Recent Developments in the Syndicated Loan Market

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According to the Japan Syndicated Loan Association, a group of 32 Japanese and non-Japanese financial institutions formed to encourage the development of the market in syndicated loans, work on standardizing transferable loans is now well under way. This should make it easier to transfer loans, which are one of the tools of indirect finance. This, in turn, should encourage trading in loans and lead to the creation of a secondary market—a development that could have a major impact on Japan's capital markets.

1. Reasons for Trying to Free Up the Loan Market

There are two basic reasons for these moves to free up the loan market: (1) the fact that capital adequacy requirements have forced banks to try to reduce their risk assets and (2) the fact that they still want to be able to extend new loans, including large ones. An additional reason has been the desire to make the legal provisions that will help Japanese banks to deal with their bad loans.

Efforts to reduce risk assets have included the development of securitization techniques and legal provisions to enable these to be applied. However, it is questionable whether these have achieved what financial institutions have expected of them. An October 2001 working paper produced by the Basel Committee sounds a word of warning about what securitization can contribute to asset reduction,[1] and, depending on how things develop from now on, this may inhibit the use of this method to free up the loan market, making the creation of a secondary loan market increasingly important.

[1] See Shin'ichi Iimura, Shin BIS Kisei ni Okeru Shokenka no Toriatsukai ni Tsuite [The Treatment of Securitization under the Bank for International Settlements' New Capital Adequacy Rules], Kin'yu-Shihonshijo Doko Repoto [Developments in Credit and Capital Markets], 22 November 2001.

Table 1 Recent Legal Developments Related to Asset Securitization

	With effect from	Brief description
Special Obligation Law (Law on the Regulation of the Special Obligation Business)	June 1993	Passed in order to enable installment sales companies under the control of the (former) Ministry of International Trade and Industry to raise capital by securitizing their assets. It introduced public advertisements as a means of enabling assignors to satisfy the requirements for defending a claim that a transfer is a true sale when they transfer assets collectively.
Collective Business Law (Law on the Special Collective Real Estate Business)	April 1995	Governs companies that trade earnings distributions to investors in collective real estate products. It was designed to protect investors and contribute to the development of a market in pooled real estate investments.
Special-Purpose Company Law (Law on the Securitization of Special Assets by Special-Purpose Companies)	September 1998	Permitted special-purpose companies to acquire real estate and nominative claims (or trust beneficiary certificates representing these), and to issue bonds, commercial paper and preference shares. Its main features are that these securities are now recognized by the Securities and Exchange Law and that special-purpose companies can treat their dividend payments as losses (and offset them against their income tax liabilities) provided they distribute at least 90% of their income in this form.
Special Case Law on the Transfer of Loans (Law on Special Cases in the Civil Code of Defending Claims Connected with the Transfer of Loan Obligations)	October 1998	A special case law based on Article 467 of the Civil Code. By introducing a system of registering loan transfers with the Legal Affairs Bureau in addition to the existing system of notifying debtors (or obtaining their consent) by means of an officially dated document in order to satisfy the requirements for defending a claim that a transfer is a true sale against a counterclaim by a third party, it made it easier to transfer pooled assets.
Servicer Law (Special Measures Law on the Management and Recovery of Loans)	February 1999	A special case law based on the Attorneys-at-Law Act. It permitted licensed companies to specialize in asset recovery (otherwise known as "servicing").
Asset Securitization Law	November 2000	It amended the Special-Purpose Company Law so that it became less of an emergency measure and more general and permanent. Its scope was widened to cover all property rights; the procedures for setting up special-purpose companies were simplified ; and the requirement that plans to securitize assets be registered was abolished.
Investment Trust Law (amended) (Law on Investment Trusts and Investment Companies)	November 2000	The main point, as far as asset securitization is concerned, is that, as amended in 1998, the law allowed investment trusts (in the sense of listed investment funds rather than the sense of mutual funds) for the first time, while, as amended in 2000, it widened the range of products in which investment companies could invest to claims on property in general (and not just securities). This enabled real estate investment trusts (REITs) to be set up in Japan.

Source: NRI.

