Japan's Financial Markets and Turning Around Japanese Industry

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1. Hard Landing, Soft Landing and Turnaround

It is two years since Junichiro Koizumi became prime minister of Japan. Soon afterwards the TOPIX and the Nikkei 225 Average recorded recovery highs of 1,400 and 14,000, respectively. Since then, however, they have failed to regain those levels and recently even recorded levels not seen since the early 1980s.

Perhaps inevitably, public support for the structural reforms that the new government advocated so strongly has waned in the face of falling share prices, while demands for more aggressive fiscal and monetary policies to stimulate the economy and prevent a deflationary spiral appear to be escalating.

Where the advocates of structural reform perhaps went wrong was in failing to foresee that their policies would be seen by many as amounting to an acceptance of the view that companies that are in difficulty should be wound up (i.e., that the cause of Japan's economic woes is structural oversupply and that the solution lies in reducing capacity).

However, as deflation has taken hold, it was perhaps inevitable that such a hard-landing approach should be increasingly seen as an inappropriate recipe.

Instead, calls have increased for decisive macroeconomic policies seen as offering hope of a soft landing. Such policies have been advocated by those who see Japan's economic woes as being caused by a shortage of demand rather than by oversupply and who see a solution in stimulating demand.

However, those who take this view would appear to regard the asset boom of the late 1980s as a normal state of affairs and the adjustment that has occurred since as a deep and prolonged recession rather than a return to normality.

There is, however, an alternative view, which should perhaps be considered before any attempt is made to go from one extreme (i.e., supply-side adjustment or the "hard-landing approach") to the other (i.e., demand-side adjustment or the "soft-landing approach"): the so-called "turnaround approach."

2. The Structures Needed to Implement the Turnaround Approach Are Now in Place

Unlike the hard-landing approach, which advocates that companies and industries in difficulty should be wound up sooner rather than later, the turnaround approach advocates that such companies and industries should be helped to recover where possible. Rather than naively assuming that rightsizing always means downsizing, this approach takes the view that, while those sections of a company or industry that cannot be turned around should be wound up, those with the potential to survive should be given every assistance.

Indeed, even if the decision were taken to adopt a demand-side approach, it would surely make sense first to adopt a turnaround approach to ensure that any stimulus to demand did not serve simply to prolong the life of companies that had failed to adapt to structural changes in the macro- and microeconomy.

The notion of "turnaround" has been reflected in the names of many of the policies adopted by the government in recent years (rendered in English by synonyms such as "reconstruction," "revitalization," "revival" and "reform"), so readers may well wonder whether there is much point in touching on this yet again, however important it may be.

However, it is doubtful whether the difference between the hard-landing approach and the turnaround approach has been properly understood in Japan. Indeed, it may well be that "structural reform" has generally been understood to refer to the former approach and that attitudes to structural reform might have been different if more people had understood it to refer to the latter approach.

It was perhaps inevitable that in a country like Japan the notions of liquidation and turnaround should become confused. Bankruptcy has generally been seen as the end of the road for a company as it is pursued by its creditors and shunned by financial markets, its employees left to fend for themselves, its owner saddled with debts he will never be able to repay, and those relatives of the owner's who have acted as guarantors subject to considerable inconvenience. Traditionally, bankrupts in Japan have no second chance.

Many reforms have been needed for the turnaround approach to be possible. Particularly important has been the Reorganization Law, which came into effect in April 2000 and enables companies to begin bankruptcy proceedings with a view to rehabilitation. At national level the acceptance of the need for a turnaround approach was signaled by the decision to set up a "Strategic Headquarters for Industrial Revival and Employment Measures" within the Cabinet in November 2002 as well as by the latter's decision to establish the Industrial Revitalization Corporation.

More than 10 years since its asset boom of the late 1980s turned to bust, Japan is only now beginning to put in place the mechanism it will need to implement the turnaround approach. Had it responded more quickly, it might have been in better shape to achieve a turnaround. However, rather than dismiss the latest measures as belated and engage in a pointless economic debate, it would be better for all concerned to make the most of what this new mechanism offers.

3. Will Industrial Revival Solve the Problem of Oversupply?

There is a risk that the term "turnaround" (or one of its synonyms) may be used to disguise attempts to rescue lame ducks. Where the problem is one of oversupply, rescuing too many companies that have failed to hold their own will inevitably only prolong pointless competition and eventually threaten the viability of entire industries. It may well be the case that sectors such as construction and finance have already reached this stage.

