Regulatory Initiatives for Expanding Japan's Syndicated Loan Market

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I. Loan Trading in Japan

1. Three Channels for Redirecting the Flow of Money

In Japan people are questioning the way in which the dominant role played by bilateral bank lending and the resulting concentration of risk in the banking sector exacerbated the country's bad debt problem. In order to deal with this problem, the flow of money needs to be redirected in the following three ways: first, banks need to improve the way they manage the risk of their bilateral lending (e.g., by valuing their assets more rigorously, charging more appropriate interest rates, assessing collateral and guarantees more accurately, and ensuring that they are adequately capitalized); second, they need to transfer some of the risk by using syndicated loans, loan sales and loan securitization to trade their loans in a liquid market as well as by means of credit derivatives; and, third, greater use needs to be made of the country's securities markets.

Although genuine progress has been made in recent years with regard to the third of these (as a result, for example, of tax reforms and amendments to the Securities and Exchange Law), the fact that companies still depend largely on banks for their capital means that more needs to be done to reform bilateral lending and to transfer risk. In particular, the fact that risk transfer can act as a link between bilateral lending and the securities markets means that greater use of risk transfer will help to revitalize the country's securities markets.

As far as risk transfer is concerned, the growing number of corporate recovery funds and the growing number of investors in such funds has led to greater participation in the market for nonperforming loans and a greater demand for the increased liquidity provided by loan sales and securitization. In addition, there has been an increase in sales of performing corporate loans as well as of securitizations of mortgage loans issued by the banks themselves (see Figure 1).[1]

2. Growth in Syndicated Loans

At the same time, there has been a sharp increase in syndicated loans since 1999 (see Figure 2) in spite of an overall decline in bank lending. Unlike loan sales, where a bank sells some of its existing loans on the secondary market, loan syndication involves a bank sharing information on a borrower with a group of other banks to create a new loan that is more liquid than a traditional bilateral loan.[2]

Although syndicated loans originally tended to be in the form of a commitment line, there has recently been an increase in term loans, where an actual cash flow takes place. As can be seen from the Bank of Japan data in Figure 1, nearly ¥20 trillion in syndicated loans was originated in fiscal 2003.

Among Japan's leading banks, Mizuho Corporate Bank showed its commitment to the loan syndication business in October 2002 by setting up a syndication business unit with 200 staff working in six sections instead of only 30 staff working in one section, while SMBC and MTFG have emphasized the importance of loan syndication in their wholesale business plans.

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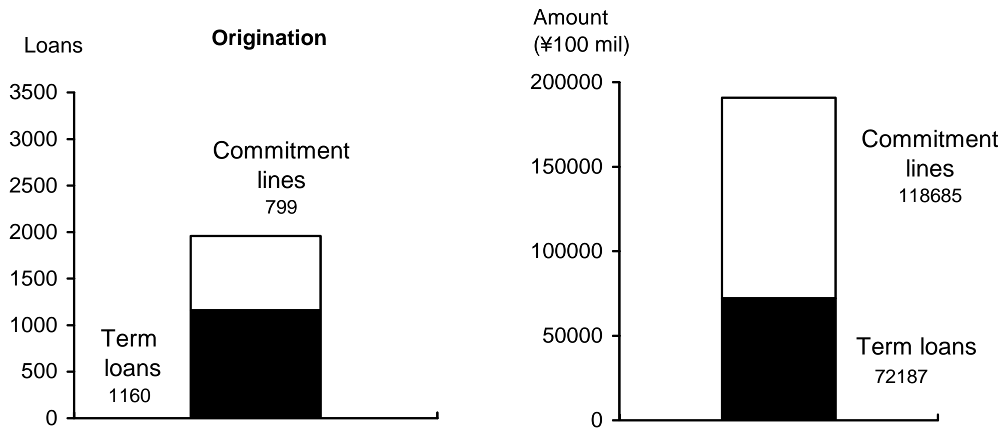
1 The charts in Figure 1, which are based on loan market trading statistics from the Bank of Japan, show figures for syndicated loan originations and loan sales. The figures for loan sales include loans that have been transferred by financial institutions to special-purpose companies. Therefore, such loans could also be described as "loan securitizations" if the special-purpose company concerned sold them in the form of securities. Also, the statistics cover only loans to corporate borrowers and therefore exclude any other bank loans (e.g., residential mortgage loans) that may have been securitized.

2 For a long time, efforts to originate commitment line-type syndicated loans were handicapped by the fact that commitment fees were regarded as deemed interest. It was therefore feared that, if the committed balance was low, commitment line agreements risked infringing either the Interest Rate Restriction Law or the Capital Subscription Law. With the enactment of the Law Concerning Commitment Line Agreements in March 1999, however, commitment fees were exempted from the provisions of the Interest Rate Restriction Law and the Capital Subscription Law provided the conditions of the new law were satisfied. As a result, demand for commitment line-type syndicated loans has increased significantly.