Table 2 Categorization of Asset-Backed Products Other than Real Estate

<table>
<tr><td rowspan="13">Asset-backed products other than real estate</td><td rowspan="4">Lease and credit assets (based on the Special Obligation Law)</td><td>Asset-backed securities and asset-backed commercial paper</td><td>First approved in April 1996. Bonds and commercial paper issued by special-purpose companies and backed by interest and other income from particular assets that have been transferred to those special-purpose companies by leasing and credit companies.</td></tr>
<tr><td>Trust beneficiary certificates</td><td>Trust beneficiary certificates issued by trust banks and backed by interest and other income from particular assets that have been transferred to the trust banks by leasing and credit companies and sold to investors in units.</td></tr>
<tr><td>Unitized obligations created by transfer</td><td>Unitized claims on the proceeds of the transfer to special-purpose companies of lease and credit obligations and assets owned by leasing companies. These units are then sold to investors.</td></tr>
<tr><td>Secret and voluntary partnerships</td><td>Equity interests in secret and voluntary partnerships formed for the purpose of distributing the income from acquiring, owning and managing lease and credit obligations.</td></tr>
<tr><td rowspan="2">Receivables</td><td>Asset-backed commercial paper</td><td>Commercial paper backed by receivables that have been transferred to special-purpose companies.</td></tr>
<tr><td>Receivables in trust</td><td>Trust beneficiary certificates backed by receivables that have been transferred to trust banks.</td></tr>
<tr><td rowspan="4">General loan obligations held by financial institutions</td><td>Loan obligations in trust</td><td>Trust beneficiary certificates backed by loan obligations that have been transferred to trust banks. Another financial institution may act as an intermediary because of the illiquidity of the obligations that are being transferred. These certificates are considered securities under the Securities and Exchange Law.</td></tr>
<tr><td>Use of both collateralized loan obligations and trust certificates with special-purpose companies</td><td>Securitized products backed by loan obligations (and trust beneficiary certificates derived from these) that have been transferred to special-purpose companies.</td></tr>
<tr><td>Loan participations</td><td>A way of participating in the distribution of claims on the principal and interest from loans without transferring the original contract. The participants share the risks of both the original creditors and the original debtors. Introduced in June 1995, but only for loan obligations held by banks.</td></tr>
<tr><td>Privately negotiated loan assignments (bulk sales)</td><td>Loan obligations are transferred in their original form by private negotiation without the use of either special-purpose companies or trust certificates. The term "bulk sale" indicates that the obligations are collected and sold as a package because of the difficulty of valuing them separately.</td></tr>
<tr><td>Other nominative claims</td><td>Local public entity loan obligations</td><td>Securities backed by claims (including ones with different conditions) on loans to local public entities and public corporations that are held by banks and pooled in minimum amounts. These securities are then transferred by private negotiation.</td></tr>
<tr><td>Other real assets</td><td>Leveraged leases, etc.</td><td>Equity interests in secret partnerships formed by investors who buy aircraft in order to enjoy the tax advantages of depreciation.</td></tr>
</table>

Source: NRI.

2. Ways of Trading Syndicated Loans

There is nothing new about the idea of transferring loans. In principle, Japan's civil law allows the transfer of nominative claims (i.e., claims payable to specific persons), including loans, and frequent use has been made of this in recent years—e.g., to create securitized products, to sell non-performing loans in bulk and to sell the assets of failed financial institutions.

1) Transferring original loan contracts

(1) Civil law definition of "loan assignment"

Under Japanese civil law all that is required for a loan to be assigned (i.e., transferred) is that the assignor and assignee agree—the consent of the debtor is not required. In addition, notification by the assignor or the consent of the debtor is required if the assignor is to be able to defend a claim that the transfer is a true sale against a counterclaim by the debtor (Civil Code, Article 467.1). Moreover, this notification or consent must be in the form of an officially dated document if the assignor is to be able to defend such a claim against a counterclaim by a third party (Civil Code, Article 467.2). However, if a debtor does not give his unreserved consent when he receives notification of transfer, he is entitled to maintain any claim against the assignee that he would have been able to make against the assignor. This is on the grounds that they (the assignee and assignor) are in a similar position (i.e., as creditor) vis-à-vis himself.