Turning around a company or industry means identifying those parts that are viable and helping them to survive: it does not mean keeping them on a life-support system indefinitely. This point was emphasized in the "Basic Policy on Corporate and Industrial Revival" published by the government in December 2002.

The key to a successful turnaround is not the various stakeholders in a company with their own vested interests but a turnaround specialist (or "company doctor") who is able to look at the company dispassionately, identify its potential and separate the parts that can generate a meaningful cash flow from those that cannot. Vested interests have made it difficult for Japanese companies to do this by themselves, so much will depend on whether the Industrial Revitalization Corporation can achieve this on a national basis.

It will be up to the Corporation's Industrial Revitalization Committee to judge whether proposed reorganization plans and price tags are reasonable, thereby ensuring that turnarounds do not become rescues. Provided a company is capable of generating a cash flow with a present value in excess of its liquidation value, it will find a sponsor, and it would be a fallacy to assume that the role of the Corporation is to rescue lame ducks by using taxpayers' money to acquire their loan assets at inflated prices.

4. Reform of Bank Lending Essential to a Turnaround

If attempts to turn around Japanese industry are to succeed, Japanese banks will have to adopt a different approach to lending, as was recognized in a report on relationship banking by a working group of the Financial System Council published on 27 March 2003.

The main problem with Japanese banks' current approach to lending is that the interest rates charged reflect neither the risk nor the costs involved and that, as a result, their core business of deposit-taking and lending has, to all intents and purposes, been unprofitable for many years. It is difficult to imagine such a state of affairs occurring in the private sector, and the fact that it has been possible at all is surely the result of a tacit understanding that, if a bank should find itself in difficulty, it will be bailed out by the taxpayer.

Be that as it may, lending at less than commercial rates means that many companies that would otherwise have difficulty servicing their debts and be forced to consider restructuring are given a clean bill of health. This makes it more difficult to implement a turnaround approach, which relies on encouraging companies to restructure sooner rather than later while they still have a good chance of survival.

Another criticism that has been leveled at Japanese banks is that they have relied too much on collateral and guarantees and not enough on profit margins and growth prospects when assessing the risk attached to a loan. Moreover, in many cases they have failed to monitor the value of such collateral and guarantees properly after granting a loan. Also, if a debtor company does fail, the fact that under Japanese law the assets that can be seized are more extensive than under US law means that the action taken against such a company is likely to be punitive.

In particular, the prevalence of third-party guarantees means that, even if a debtor company's future is in doubt, rather than cut its losses and file for bankruptcy with a view to rehabilitation, it will usually not declare bankruptcy until the very end in an effort to spare its guarantors. As a result, the company is likely to declare itself bankrupt only when it is past the point of no return. Once this happens, not only does the owner lose his personal guarantee, but the impact on relatives who have provided third-party guarantees is such that he will never have a second chance.

This bias in favor of the banks is the result of the fact that for many years they were a monopoly provider of scarce capital.

It would be preferable if companies that found themselves in financial difficulty could file for bankruptcy with a view to rehabilitation while this was still a possibility and banks would take the initiative by assessing companies more realistically, help them sooner rather than later and, if they do declare themselves bankrupt, offer them debtor-in-possession finance in the form of a prepackaged deal.

Furthermore, if Japan is to embrace the turnaround approach, Japanese lenders will have to use scoring models and restrictive financial covenants rather than just collateral and guarantees; monitor the value of collateral and guarantees more carefully if they do use them;limit their use of third-party guarantees; and overhaul the lending practices mentioned above.

5. Bank Lending in Japan Has Been Equity in Disguise

There is a further aspect of bank lending in Japan that is open to question: whether or not it is really debt or actually equity.

Japanese companies have traditionally relied on bank lending for their long-term working capital. Not only have repayment deadlines seldom been an issue, but companies have often been allowed to reduce interest payments if their earnings have not been in line with expectations. In other words, banks have really been providing equity in disguise.

It is often said that Japanese companies' equity ratios are low. In fact, Japanese banks have bolstered them by calling their equity investments "loans." Moreover, they have hedged the risk of using customer deposits for this purpose by relying excessively on collateral and guarantees.

