Bank began to accept ABSs as collateral for its market operations to provide liquidity, and since then it has expanded the scope of ABSs as eligible collateral. Currently, the Bank is also working on detailed ways of using syndicated loans as collateral, a project for which it has sought the opinions of market participants.

In the summer of 2003, the Bank launched operations to purchase ABSs. This represents an unconventional policy measure for a central bank. However, since the market for ABSs is still in an embryonic stage, with relatively few market participants willing to assume the associated risks and with difficulties in arranging the securities, the Bank decided to shoulder the credit risk of holding ABSs itself. Although it is conceivable that this intervention by the Bank may distort the price discovery function of the market and thereby jeopardize its sound development, the Bank's design and management of the purchase scheme makes careful allowances for this risk.

The Bank wishes to make every effort to cooperate with market participants in the revitalization of credit markets. To this end, the Bank has inaugurated a “Workshop on Securitization.” I hope that various market participants, including both originators and investors, will take part in the workshop and suggest further ways to nurture and improve these credit markets. I expect this workshop to provide valuable insights in these areas.

Concluding remarks

To achieve a dynamic economy in Japan, efficient allocation of economic resources through market mechanisms is indispensable. In this regard, it is of the utmost importance to reform the framework for corporate financing so that participants can accurately evaluate the risk and return associated with transactions and products. This, I would like to emphasize, is the core message of my speech today.

The traditional framework for corporate financing in Japan worked well in the economic environment and structures of the past, which explains why it will take a substantial amount of effort and energy to change its direction. All the parties concerned, including companies, financial services providers, and the relevant authorities, should tackle the issues boldly by sharing new ideas and promoting innovations.

Let me conclude by stating that the Bank commits itself to playing a leading role in such efforts and cooperation.

Thank you for your kind attention.