The Growth of Loan Syndication in Japan

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Japanese corporate finance has traditionally been dominated by bilateral bank lending (i.e., intermediation) and by the corporate bond market (capital market). In recent years, however, a growing number of companies have raised capital in the form of marketable loans. (i.e., market type intermediation)

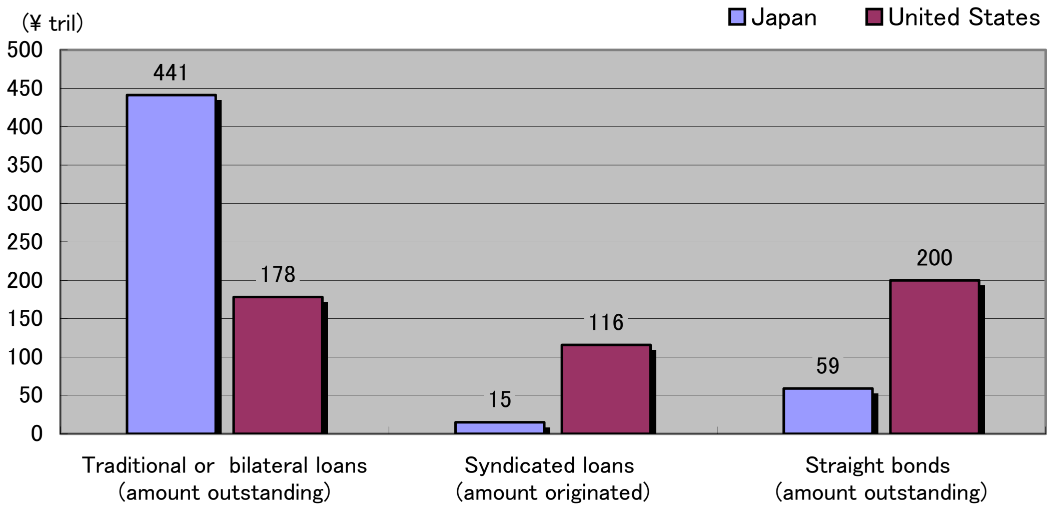
This report deals mainly with syndicated loans and explains their characteristics and advantages. In addition, it describes the work of the Japan Syndicated Loan Association (JSLA) to promote market-type intermediation by establishing a secondary market in syndicated loans and the challenges facing corporate finance in Japan.

1. The Japanese Financial System

For many years the Japanese financial system relied mainly on the banking system (intermediation), while the country's securities markets (disintermediation) played a relatively limited role. The exhibit below compares how US and Japanese companies obtained external funds for their businesses in 2002. It shows clearly how Japanese companies still tend to rely on traditional or bilateral loans from a particular bank. In fact, although an increasing number of companies are raising capital on the corporate bond market, this accounts for only 8.8% of the external funds obtained by large companies.

This excessive reliance on traditional or bilateral loans has created a situation where all the risk is borne by the banking system, and it is this that has prevented the Japanese financial system from functioning properly when, in fact, a sophisticated financial system requires that risk should be borne evenly by society as a whole.

Figure 1 Sources of Capital in Japan and the United States



Note: As of end-2002. US figures have been converted at a rate of $1 = ¥120.
Source: NRI, from various sources.

For many years, however, the Japanese banking system enabled Japanese companies to obtain inexpensive funds more or less whenever they needed them without having to use the country's securities markets: all they had to do was approach their main bank and they would be presented with a range of options to suit the purpose, timing, amount and duration of the loan. So long as the economy continued to follow an upward-sloping growth pattern, this system worked well enough. When the property and stock market boom of the 1980s turned to bust in the 1990s, however, the value of the collateral the banks were holding against their loans declined as did corporate profits, leaving the banks with large amounts of non-performing loans. Since then and in the absence of radical reform, the banks have gone from one crisis to the next.

Banks traditionally finance their loans from deposits which they guarantee to repay in full. However, if any of their loans cease to perform, they may not be able to recover their full value. In exchange for assuming this risk, banks charge borrowers a higher rate of interest than they pay their depositors, and it is this differential that forms the basis of their revenues. When the value of the collateral Japanese banks held against their loans declined along with the earnings of their corporate clients, their ability to assume this risk was impaired. The banks were therefore forced to write down their losses on these loans and to recapitalize.