While this may have been all well and good so long as the Japanese economy was growing and the value of banks' loan assets remained unimpaired (with banks hardly ever having to foreclose on their loan collateral or require guarantors to honor their commitments), it becomes a very different story when corporate failures are an everyday occurrence: then banks have no choice but to perform their role as debt collectors. Naturally, this change of roles nips any chances of a turnaround in the bud.

Turnaround specialists often say that banks cannot by their very nature play a key role in turning companies around. This is because there is a conflict of interests between trying to do this and trying to recover debt. In their view, banks need to act as equity investors rather than creditors and swap their loan assets for equity if companies are to achieve a turnaround.

By swapping what has, to all intents and purposes, been equity in disguise for equity proper, banks will make it easier for both themselves and their corporate clients to assess risk and return properly.

6. Debt-Equity Swaps and the Need to Rightsize Non-Market-Type Indirect Finance

Nor are companies that need to achieve a turnaround the only cases where debt-equity swaps need to be considered. Banks should treat at least a portion of their existing corporate loans as equity in order to recognize the risk involved. Venture businesses often want banks to be impressed by their technology and growth potential, and to offer them a loan. Strictly speaking, however, the job of financing this should be that of venture capitalists, who specialize in high-risk high-return investments. The fact that Japanese banks have traditionally performed this role helped companies such as Sony and Honda in their early years.

However, Japanese banks are no longer in a position to grant such high-risk loans. Instead of continuing to provide Japanese companies with equity in disguise, they should make equity investments in these companies and recognize the risk involved.

Clearly, the fact that these banks are deposit-takers means that there must be a limit to the degree of risk that they may assume when making such investments as part of the process of swapping equity in disguise for equity proper, whether it be as part of a turnaround or in order to help a company in difficulty.

A greater role clearly needs to be played by private equity funds and direct finance. Provided banks recognize their bank lending for what it really is and start to swap their loan assets for equity, other risk-takers can begin to lighten them of their burden and accelerate the process. In order to rightsize indirect finance in Japan, bank lending needs to be overhauled, whatever measures may be taken to stimulate the country's securities markets.

7. The Difficulty of Pricing Credit Risk and the Need to Develop the Secondary Market in Loan Assets

As well as swapping the portion of bank loans that is really equity for equity proper, banks need to recognize the debt portion for what it is and price it properly (i.e., as a normal commercial transaction).

The problem with pricing debt properly is that the way in which credit risk is currently priced in Japan is anything but normal. For example, there are still big differences between the premiums on debt belonging to one and the same company, depending on whether it is in the form of a bank loan, a corporate bond or a credit derivative.

As was mentioned above, bank loans in Japan are not priced as normal commercial transactions. However, it is also difficult to trust the prices of debt issued by companies whose credit rating has been downgraded as there are unlikely to be any buyers for such paper on the bond market and the companies concerned are unlikely to be able to issue any new paper.

However, this does not mean that investors should distrust market prices altogether. A properly functioning market should solve this problem. One possible solution would be to securitize such loan assets. Making them available not only to banks but also to ordinary investors would enable them to be bought and sold at a yield that properly reflected the risk involved.

In this regard, the publication in March of this year of a report by the Japanese Bankers Association on measures to expand the secondary market in loan assets, discussion on which began in November 2002 as part of the government's Program for Financial Revival, marks a major step forward. Although numerous issues still have to be resolved, this year should see the beginning of a significant increase in loan asset trading in Japan.

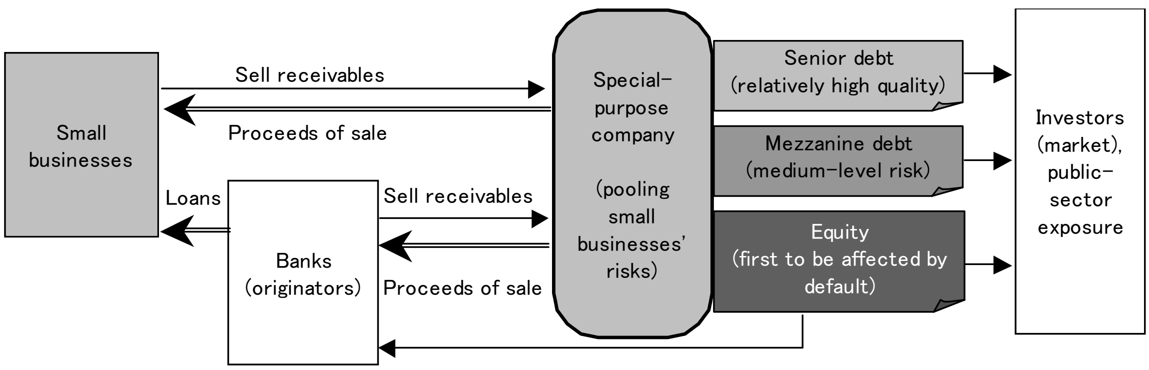
8. Lending to the Private Sector by the Bank of Japan as a Model of Market-Oriented Indirect Finance