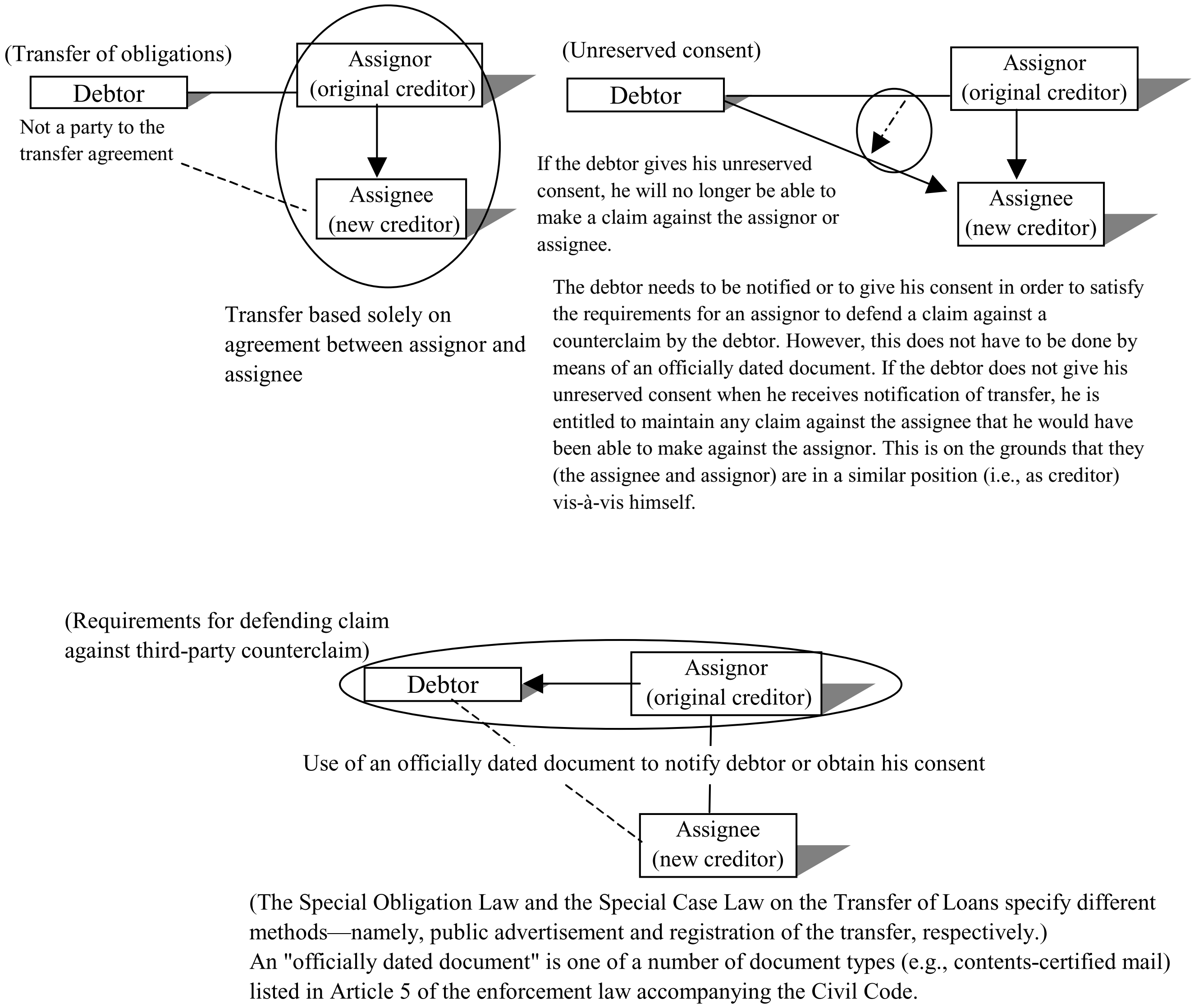
(2) Simplifying the requirements for defending a claim

The civil law requirements for defending a claim can lead to considerable complications when the aim is to transfer collective obligations with multiple debtors—e.g., in order to securitize them. This is because it is only possible to satisfy these requirements if all the debtors are notified individually. This is why the Special Obligation Law of 1993 and the Special Case Law on the Transfer of Loans of 1998 sought to simplify these requirements.

Although the Special Obligation Law applied only to lease assets and credit assets, it does make it easier to securitize obligations and to satisfy the Civil Code's requirements for defending a claim. It also enables an assignor to satisfy the requirements of Article 467 of the Civil Code by allowing him to "notify" debtors by public advertisement instead of having to notify them individually by means of an officially dated document.

The Special Case Law on the Transfer of Loans distinguishes between the requirements for defending a claim against third parties and those for defending a claim against debtors. It is no longer necessary to notify or obtain the consent of a debtor in order to be able to defend a claim that the transfer is a true sale against a counterclaim by a third party. All that is required is that the assignor and assignee register a new loan transfer. Similarly, the requirement that a debtor be notified or give his consent is deemed to have been satisfied if either the assignor or the assignee notifies the debtor by sending him a certified copy of the new registration.

Figure 1 Transfer of Loan Obligations under Japanese Civil Law



Source: NRI.

2) Loan participations

One way to overcome the difficulty of satisfying the requirements for defending claims against third parties, which are the biggest obstacles to effecting a sale of a loan, is loan participations, which have been permitted in Japan since June 1995, although only for bank loan obligations.

