Challenges in Japanese Commercial Paper Market

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Restrictive lending policy of banks is one of the big problem today in Japan. Generally, direct financing such as securities market and money market should have substituted bank's indirect financing when the latter fails to work or decrease its importance. However, brief overview of direct financing market in Japan reveals that it is premature to successfully take over such functions. Issues of commercial paper (CP) market that represents short-term direct financing market are reviewed in the following article.

1. Commercial Paper Market in Japan: current situation and problems

1) Current Situation

Japanese Commercial Paper market was created in November 1987, and ten years have passed since then. Table 1 shows a comparison of CP between at the beginning and today. Issue terms were limited at first, as the maturity was set to be a month up to six months with a few eligible issuers. Then the system was reviewed accordingly, abolishing the minimum maturity while expanding the maximum to less than one year. Rating criteria instead of original narrow criteria was introduced to effectively increase the eligible issuers. In addition, financial companies which were prohibited to issue CP, such as securities companies, non-banks and insurance companies, became allowed to be CP issuers. The number of eligible CP issuers increased from some 170 firms at the beginning to approximately 800.

Also, stamp duty for CP issue became uniformly decreased to 5000 yen per issue since FY 1990 by special taxation measures, since it was pointed out that class-wise flat rate stamp duty, originally imposed against bills, caused higher issue cost for CP. In addition, Direct Paper, which is issued directly by companies to investors without through dealers, is introduced in FY 1998. Usage restriction for financing by CP, which is imposed on non-banks, is lifted at the same time.

Regardless of the above-mentioned deregulation process, CP market fails to expand its scale. CP outstanding balances reached 10 trillion yen in 1989, in two years from the start-up, and continued to expand up to less than 16 trillion yen in 1990. However, the balances decreased after "de-bubble period ", went sideways around 10 trillion yen these days. This contrasts significant growth of other short-term financial markets such as CD and call loan, of which balances are increased some 250% to post 37 trillion yen and more than 200% to reach 37 trillion yen or so respectively in the period from 1988 to 1997(October) (see Table 2).

Table 1. Overviews of Commercial Paper Market in Japan

	1987 (start-up)	1997 (at present)
Legal nature	Promissory note	Promissory note
Maturity	1 to 6 months	Less than one year
Interest rate	Sold at a discount	Sold at a discount
Book value	100 million yen or more	100 million yen or more
Eligible issuers	Eligible issuers of unsecured straight bond (some 170 firms). Financial companies excluded.	Similar to A-3 rating or above (some 800 firms). Securities, loan brokers, lease and consumer credit companies, and insurance companies included. (Issues for the purpose of re-invensting the proceedings to lending is prohibited
Back-up line/ guarantee	Back-up line or guarantee of financial institutions required, except the firms that meet a certain criteria (trading house, electric power etc.)	Not required when rating agency determines so.
Issuing Method	Issue via dealer (dealer paper system)	Issue via dealer (dealer paper system)
Dealer	Financial institutions, securities, call loan brokers	Financial institutions, Securities, call loan brokers
Purchaser	Institutional investors familiar with financial markets	Institutional investors familiar with financial markets
Stamp duty	Class-wise flat rate	5000 yen per issue uniformly
Securities transaction tax	Exempted	Exempted
Interest withholding tax	Exempted	Exempted

Note: Issue method limitation and usage restriction for non-bank's financing through CP will be abolished in FY 1998.
Source: Nomure Research Institute.

Table 2. Outstanding balances of short-term financial instruments

(trillion yen)