The Bank of Japan's decision on 8 April to consider purchasing asset-backed securities may well mark a significant development in the efforts to reform bank lending in Japan. Although such a move would be exceptional in that it would involve the Bank in providing liquidity to private-sector companies, it represents what should be an effective way of easing monetary policy at a time when Japanese banks are being criticized for being reluctant to lend to small businesses.

However, as well as helping to implement monetary policy, this measure should be welcomed for trying to establish a new market (namely, in asset-backed securities). Any loan assets that the banks try to dispose of by means of this scheme will clearly have to reflect the price that final investors can expect to receive for them. Banks will therefore increasingly have to take the market into account when setting terms for their loans—even at the origination stage. One of the Bank's aims is to ensure that credit risk is priced more effectively.

Another interesting aspect of the Bank's decision is that the scheme will involve the use of receivables as collateral rather than (as has traditionally been the case with bank lending in Japan) property. This is significant because the value of small businesses' receivables tends to be greater than that of any property, cash or bank deposits they may own.

Figure The Bank of Japan's Scheme for Revitalizing Japanese Corporate Finance by Means of a Market in Asset-Backed Securities



Note: The Bank of Japan has called for the creation of new asset-backed securities along the lines of the above scheme and announced that it will itself purchase such securities provided they are of a certain quality. The Bank hopes that the use of different types of paper (e.g., commercial paper, short-term corporate bonds and corporate bonds) will help to create well-diversified asset-backed securities.
Source: Bank of Japan.

While it would have been preferable for such a scheme to have developed without the Bank's involvement, the fact that Japan's private-sector lenders are still unable to change their traditional lending practices means that the Bank, as the bankers' banker, had little choice but to lead the way in establishing a new approach to indirect finance.

The Bank's decision should therefore be welcomed more warmly than some of its other recent decisions (e.g., its decision to buy shares from banks, which has caused concern because of the unconventional intervention it would entail) because it will help to establish a new market and reform indirect finance in Japan.

9. Need to Prevent the Program for Financial Revival Becoming a Bank Rescue Program

Unless Japanese private-sector banks can adapt to this new type of lending, their continued existence will be threatened. In view of the fact that the corporate sector as a whole has a net surplus, banks cannot count on their business in future, whether they stick to their traditional type of lending or adapt to the new type. Rightsizing non-market-type indirect finance will mean reducing the number of lenders.

The issue is whether this will be done without bailing out all and sundry. With regard to this, it would appear to be widely believed that since Hakuo Yanagisawa was replaced by Heizo Takenaka as Minister for Financial Services on 30 September 2002 the government has made it clear that it is prepared to take a hard line with the banks.

In fact, however, under Yanagisawa it was decided to lift the blanket guarantee on bank deposits and to thoroughly restructure all the problem banks beforehand. There was a clear policy that, once the blanket guarantee was lifted, any bank that found itself in difficulty would be required to take prompt corrective action and that, if this proved unsuccessful and the bank failed, depositors would only be protected up to a certain amount. However, it was also made clear that, if there was a threat to the banking system as a whole ("systemic risk"), taxpayers' money would be used in accordance with Section 102 of the Deposit Insurance Law.

However, Yanagisawa's statement that there was no systemic risk and therefore no need to use taxpayers' money was heavily criticized at the time—even by the then Governor of the Bank of Japan, Masaru Hayami, and the Minister for Economic and Fiscal Policy, Heizo Takenaka. Accordingly, when Takenaka's brief was extended to cover financial services, he announced that the bad debt problem was a major one and would require the use of taxpayers' money. At the same time, work began on the "Takenaka Plan."