Under a loan participation agreement the participants acquire the right to receive payments of principal and interest without amending the original contract between the financial institution and the debtor. A loan participation is regarded as a bilateral agreement between the financial institution and the participant that does not affect the original loan obligation. Nor does it create any creditor-debtor relationship between the original debtor and the participant. Therefore, unlike a true sale, the problem of having to satisfy the requirement for notifying or obtaining the consent of a debtor does not arise.

Under a loan participation agreement a participant also incurs the risk that both the debtor and the original creditor (i.e., the financial institution) may default. Therefore, if the debtor defaults, a participant will not only not receive payments of principal and interest as scheduled—the only way he can try to preserve his assets is via the original creditor (i.e., the financial institution). Similarly, if the original creditor defaults, the fact that it has not satisfied the requirements for defending a claim against either the original debtor or third parties means that a participant will be unable to demand payment directly from the original debtor or enforce the rights that he should have acquired vis-à-vis the financial institution's other creditors under the loan participation agreement.

Finally, although loan participations are not the same thing as a true sale, the Japanese Institute of Certified Public Accountants allows the original creditors (i.e., financial institutions) to deal with them off their balance sheets.

3) Special-purpose companies and trusts

Another well-known way of dealing with loans is for financial institutions to entrust or transfer them to trust banks or special-purpose companies, which then use them to collateralize beneficiary certificates, commercial paper and bonds which they then sell to investors.

In such cases, the requirements for defending a claim that the transfer is a true sale against a counterclaim by a third party are satisfied so that the assignee can defend any such claim if the original creditor (i.e., financial institution) defaults.

As the credit rating of securitized products depends on how reliable payments of principal and interest on the loans that form their collateral are, it is standard practice to enhance their credit rating by giving them a senior-subordinate structure or a third-party guarantee in order to minimize the risks of such products to investors.

4) Syndicated loans

One type of loan transaction included in the category of transfers of original loan agreements but differing from normal loans in that they are created in order to be sold is syndicated loans. With such a loan a single agreement applies to all the financial institutions belonging to the syndicate, which is coordinated by a managing bank.

For a number of reasons, including the fact that the problem surrounding fees for commitment lines (i.e., lines of credit that a borrower can draw on up to an agreed amount during a certain period) has now been resolved,[2] demand for syndicated loans has risen—from only ¥1 trillion in fiscal 1998 to ¥13 trillion in fiscal 2000.[3]

Syndicated loans save companies the cost of spending time and effort negotiating with multiple financial institutions by enabling them to conduct all their negotiations with the managing bank. Similarly, financial institutions gain the opportunity to lend to companies in geographical areas and business sectors where they have not done any business before.

Syndication is now also used not only with corporate borrowers but also for non-recourse loans collateralized by real estate and for limited recourse loans to special-purpose companies set up for the purpose of project finance.

The banks that underwrite a syndicated loan normally sell their commitments straight away, so the development of a secondary market for such loans is important.

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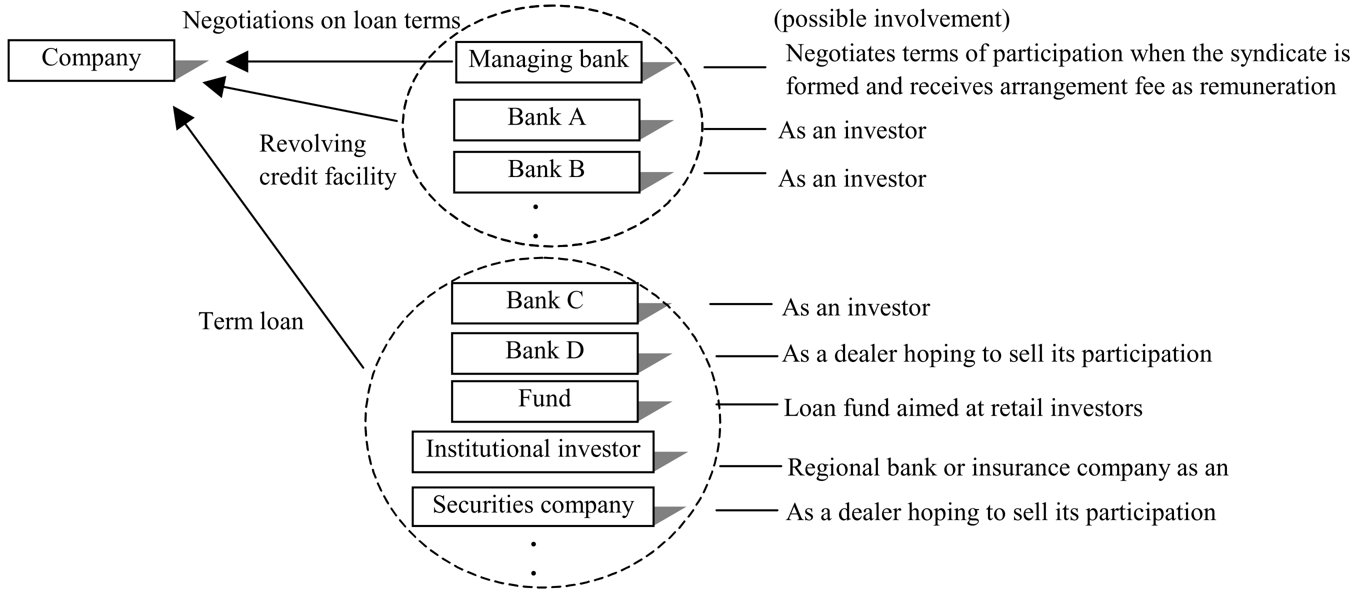
2 Law Governing Commitment Lines. The problem was that commitment fees risked being seen as equivalent to interest and therefore subject to upper limits under Japanese law.