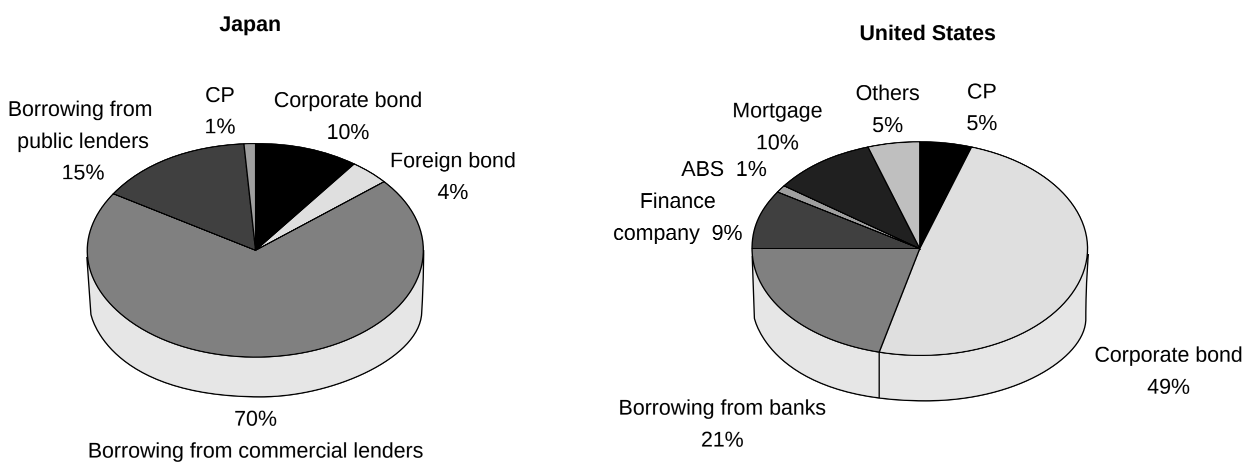
	Call loan	Bill	Bond transaction with repurchase agreement	CD	CP	FB	TB
1987	14.6	14.0	6.9	12.1	1.7	0.9	2.7
88	16.6	12.0	7.4	15.0	9.3	1.0	2.0
89	22.3	18.0	6.3	19.0	13.1	-	4.0
90	26.4	16.4	6.6	18.9	15.8	1.0	7.6
91	29.0	15.3	6.0	17.9	12.4	-	9.0
92	38.9	15.0	8.8	16.8	12.2	1.8	10.4
93	42.8	10.5	8.3	19.1	11.1	2.8	11.0
94	41.7	8.2	11.7	19.4	9.9	1.5	11.3
95	42.0	9.0	11.1	22.3	10.5	0.6	12.8
96	39.4	8.3	11.9	29.0	10.8	0.9	12.9
97	37.3	7.3	16.4	36.9	10.6	3.6	13.1

Note: Average balance is shown for call loan, bill and CD. Balance at the end of term is shown for Bond transaction with repurchase agreement, CP, FB and TB. 1997 figures shows November data for call loan and bill, September data for Bond transaction with repurchase agreement, October data for CD and CP, November data for FB and TB.
Source: Bank of Japan.

Although CP is widely used as a financing tool of companies in the United States, the birthplace of CP, Japan is not yet to see such developments. Figure below illustrates the comparison between Japan and US non-financial companies' debt financing[1]. Financing via CP occupies 5% of the total amount in the United States, while it remains as low as 1% or so in Japan. Since U.S. main issuers of CP are finance company subsidiaries, fund raising through finance companies shown in the figure below obviously includes financing through CP. Accordingly, CP plays a greater role in the United States as a vital financing tool.

Moreover, CP outstanding balance highlights that U.S. CP market is approximately ten times as large as Japanese CP market.(i.e. U.S. market with 100 trillion yen, Japanese market with some 10 trillion yen)(see Table3)

Figure 1. Debt financing of companies: balances shown by methods



Notes: U.S. corporate bond includes revenue bond.
Source : Bank of Japan, FRB.

Table 3. Comparison between Japan and US CP markets (outstanding balance)

(trillion yen)

	Japan	United States
1987	1.7	51.9
88	9.3	58.8
89	13.1	72.5
90	15.8	81.5
91	12.4	71.2
92	12.2	69.1
93	11.1	61.7
94	9.9	60.9
95	10.5	63.5
96	10.8	84.3
97	10.6	109.2

Note: Used average exchange rate of the year.
Source: Bank of Japan, FRB.

1 Financing through securities issues, and borrowings except inter enterprise credit.

2) Problems

Then what are the reasons for sluggish growth of CP market in Japan?

When one may ask CP issuer companies why you don't make use of CP market more, many answer that "we would like to, however we are lacking in investors purchasing our CP ". On the other hand, when one may ask investors why you don't buy more CP, some may answer " we wouldn't like to buy them for the fear of liquidity risk caused by too small volume ", others may answer "the risks are not justified by the returns ".

These answers suggests that main reasons for sluggish growth of CP market is parallel to the question of "which came first, the chicken or the egg? ". Another point of view would suggest that they were due to absence of close communication between fund raising companies and investors. Historically, all CP had to be issued through dealers in Japan. We believe that mismatching between those who are on the fund raising side and on the investing side are caused by the malfunction of dealers.

Despite of significant increase in the number of eligible firms, only limited companies such as blue chip companies could virtually to issue CP in Japan. Indeed, most CPs in Japan are ranked as supreme rating of A-1. When the banks were not yet to take restrictive lending policies that now undermine Japanese economy, banks were willing to underwrite CP in order to maintain business connections with these excellent companies, judging from the viewpoint of securing the borrowers. In fact, more than 80% of CP issues are via banks, which majority is occupied by city banks and long-term credit banks. Securities companies share remains as low as 16.7% (see Table 4).