However, the plan did not, as some people had feared, amount to a blueprint for nationalizing banks. In rather simplistic terms, one could say that Yanagisawa's approach was more hard-line than Takenaka's. This is because under Takenaka the lifting of the blanket guarantee on bank deposits was postponed and no thorough restructuring of the banks has been carried out similar to that carried out under Yanagisawa in the run-up to March 2002. Another reason for taking this view is that the Program for Financial Revival introduced the new concept of "special support." This would involve the use of a special loan from the Bank of Japan or taxpayers' money if a bank were to find itself, for example, in financial difficulty or short of capital and there was any possibility that this might lead to systemic risk or a recession.

Whereas Yanagisawa made a clear distinction between individual and systemic risk, regarding the latter as an exception, and believed that taxpayers' money should be used only in extreme circumstances, Takenaka has allowed for support to be given to individual banks if there is any possibility at all of systemic risk. Moreover, this support would be available not only to the country's largest banks but also to banks servicing small businesses and local communities.

Whereas strict conditions have been laid down for any purchase of loan assets from ordinary companies by the Industrial Reconstruction Corporation (in order to prevent any indiscriminate bailouts), the increasing stringency of the conditions that apply to banks is only apparent: if anything, it may even become more difficult to cure the problem of structural oversupply in the banking industry by closing individual banks..

As has been advocated many times in these pages, Japan needs to reduce the number of banks offering traditional deposit-taking and lending services, and encourage greater use of the securities markets to spread risk more widely and evenly across society as a whole.

10. Need to Choose between Different Sets of Accounting Standards Rather than Cherry-Pick from the Same Set of Standards

So far, this report has emphasized the need to reform bank lending and make greater use of the securities markets if Japan is to implement the turnaround approach.

Underlying this, however, is the assumption that a proper system of accounting and disclosure exists. Timely access to accurate information about company finances is essential not only to safeguarding the interests of investors in the securities markets but also if credit risk is to be priced properly and banks weaned from their overdependence on loan collateral and guarantees to greater use of cash flow.

However, running counter to these developments, there have been growing calls to amend accounting principles in order to make it easier to obscure the true picture. The most extreme examples of this are moves to amend the rules governing market value accounting and a private member's bill which aims to delay the introduction of impairment accounting. Such calls are rather like someone who, discovering to his regret that he is overweight, sets his bathroom scales so that they will not register more than a certain weight.

The introduction of market value and impairment accounting has been accompanied by arguments for and against, including arguments about their international aspects. This reflects the realization that factors such as the increase in mergers and acquisitions and the growing importance of asset price volatility mean that balance sheets must reflect the true picture. In addition, unlike the situation before the Second World War, corporate securities are now owned by a broad cross-section of society in the form of collective investments such as pensions and investment trusts, and this makes it essential that companies paint an accurate picture of themselves for investors.

What makes the introduction of such accounting systems particularly urgent in the case of Japan is the fact that the upward-sloping growth curve that the Japanese economy traced for so much of the post-war period has been flattened, producing a wide gap between the acquisition cost of assets and their current market value, and the bitter experience that many of the large companies that have failed in recent years did not display the symptoms in their financial statements. Any decision to flout rules based on a mass of arguments along such lines and on a wealth of experience needs to muster detailed counterarguments on a similar scale.

Having said that, it is perhaps wise to remember that accounting principles are ultimately always liable to be distorted as a result of political pressure. In the United States, for example, the debate about whether stock options should be treated as an expense ultimately succumbed to such pressure.

In this connection, it is interesting to note that Robert E. Litan at the Brookings Institution advocates that companies should be allowed to choose the set of accounting standards they adopt.[1] For example, they might be allowed to choose between their national standards and the international standard. In such a case, if the national standards were arbitrarily tampered with by politicians, companies engaged in international business and with international investors could adopt the international standard to ensure that they did not lose the trust of those investors. In contrast, companies that are neither engaged in international business nor interested in international investors and do not want to be subject to international accounting standards might be better to adopt their national standards. Litan also argues that, since even the international standard is subject to political pressure, there should be other standards in order to encourage competition and allow companies to make a choice.

In contrast, allowing companies to cherry-pick from the same set of accounting standards would only obscure the basic approach to accounting underlying those standards as a whole. There would also be a risk that compatibility between different parts of the same set of standards might suffer. It would therefore be better for different companies to adopt different sets of standards from the outset as this would minimize any confusion among investors.