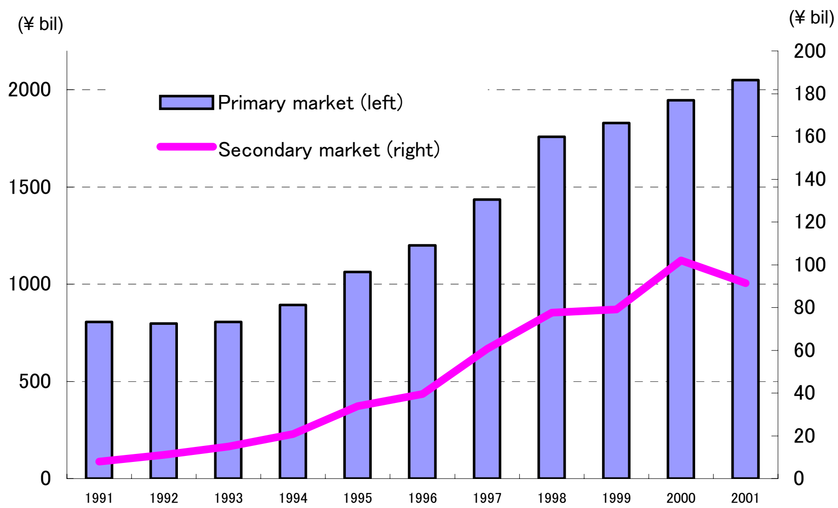
3 See Retingu Joho [Rating News], Rating and Investment Information, Inc., October 2001.

Figure 2 Hypothetical Examples of Syndicated Loans



Source: NRI

Figure 3 Size of Primary and Secondary Markets in Syndicated Loans in the US



Note: The figure for 2001 is for the first two quarters only.
Source: NRI, from Federal Reserve and Loan Pricing Corporation data.

3. Standardization

As part of the move to develop a secondary market in syndicated loans, loan documents (and especially agreements) are increasingly being standardized. We shall now look at this and its effects in more detail.

1) Japan Syndicated Loan Association

Most loans other than syndicated loans have traditionally not been intended for sale at some point in the future. The complicated contractual rights of the parties involved and the fact that each financial institution tends to use its own agreement documentation[4] have become major obstacles to attempts to streamline their transfer.

The Japan Syndicated Loan Association (JSLA), with 32 member financial institutions from Japan and overseas, was established on 1 January 2001. Its main aims are to put loan syndication on a par with the primary market in corporate bonds and to standardize the agreements used when loans are transferred on the secondary market.[5]

Following the publication in June 2001 by the Association's Secondary Market Committee of model agreement documents for the transfer of loan obligations (consisting of a general agreement and individual agreements plus commentary), its Loan Syndication Committee is planning to publish similar model agreement documents for syndicated loans.[6]

2) General and individual agreements for the transfer of loan obligations

These agreement documents for the transfer of nominative claims consist of a general agreement document and two individual agreement documents. Although use of these documents is voluntary, the Association hopes that they will become the industry standard.

(1) Envisaged scope

These model agreement documents are meant to cover the following cases: (1) loans which are solely owned by the assignor and which he intends to transfer intact; (2) loans where all the parties to the transfer (i.e., the original debtor, the assignor and the assignee) are incorporated and resident in Japan; (3) loans governed by Japanese law; (4) loans other than non-recourse and other special types; (5) loans which, if collateralized, are collateralized by Japanese assets and, if guaranteed, are covered by a

4 Also, the Japanese Bankers Association's model bank transaction agreement documents were discontinued in April 2000.

5 As well as a Loan Syndication Committee (responsible for drafting model loan syndication agreement documents) and a Secondary Market Committee (responsible for drafting model agreement documents for the transfer of loan obligations) JSLA has a Transaction Information Committee (responsible for public relations).