Moreover, pricing tended to favor issuers and zero underwriting fee was not unusual, since banks were driven by non-economical incentive of retaining business connections with their clients. Consequently, interest rates of CP has become 0.05-0.1% lower than that of CD ranked at the same rating. Naturally, CP has turned into a lackluster instrument from the standpoint of investors. In turn, it was the banks that purchased the CP that had difficulty to find potential buyers. In other

Table 4. CP issues : dealer shares by category

(in %)

	Financial Institutions total							Securities Companies
		City Banks	Regional Banks	Regional Banks II	Trust Banks	Long-Term Credit Banks	Other Financial Institutions	
1988	72.4	43.0	1.5	0.1	3.5	21.0	3.3	27.6
89	75.2	53.4	1.3	0.3	3.7	14.0	2.3	24.8
90	80.9	52.5	3.0	0.3	5.6	18.3	1.1	19.1
91	81.8	46.1	4.6	0.1	2.9	27.8	0.4	18.2
92	81.7	46.6	2.8	0.2	2.9	28.5	0.7	18.3
93	79.0	49.8	2.5	0.1	3.2	21.9	1.4	21.0
94	78.7	50.8	2.3	0.1	3.4	17.5	4.7	21.3
95	82.5	53.7	1.9	0.1	3.5	16.6	6.8	17.5
96	82.4	53.0	2.3	0.0	5.1	13.3	8.5	17.6
97	83.3	52.4	2.8	0.0	5.8	8.8	13.5	16.7

Note: "Other Financial Institutions" consists of foreign bnaks, foreign bank trusts, Zenshinren Bank, Central Union of Agricultural Cooperation, Central Co-operative Bank for Commerce and Industry.
Source: Bank of Japan.

words, their behavior may be interpreted that CP was positioned as a substitute for lending. The situation is obviously depicted by share the fact that approximately 50% of CP are held by banks and other financial institutions, and less than 20% are by institutional investors including investment trusts and insurance companies (see Table 5). In short, it should be pointed out that banks have failed to fulfill their dealer function of matching the needs of investors and issuers in the CP market.

Table 5. CP holders share by category

(in %)

	Banks etc.	Trusts	Investment Trusts	Insurance Companies	Securities Companies	Bank of Japan	Business Corporations
1987	45.1	12.5	35.9	-	0.6	-	5.8
88	41.2	16.7	22.4	-	0.3	-	19.4
89	41.2	24.0	13.6	0.1	0.1	-	21.2
90	32.0	19.7	15.7	0.2	0.1	-	32.5
91	41.7	13.5	10.9	0.2	0.2	-	33.7
92	44.9	5.0	17.8	0.7	0.1	-	32.2
93	38.1	3.9	38.1	1.0	0.1	-	19.9
94	40.4	4.5	29.1	1.1	0.2	-	25.7
95	55.0	1.7	18.4	1.2	0.6	8.4	15.8
96	60.7	1.8	17.4	1.1	2.5	5.4	12.3

Source: Bank of Japan.

On the other hand, investors suggest that they are reluctant to invest in CP because CP ratings are not always fully reliable[2]. As a matter of fact, for CP issued by the companies in non-bank, real estate and construction business, institutional investors have long required a certain interest rate premium, regardless of ratings' level. Today they apply the same manner to other businesses such as trading houses, securities industry and distribution industry.

Also, we could not disregard documentation cost at CP issue. Issuers have to prepare the bills, place stamps on, and deliver them to the dealer, the financial institution. Thus the issuers must cover considerable amount of documentation cost as well as time. In addition, some issuers find it hard to issue CP, as they are located too far from the head office of dealers to implement the physical deliveries of the papers.

2 CP rating is generally called as short-term rating, that differs from long-term rating for long-term bonds and alike. For example, Moody's has four ranks of Prime-1, Prime-2, Prime-3 and Not Prime, while S&P has six ranks of A-1+, A-1, A-2, A-3, B, C and D. As the ranks are not as detailed as the same for long term bond (Moody's has 21 and S&P has 22 ranks), US issuers and investors reportedly review long term rating as well as short term at CP issues or transactions.

2. Restrictive lending policies of banks and Commercial Paper

1) Bank's intermediary function weakened

These problems of CP market were not apparent in the circumstance where banks constantly sought to increase their lending volume. In the current situation of restrictive lending policies of financial institutions, however, these problems of direct financing instruments including CP are observed in a new light, since the instruments should essentially compliment weakened indirect financing function.