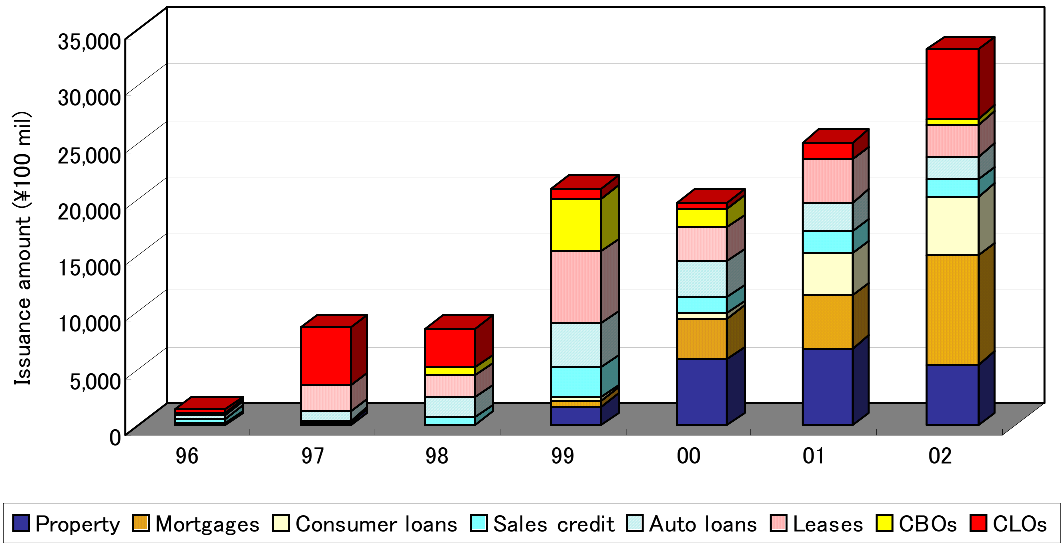
This means that the Japanese financial system as a whole must be able to assume this risk by relying less on the banking system and more on the market and by spreading credit risk (e.g., by means of securitization) rather than concentrating it. However, in Japan's case, it should be noted that that this transition cannot take place overnight: mainly because the companies that would be the end users would encounter major difficulties in accessing the market and because there are not yet enough investors capable of assuming the considerable risks that would be involved. What is needed is a financial system that strikes a balance between intermediation and disintermediation and includes loan syndication as an intermediate stage between the two.

2. Main Techniques for Sharing Credit Risk

Advances in financial technology have produced many risk sharing techniques that would enable the financial system as a whole to assume this burden, and many financial institutions are busy trying to persuade corporate clients to adopt them.

Risk sharing techniques would benefit financial institutions by enabling them (1) to actively control their credit risk, (2) to reduce their risk assets and improve their capital adequacy ratio, and (3) to change their business model by developing new "asset-turnover" businesses and diversifying their revenue base by means of increased fee income. Adopting such techniques might also alleviate the current situation where roughly half of Japanese bank lending is concentrated in Tokyo and three of the adjoining prefectures (Saitama, Chiba and Kanagawa).

Figure 2 Issuance of Asset-Backed Securities



Note: CBOs and CLOs do not include super-senior portions.
Source: NRI, from data compiled by Nomura Securities.

They would also benefit companies by making it easier for them to obtain funds (namely, by using collective investment schemes such as collateralized loan and collateralized bond obligations). Also, instruments such as asset-backed securities and asset-backed commercial paper would enable companies with restricted access to this type of finance to gain greater access by using assets such as receivables.

Finally, investors would benefit from a greater choice of credit risk products than simply corporate bonds.

3. Reasons for the Growth in Loan Syndication

The Japanese loan syndication market, which in 1997 was virtually non-existent, has enjoyed rapid growth during the past few years, and there was nearly ¥15 trillion in loans outstanding in 2003. The use of syndicated loans in Europe and the United States became increasingly widespread in the late 1960s and early 1970s, and is now well established. This section considers why such a technique should have enjoyed such rapid growth in Japan in the past few years.

One reason is the emergence of commitment line agreements. Such agreements give a borrower access to funds up to a certain maximum amount for a certain period in exchange for payment of a fee and require the lender to make those funds available.

In the past, when fees were regarded as "deemed interest," there was a risk that the fees on a small loan could breach the permitted maximum rate of interest. However, in November 1998, when the Financial Law Board debated the legality of commitment fees, the general view was that commitment line agreements were a good idea. It was therefore decided that commitment fees and facility fees should be governed by a new law (the Law Concerning Commitment Line Agreements) and therefore exempted from the Capital Subscription Law's provisions on deemed interest. As a result, demand for commitment line-type syndicated loans has increased—not only from large companies but also smaller ones.