11. Cherry-Picking Market Functions and Free-Riding Are Not Options

Any company happy to enjoy the advantages of a market must also be prepared to accept the disadvantages. While the authorities will obviously do their best to minimize the disadvantages, even in the United States, where the market system is most developed, the situation is far from ideal and still depends on trial and error. In reality, markets are indispensable whatever their shortcomings. However, if a company felt that the disadvantages outweighed the advantages, it would do better to go private than complain about the market.

It would seem that many companies that are happy to make full use of stock markets to raise capital or make a capital gain when share prices are rising complain that these same markets are not functioning properly and that shares are mispriced when they are falling. Such companies also say they are loath to use such prices for accounting purposes.

1 See George Benston, Michael Bromwich, Robert Litan, Alfred Wagenhofer, "Following the Money—The Enron Failure and the State of Corporate Disclosure," AEI-Brookings Joint Center for Regulatory Studies, 2003.

However, this is cherry-picking. If a company has decided to use the market, it should accept the price the market puts on its shares, and, if it feels that the price is wrong because of a lack of information, it should do its best to provide that information.

As markets become increasingly important, so do the quality and frequency of disclosure. If the European Union adopts the draft directive published in March of this year, 6,000 listed companies in the Union will be required to publish financial reports every quarter from 2005. Most Continental European companies already do this, and the European Union is following the example set by the United States.

In Japan, however, many companies appear to be reluctant to publish financial reports every quarter; but, if they want to make full use of the market, they should be willing to accept the increased costs that this entails.

Many Japanese companies, eager to criticize the country's accounting standards, are apparently reluctant to pay their dues to the Financial Accounting Standards Foundation (FASF), which was established recently to try to improve these standards. In contrast, in the United States, where the Public Company Accounting Oversight Board (PCAOB) was established in the wake of the Enron scandal to oversee the work of external auditors, accounting firms and issuers are obliged to pay their dues, which are used to finance not only the PCAOB's own operations but also those of the Federal Accounting Standards Board (FASB). The reason for this approach is that simply asking companies to contribute will not ensure that accounting standards are neutral and objective. Japan should perhaps take a leaf out of the United States' book.

Considering that it is investors who benefit from accounting and disclosure, a case could be made that they should bear the costs. Clearly, some of the costs incurred by companies will ultimately be borne by investors, anyway; but, if accounting and disclosure are to serve the interests of investors first and foremost, investors should bear these costs directly in exchange for having a greater say.

It is also questionable whether investors are paying their fair share not only of these costs but also of those of providing other market-related services such as analysts' research and credit ratings. Because of the difficulty of charging investors, securities companies have tended to focus more on investment banking while credit-rating agencies have also had to charge their corporate clients for providing a rating. The problem is that, as a result, information and analyses have tended to serve the interests of companies rather than those of investors.

Similarly, the recent trend towards passive management and index funds has meant that investors have increasingly tended to rely on the prices discovered by other investors. However, it is investors who will end up paying more than they bargained for for this free-riding.

Companies and investors should both refrain from cherry-picking and free-riding.

12. Need for a Japanese "Prime Standard" Market

Although it is clear from the above how important the market is to achieving a turnaround in Japan, the recession and the bear market in equities have made people very reluctant to accept market prices and the cost of using the market.

If this means that acceptance of the market economy in Japan is limited, this in itself perhaps needs to be recognized. It would mean that many companies have simply picked those aspects of the market economy they liked and enjoyed a free ride as banks offered them loans at rates that could hardly be called "commercial."

If so, one possibility might be to abandon the attempt to adopt market value accounting or to require companies to publish quarterly financial reports and to restrict the use of the primary and second markets so as to put an end to such cherry-picking and free-riding.

If delisting were considered too drastic a measure, those companies that fully respected the market, adopted international accounting standards and were happy to publish quarterly financial reports and cultivate investor relations could be separated from the rest—partly in an attempt to maintain clear minimum standards for the Japanese equity market. For example, Japan's stock exchanges could assign the former group of companies to one segment and the other, market-unfriendly companies to a different segment.

One example of this is the Frankfurt Stock Exchange, which, since January of this year, has listed companies that publish quarterly financial reports, adopt either international or US accounting standards, make ad-hoc announcements in English as well as German, publish a corporate action calendar and hold at least one analyst meeting a year on its recently established "Prime Standard" market, while companies that do not fulfil these criteria are listed on a "General Standard" market.

The Japanese stock exchanges should perhaps consider establishing such a segment and creating a new index at the same time.