6 These include model agreement documents for revolving credit facilities that will probably be published soon and similar documents for term loans.

guarantee governed by Japanese law; and (6) performing loans.[7] Otherwise, as the Association has pointed out, the model agreement documents need to be amended accordingly.

(2) General agreement

This is a contract signed by the parties to a loan transfer before the transfer takes place. It specifies various general aspects of the transfer (e.g., how the costs are to be apportioned); but, most importantly, it defines the extent to which the assignor must disclose information to the assignee.

The assignor is not obliged to reveal to the assignee any information he possesses about the creditworthiness of the debtor or any similar information. All he is obliged to declare is that a number of items concerning the original contract are true (e.g., that he is not selling something which does not belong to him and that nothing is missing). However, as far as anything else is concerned, he is not required to disclose any information he has about the original debtor's creditworthiness other than (where applicable) that he (i.e., the debtor) has defaulted or been declared bankrupt.[8]

The assignee therefore needs to carry out his own analysis—both of the debtor's creditworthiness according to the principle of *caveat emptor* and in order to manage the obligations.

The reason for limiting the disclosure requirement in this way is that the need for financial institutions to maintain customer (i.e., debtor) confidentiality is counterbalanced by the fact that disclosing such information can be regarded as an inevitable concomitant of the fact that loan transfers are permitted under Japanese civil law. The fact that only financial institutions may be parties to such agreements may also be designed to ensure that customer confidentiality does not lead to a situation where information among the parties is compartmentalized—since, as credit professionals, they ought to be able to overcome such difficulties.

However, because the failure by an assignor to disclose important information about a debtor's creditworthiness poses the risk to any loan transfer of error, fraud or illegal conduct as defined by the Civil Code, the commentary accompanying the model agreement documents recommends that assignors disclose to assignees at least the same key information that insiders to a corporate bond transaction are required to disclose under Article 166 of the Securities and Exchange Law.

7 Defined by JSLA as "loans which have been properly serviced during the period required."
8 Article 5.2.11 of the general agreement.

(3) Individual agreements

There are two versions of an individual agreement document—an "unreserved consent version" and a "standard version."

The former is used only when a debtor gives his unreserved consent to the transfer of a loan and the assignee is entitled to take direct action to recover his claim once the transfer has been completed.

The latter version is used when an assignor is unable to transfer all his rights to an assignee (e.g., if the assignee is unable to satisfy the requirements for defending a claim against the debtor or if the assignor, as the original creditor, intends to recover his claim himself [9]).

(4) Treatment of non-performing loans

Although the Association produced its model agreement documents for the transfer of performing loans, it has allowed for their use with non-performing loans by proposing some amendments to their terms.

However, any attempt to standardize agreements for the transfer of non-performing loans is likely to be fraught with difficulty. One example is that the use of the standard version of the individual agreements could infringe the Attorneys-at-Law Act if an assignor who was also the original creditor accepted responsibility for recovering a claim on behalf of the assignee. In other words, some authorities believe that, if an assignor acted on an assignee's behalf in trying to force a debtor to repay a loan or in foreclosing on his collateral, he might be infringing a key element of Article 72[10] of the Act (namely, the section on "undertaking legal work in relation to litigation"[11]), and agreement on the matter has still to be reached. In addition, there are some who believe strongly that the fact that non-performing loans are diverse and debtors' rights intricately interconnected means that standardized agreements are totally unsuitable.

9 The standard version states that, in the event of default, the financial institution that is the original assignor is not required to recover the obligation and is relieved of any risk attached to it.

10 "Someone who is not an attorney-at-law is not permitted to undertake any legal work such as acting as an advisor, agent, arbitrator or conciliator (or to act as an agent for someone who undertakes such work) in relation to any case (whether or not in litigation) or any appeal (such as a request for review, a formal objection or a request for a second review) to a branch of government or in relation to any other general litigation."

11 "Litigation" refers to any legal dispute or obligation concerning rights and obligations, or any case where new rights and obligations arise.

(5) Collateral

Because the conditions governing the collateral and guarantees for loan transfers are so diverse and therefore still difficult to standardize, Article 3.3 of the Association's general agreement document simply says that "procedures for transferring rights pertaining to original loan obligations and procedures for satisfying requirements vis-à-vis debtors and third parties (including those pertaining to transfer of registration) will be specified in the loan transfer agreement," leaving it to the parties concerned to decide the terms.[12]

Another outstanding issue is the absence of a standard approach to valuing loan collateral, and this has been identified as an obstacle to market growth.