Another reason for the growing demand for syndicated loans is some of the changes that have taken place in relations between companies and their banks. The period when syndicated loans came into their own in Japan (1997-1998) was also the period when the Japanese financial system was seen as under threat. As has already been observed, the Japanese financial system has traditionally relied heavily on bilateral banking relationships (the so-called "main bank" system). Such was the clout of the larger banks vis-à-vis their corporate clients that the non-main banks felt obliged to observe the established pecking order in their dealings with them. For their part, companies felt that they could rely on the status quo (i.e., the main bank system) to keep them in funds should unforeseen circumstances befall them. However, as concern about the financial system grew, so did the number of companies worried that their main bank might desert them in their hour of need and ready to accept offers from overseas banks with a long track record in Europe and the United States in spite of the fact that they were relative newcomers in Japan.

4. Syndicated Loans and Their Advantages

A syndicated loan is a loan arranged by a lead manager (or "arranger") with a group of banks (or "syndicate") that agree to a common set of conditions and sign a single loan agreement document. The main advantage to the banks is that this enables them to assume credit risks that would have been unacceptable if they had not been spread.

The main advantage to companies of this method is that they can negotiate large loans with the arranger, who coordinates the syndicate members and standardizes the terms.

In Japan companies have traditionally borrowed from their main bank, with which they negotiate the basic terms of any loan such as the rate of interest and period, while any banks further down the pecking order lending money for the same purpose but within their permitted share negotiate their own terms. Although the same Japanese term is used to refer to both this type of arrangement and syndicated loans, the two should not be confused. Syndicated loans are different, for example, in that syndicate members need to agree on the detailed terms of a loan in order to sign a single loan agreement and in that they cannot act independently if the borrower defaults.

With Japan's main bank system waning, the demand from both borrowers and lenders for syndicated loans has risen sharply as a result of their advantages: the fact that they enable lenders to spread their credit risk and borrowers to borrow large amounts of money on the same terms with the flexibility and ease of a commitment line.

5. Origination and Recent Trends

A search of the Japanese press for articles on syndicated loans during the last six months shows that they have been used particularly often by drug store chains and other retailers to expand their networks. The 2000 Amendment to the Large-Scale

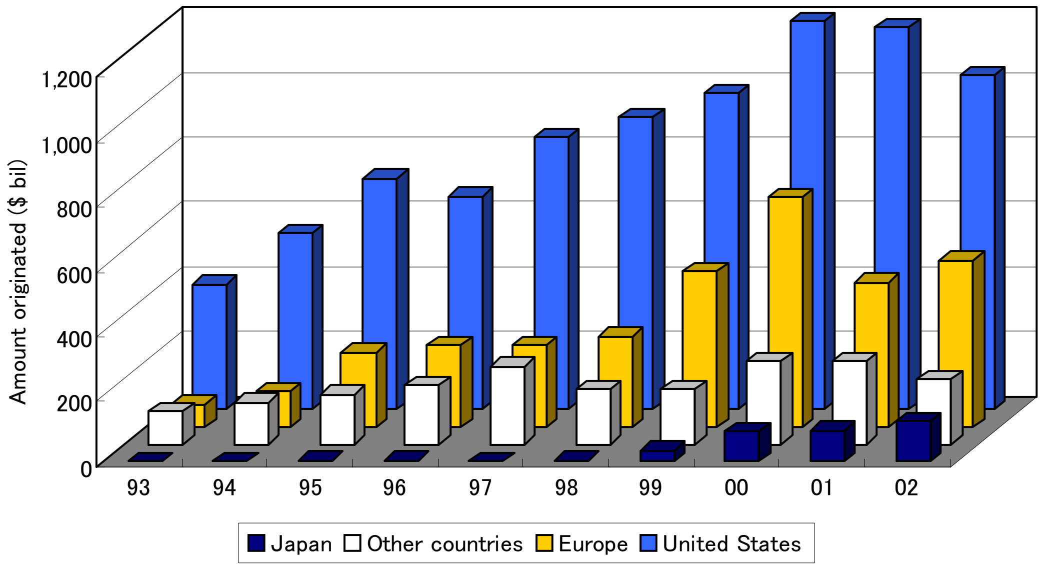
Retail Stores Law accelerated this process, and a growing number of companies are using syndicated loans as a source of capital.

Although syndicated loans entail a slight increase in the cost of company capital (our enquiries suggest by about 10-30 basis points), they offer the advantage that an arranger can save companies that are extending their retail networks the time and effort required to negotiate separately with all the banks involved.

In some cases, syndicated loans can give companies an opportunity to find out more from syndicate members about a local area. This can even be an opportunity for a borrower to hold a meeting to inform syndicate members about itself in the same way as companies hold investor relations(IR) meetings to inform their shareholders (or investors in general).