It is reported that restrictive lending policies are prevailing now since financial institutions would like to shrink major source of risk asset : loans[1].The main factor behind the movement is that they are keen to meet the capital adequacy target in prior to the introduction of prompt corrective action for financial institutions, which is scheduled to be in place in FY1998. Besides, there are growing fears that the movement should be accelerated since financial institutions are highly likely to suffer from evaluation losses of share and real estate holdings due to the weakening economy.

On January 16, 1998, Bank of Japan published preliminary report for "Lending and Deposit taking movements " of financial institutions in December 1997. The report indicated that long-term credit banks and trust banks decreased their loan growth in year-on-year comparison. It is determined, however, that the decrease is not significant in view of historical trend. On the other hand, BOJ's Tankan for December 1997 implies another perspective. Companies increasingly feel that the banks are reluctant to provide loans. The situation is obviously illustrated by one of the indices in Tankan that outlines financial institution's attitude for loans (share balance of the firms that feel it "loose " and that consider it "tight "). The index for major companies considerably dropped compared with September 1997 survey, while the same for small and medium size businesses turned to be negative. Accordingly, although there are no remarkable decrease in loans in terms of the real number so far, it should be noted that financial institutions are likely to take increasingly tight stance for loans, leading to decrease their lending over the end of fiscal year.

Restrictive lending policies of banks today may be a temporary phenomenon caused by implementation of prompt corrective action coupled with stock price collapse. In reality, however, banks are required to cut their risk assets in view of future, since they need to maintain capital assets ratio or required capital adequacy figure after the implementation as well as to increase the ratio, which is comparatively low in terms of global trend[2]. The restrictive lending policies of banks are not short-lived phenomena. It looks that intermediary function of financial institution should weaken for further years hereafter. In this circumstance, direct financing function including equities market is likely to enhance so as to take a role of substitute for weaker indirect function. Indeed, this is a reason why the financial Big-Bang targets to shift the core of intermediary operation from indirect finance to direct finance.

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1 Prompt corrective action requires the banks in international operation to submit and to implement management improvement plans when they fail to meet international uniform standard of 8% capital adequacy requirements specified by Bank for International Settlement (BIS). As for the banks that exclusively deal with domestic operation, the system also requires to do the same when their capital asset ratio fails reach 4% on the basis of domestic standard. Furthermore, in the cases that the ratio turns to be less than half of the required figure, the authorities demand the bank to cut their operation. When the ratio goes under 0%, the bank will be ordered to suspend their business.

2 Capital asset ratio (Tier 1) of Japanese city bank is relatively low, as Fuji Bank hits the highest at 5% and the average is 4.6% (as of the end of September 1997). Not a few American or European banks maintain 7% or 8%. In the United States, "well capitalized bank " is defined as the bank that scores 6%, which is required when the bank is to enter the new business. Many Japanese banks regard 6% as their target for the time being

2) CP as a countermeasure to restrictive lending policies of banks

Looking at the current situation of CP market, it is clear that direct financing function could take but extremely limited part in connection with possible countermeasures to prevailing restrictive lending policies of banks. On December 24, 1997, the government released countermeasures to restrictive lending policies of banks including i) enhanced loans and guarantees of public financial institutions, ii) flexible enactment of prompt corrective action[3], iii) adopting cost basis for financial institutions to evaluate their equity holdings[4]. In addition, iv) lower risk weighting of CP held by financial institutions at calculation of net worth[5], v) purchasing CP through BOJ operations[6] were already in place, and other measures such as vi) counting unrealized profits on landholdings as part of their equity capital are also considered.

It is obvious that any of these countermeasures focus on reinforcing indirect financing function including banks. Unfortunately, those concerned to CP apparently target to facilitate banks to underwrite CP rather than to strengthen CP market function itself.

3. Commercial Paper market in Japan: the future

Therefore, in the countermeasures to restrictive lending policies of banks, CP is merely positioned as part of bank's indirect financing function. So far no actions are conceived for CP to sufficiently demonstrate its inherent function as part of the direct financing market. It is regretful to point out that current situation, where banks are the main players of CP market, may continue even the Big Bang started. It is true that the recipients of the funds enjoyed favorable conditions in the past through banks tendency to underwrite CP at sub market rate to keep good relationship with issuers. But since they were so depending on banks at CP issues, that they face difficulties once banks start reconsidering such relationship-driven practices. Hereafter companies need to secure several financing channels besides bank channels.

Direct Paper would be a possible breakthrough when the ban is lifted next year. Most companies may find it difficult to issue Direct Paper as a matter of fact, however, since it requires the issuers to do marketing by themselves to secure investors. That means the issuers would be limited to some non-banks and leading trading houses that are expected to issue in a large amount continuously[7]. Nonetheless, Direct Paper is expected to make a contribution to facilitate clear and reasonable prices in CP market, as it brings somewhat wider transaction opportunities that bypassing the banks.