3. Issues and Prospects

Although the Association's efforts to standardize loan transfer agreements are worthwhile, many issues in trying to set up and expand a secondary market in loan obligations remain unresolved, and existing loan agreements are unlikely to be affected very much. The following are some of the many difficulties facing buyers and sellers of existing loans.

1) Difficulties facing buyers and sellers[13]

Although, in the future, loan agreements may contain covenants governing the future sale of such loans, buyers and sellers of existing loans are likely to face the following difficulties.

(1) Difficulties facing debtors

Although debtors are not directly involved in loan transfers, claims against them cannot be fully enforced unless they give their unreserved consent.

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12 However, the commentary does point out, for example, that revolving guarantees and collateral (in contrast to normal loan guarantees and collateral) are not, as a rule, transferable.

13 See Masayuki Yoshida, Joto o Zentei to Shita Kashitsuke Keiyaku o Sakusei Suru Koto de Oku no Hoteki Mondai wa Kaiketsu Dekiru [Loan Transfer as a Basis for Solving Many Legal Problems Related to Loan Agreements], Kin'yu Zaisei Jijo [Financial and Fiscal Matters], 3 September 2001.

However, in Japan, any sale of bank loans tends to be seen as a symptom of credit risk. Many Japanese borrowers appear to be concerned that doubts could be cast on their creditworthiness if it became public knowledge (e.g., as a result of changes in the amounts of the loans that they have with each of their banks—information which they are required to submit to any bank with which they do business) that a bank had transferred any loan in which they were the debtor.[14] For this and other reasons (e.g., the fact that debtors will no longer be able to have transactions settled by the bank that used to own the loan; the fact that every time a loan is transferred debtors will have to suffer the inconvenience of having yet another unfamiliar creditor try to make good its claim for repayment; and the fact that debtors may want to maintain a situation where they can offset any borrowings against deposits with the same bank), debtors are unlikely to give their consent.

(2) Difficulties arising from general conditions attached to bank transaction agreements

Existing loans are governed by the general conditions attached to bank transaction agreements. However, there is no consensus on exactly how these conditions would apply to the transfer of a loan whose sale had not been envisaged when the original agreement was signed.

For example, if these conditions do apply, there is the question whether a lender's right to require a borrower to provide more collateral or to change the rate of interest on a loan (normal conditions attached to bank transaction agreements) would be transferred to a new creditor as a result of a market purchase. If they do not apply, there is the question whether the loss by a debtor of any benefits of acceleration would be subject solely to the provisions (Article 137) of the Civil Code or whether the loss of any such benefits would be invalid if it was not stated in the Civil Code (as would be the case where trading in a bill drawn on a debtor was suspended).

2) Impact of the creation of a secondary loan market

Although it remains to be seen whether Japan's syndicated loan market will develop on the same scale as that in the United States, the fact that the outstanding amount of syndicated loans in Japan in fiscal 2000 was only ¥13 million would suggest that there was ample scope for expansion.

If loan agreements can be standardized and if a proper secondary market in syndicated loans develops, the impact on Japan's capital markets is likely to be considerable.

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14 It has been pointed out that a similar risk is posed by receivables-backed financing by small and medium-sized companies.

(1) Emergence of new financial products to bridge the gap between bonds and loans

The institution that proposes a financing scheme and the one that ultimately provides the capital are usually one and the same. However, in the case of loans (such as syndicated loans) that are intended to be sold, the institution that arranges for the capital to be provided does not ultimately have to provide it itself. In this respect, loan syndication is similar to corporate bond underwriting, and syndicated loans have the potential to create a new type of finance between bonds and loans in a market dominated by indirect finance.

In this regard and given the current situation in Japan, the Association may have had no alternative but to restrict participation in the secondary loan market to professionals (i.e., financial institutions). By doing so, however, it runs the risk of also reducing the importance of standardizing loans. If the secondary market is to grow and if loans are to become more liquid, ways will eventually have to be found to attract a wide range of investors besides financial institutions.

(2) Institutional arrangements

In the United States during the 1990s, institutional investors (such as mutual funds and insurance companies) and investment banks used the know-how they had acquired in the high-yield bond market when they first entered the loan market. Today, when some 50% of leveraged loans[15] is owned by institutional investors, the US loan market is no longer simply an interbank market.

Therefore, although participation in the Japanese syndicated loan market (as envisaged by JSLA) is limited to financial institutions, the following arrangements (based on what happens in the corporate bond market) may be necessary in order to attract institutional investors into the loan market.