Since 1997 the demand for syndicated loans in Japan has increased dramatically and is likely to reach ¥50 trillion, judging by the size of the markets in the United States (some ¥110 trillion) and Europe (some ¥45 trillion).

Figure 3 Global Origination of Syndicated Loans



Source: IFR Database.

Since December 2003 the Bank of Japan has published figures for the amount of syndicated loans originated as an indication of the volume of loan activity. In July-September 2003 613 loans worth ¥4,605.7 billion were originated—an increase on the previous quarter (April-June 2003) of 250% in terms of number and 40% in terms of value.

Of these, most commitment line-type loans were made to listed companies (177 compared with 57 to unlisted companies) while most term loans were made to unlisted companies (227 compared with 152 to listed companies).

Not just anyone can arrange a syndicated loan. Although the market has tended to be dominated by either overseas banks or the big domestic banks, there has recently been an upsurge in activity by regional and shinkin banks that have acquired the necessary expertise, and this has contributed to the rapid growth in the size of the market.[1]

6. Secondary Loan Market

An active secondary loan market is a *sine qua non* if loan syndication and other forms of market-type intermediation in Japan are to thrive. Such a market would reduce lenders' liquidity costs and, as a result, borrowers' cost of capital.

In the United States the secondary loan market is now just over one tenth the size of actual loan originations and serves to redistribute a wide variety of risks. Also important, however, is the existence of the Loan Syndications and Trading Association (LSTA), which helps to increase the efficiency and liquidity of secondary market trading. There are standard formats for loan agreements, standard trading rules and rules of conduct for market participants. In addition, the Loan Pricing Corporation (LPC) publishes bid-and-offer indications and the details of nearly 1,800 loans provided by market participants as well as the "Gold Sheet" with details of loan terms and borrower ratings.

In January 2001 a similar organization, the Japan Syndicated Loan Association (JSLA), was established in Japan with just over 70 members (mainly financial institutions and institutional investors) in order to ensure the proper development of both the primary and a secondary loan market by providing standard formats for loan

1 As of end-November 2003, there was ¥17.5 trillion outstanding in commitment line-type loans, ¥2 trillion of which had been drawn down. (In the Bank of Japan's statistics the figure for commitment line-type loans includes those counted as syndicated loans.)

agreements and rules of conduct for market participants. As interest rates rise and originations increase, trading activity should pick up.

7. Requirements for Market Growth

There are two main requirements if the market in syndicated loans is to grow. First, borrowers need to be persuaded to allow lenders to transfer loans. Generally speaking, Japanese borrowers used to be reluctant to allow lenders to transfer loans because this meant (1) that they were no longer able to offset borrowings against deposits and (2) that information (especially, financial information) about the borrower would be divulged to a number of banks.

According to the findings of a survey carried out by JSLA in February 2003, however, nearly 80% of Japanese companies now either welcome or no longer object to the transfer of loans, indicating that there has been a change of attitude.

Second, borrowers need to be persuaded to divulge information about themselves to any financial institutions or institutional investors willing to purchase loans that have been made to them. As well as drawing up standard loan agreement documents, JSLA is trying to standardize the information exchanged when loans are transferred. Hopefully, information technology will enable banks to exchange more information about borrowers.

At the same time, banks need to promote these schemes more actively to potential borrowers (especially, small and medium-sized businesses) and explain the function of a secondary loan market and the need to spread credit risk.

Also, while local banks need to devote more resources to "relationship banking", they would also do well to devote more resources to loan syndication as a new means of making capital more easily available to small and medium-sized businesses. Nor should the use of syndicated loans be confined to businesses. Just as the use of bonds has been proposed as a means of providing finance to organizations in a whole host of areas, including education and healthcare, so syndicated loans can be expected to be used increasingly by universities and hospitals as a new source of finance.

Furthermore, although syndicated loans are now often used to fund local government private finance initiatives such as school rebuilding programs, they can also be expected to be used increasingly to fund local public works programs. Not only do they enable local banks to diversify their loan portfolios geographically: they also offer them the opportunity to diversify their client bases and reduce their dependency on local governments.

Syndicated loans can be offered to a wider range of borrowers and for a wider range of purposes than corporate bonds. Now that Japan's main bank system is in decline, the sources of finance available to companies have failed to keep pace with the changes in the economic environment. As a new approach to corporate finance that has enjoyed rapid growth in the past few years, loan syndication can be expected to attract growing interest.

As Japan's secondary market in syndicated loans develops and trading increases, financial institutions can be expected to participate in this market in the same way as they participate in the bond market. In the long run, this growth in market-type intermediation can be expected to change the landscape of Japanese finance and of corporate finance, in particular.