Meanwhile, securities companies, which are in parallel to banks in terms of CP underwriting, were not willing to deal with, as they recognized CP not to get sufficient fees. However, it is

3 Prompt correction order will be postponed for the banks with domestic standard when their ratio of net worth is less than 4% at April 1998 but they are assumed to be sure to reach more than 4% within a year. However, prompt corrective action system will be implemented as scheduled for the banks with global standard, starting from April 1998.

4 Released as "Countermeasures for restrictive lending policies of banks "

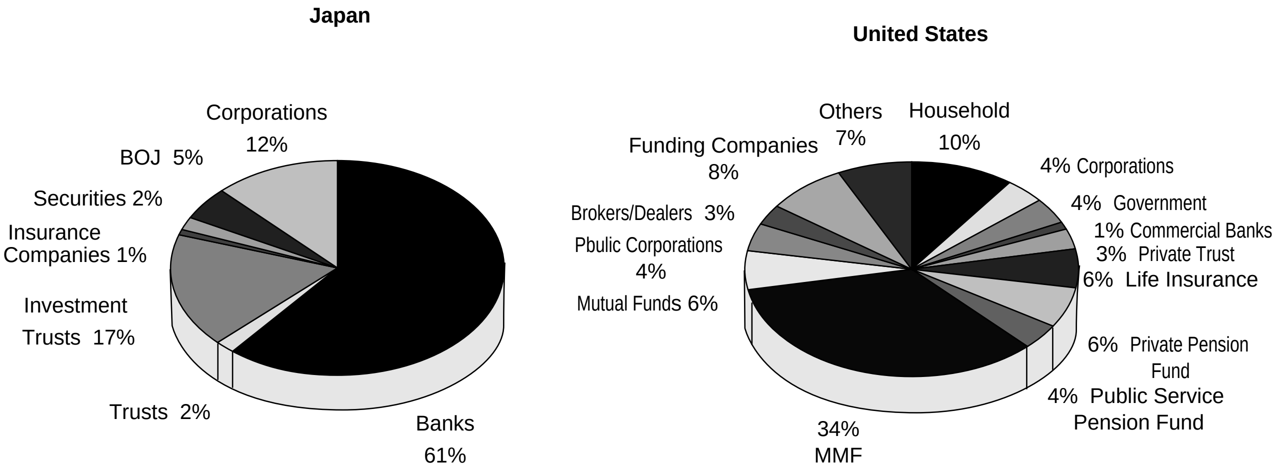
5 CP was originally categorized to "other bonds " with 100% risk weighting at BIS's secondary requirements that will be implemented from April 1998 (added by market risk assessment. Then the authorities put CP into "prime bond" category, thus decreasing risk weighting to some 3.1-12.5%.

6 First operation was on January 16, 1998.

7 More than 50% of CP issuers are trading houses.

expected that banks may refrain from manipulating the rates hereafter. That is, securities companies may have chances to earn the revenues by increasing CP turnovers through exploiting their client relationship with institutional investors such as investment trusts. For example, in the United States some 40% of CP investors are occupied by investment trusts (with 34% occupied solely by MMF). The figure reaches 50% with addition of pension funds and insurance companies (See figure 2). For information, US MMF invests some 40% of their assets in CP while the share of CD is some 10%. In contrast, CP investment in Japanese MMF is as low as less than 5% of total assets. They invest some 60% to the instruments provided by banks (i.e., CD, call loans).

Figure 2 . Japan and US CP holders by share



Source : Bank of Japan, FRB

Currently, companies with loans and accounts receivables increasingly utilize asset-backed CP for financing. The authorities are ready to rearrange legal system, as part of the Big Bang timetable, to allow the establishment of Special Purpose Company (SPC) in Japan. Further development in CP market is also expected in this area.

Finally, facilitating CP issues and transactions should require infrastructures, that include lifting of stamp duty[8], efficient electronic processing system of bills, and building a new settlement system via on-line system. As the Revised Foreign Exchange Law became effective in April, there are concern that domestic short-term borrowers would go abroad to tap foreign CP market if Japan delays reforming its CP market. Therefore, rearrangement of CP market is highly awaited in the face of financial Big Bang, which aims to develop Japanese market to vie with other international financial centers.

8 As mentioned above, CP stamp duty was cut to 5000 yen per issue. However, industries claim to lift it perfectly, as it cost too much for short-term instrument such as CP. In the case of financing 100 million yen for two weeks via CP, stamp duty would cost more than 0.1% in annual basis.