(i) Credit ratings

Under JSLA's general agreement, original creditors are not required to disclose any credit information to assignees (i.e., investors) when they transfer ownership of a loan obligation to them. However, investors who are not financial institutions are not in a position to gather information and carry out checks on their own to help them decide whether to buy or sell a loan obligation or manage credit risk afterwards. Even financial institutions capable of carrying out their own credit checks will not find this easy if they

15 The Loan Pricing Corporation defines "leveraged loans" as loans (1) where the company's senior debt rating is BB+/Ba1 or below and the spread on all facilities of the deal is at least L+150 bps or (2) where the deal is unrated and the minimum spread for the deal is L+150 or higher.

have not had any dealings with the debtor concerned. This will severely impair their ability to make a quick decision on any loan transaction and increase their costs. One solution to this problem and also a prerequisite to increasing the number of participants in a secondary loan market would be to encourage the use of credit ratings similar to their use in the corporate bond market. Although it is still quite rare for such ratings to be published, a number of Japanese credit-rating agencies have already produced them for syndicated loans, and it is to be hoped that this will be extended to a wider range of loans.

(ii) Benchmarks

When institutions begin to play a more active role as loan investors, the issue of a benchmark is likely to arise. In the United States, banks have traditionally calculated their own indices and published them for the benefit of institutional investors.[16] In October 2001, however, Standard & Poor's and the Loan Syndications and Trading Association (LSTA)[17] in conjunction with seven institutions began to publish a leveraged loan index once a week. It covers about 75% of the leveraged loans held by institutional investors and is the first loan benchmark to be produced independently. Hopefully, it will gain wide acceptance.

(iii) Online data

If more investors are to be attracted to the loan market, they will need to have ready access (especially on line) to price and product data on particular loans—preferably from a neutral third party. In the United States, the Loan Pricing Corporation (a subsidiary of Reuters) provides such a service, which also enables users to create a database of their own trades and do calculations on line. Hopefully, those involved in developing a secondary loan market in Japan will draw on US experience in this area.

3) New role for financial institutions

Companies wishing to raise capital are making increased use of syndicated loans for a number of reasons, including (1) the fact that they allow rapid access to large amounts of long-term capital, (2) the fact that their standardized conditions increase efficiency, (3) the fact that they enable companies to do business with new partners without having to spend time and effort on explaining their business plans, and (4) the fact that they are also a good way of deciding short-term commitment lines.

16 See Yuko Numata and Yukihiko Endo, Beigin no Kigyomuke Yushi Gyomu no Hen'yo [The Changing Pattern of Corporate Bank Loans in the United States], Zaikai Kansoku [Financial World Observations], February 1998.

17 A non-profit organization established in 1995 by loan brokers to ensure that trading in loans is fair and efficient.

Also, as the market expands and an increasing number of syndicated loans are done on an underwritten basis (where the managing bank takes responsibility for the full amount) as well as on a best-effort basis (where the banks participating can increase their commitments), it will become increasingly important for banks to be able to sell the loans they underwrite.

With an eye to the future, banks that want to arrange a large number of syndicated loans may therefore have to develop their contacts with investors other than financial institutions and familiarize themselves with their needs as well as set up systems for managing and hedging loans separately according to whether they are acquired for their own account or for sale to customers.

Meanwhile, securities companies that want to sell loans to a large number of investors will have to either offer their own loans or build up an inventory of loans for sale (e.g., by purchasing loans in the market). Moreover, the fact that securities companies have less experience of the loan business than banks means that they will have to incur costs and spend time establishing the infrastructure and training staff in order to underwrite loans in the primary market and trade them in the secondary market.

However, it is doubtful whether the syndicated loan business *per se* will prove profitable. Furthermore, building up an inventory of loans will increase the credit risk of a securities company's balance sheet, possibly even threatening its credit rating. However, financial institutions (including securities companies) may find that the loan business and the infrastructure needed to be a player in the loan market eventually become so taken for granted that not to be a player proves a serious handicap to any corporate finance department trying to persuade a customer to finance.

4. Conclusion

Loans have a number of advantages over corporate bonds (e.g., the fact that they are exempt from the accounting requirements that apply to financial products and do not have to be valued at market and the fact that the covenants on their collateral make them more secure), and many investors may come to regard them as a new financial product on a par with securities such as corporate bonds.

At the same time, the fact that there is very little demand for the kind of loans (namely, Category III ("recovery doubtful") and Category IV ("irrecoverable") loans) that banks are so eager to dispose of whereas there is very little supply of the kind of investment-grade loans that regional banks and other institutions with surplus funds are eager to purchase means that there is a mismatch between demand and supply.

One of the long-term challenges facing Japan's capital markets—both in order to correct the bias towards indirect finance and to deal with the banks' non-performing loans—is to establish systems that will enable the secondary loan market to appeal to a wider range of investors.