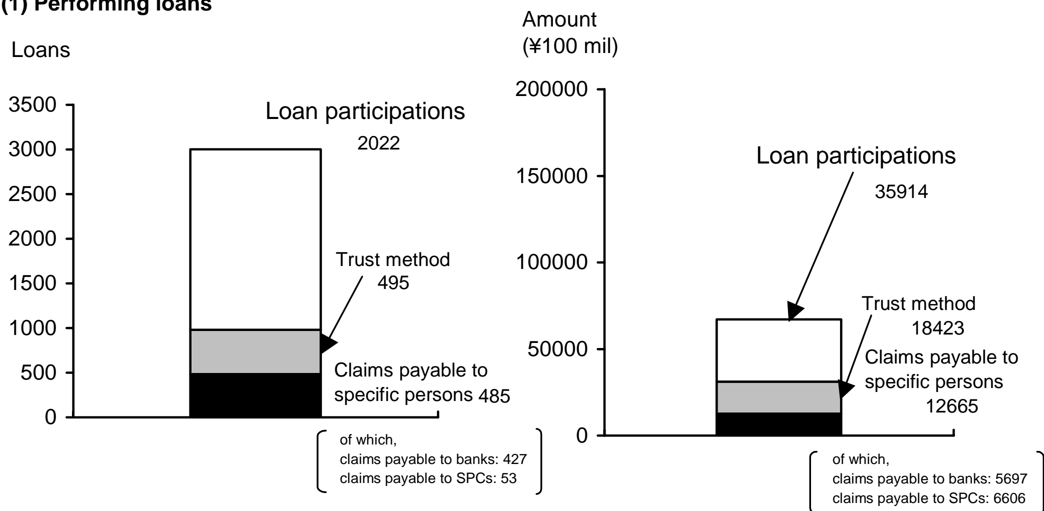
Figure 1 Loan Syndication and Sales in Japan (fiscal 2003)

(1) Syndicated loan originations

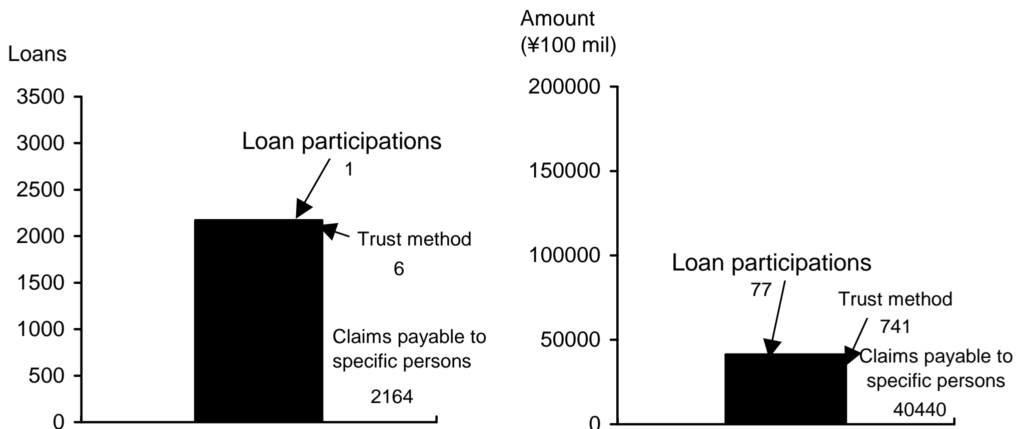


(2) Loan sales

(1) Performing loans

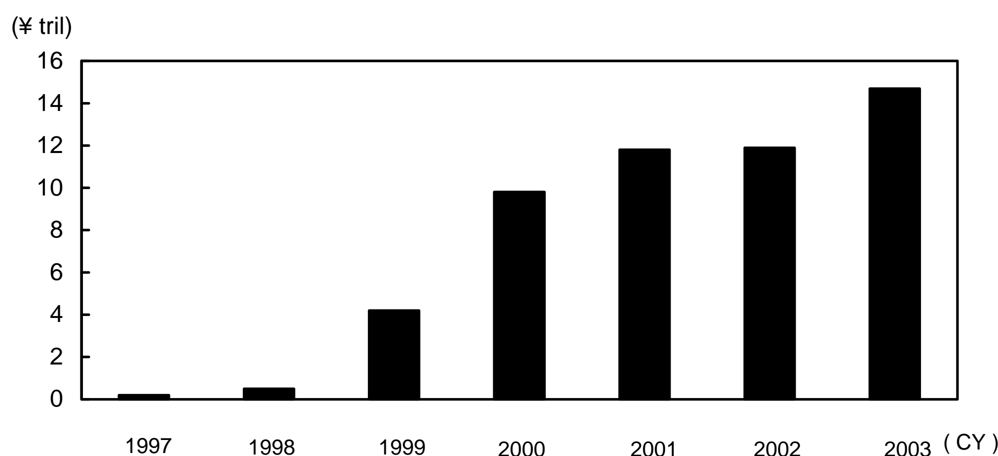


(2) Nonperforming loans



Note: The statistics cover only loans to corporate borrowers.
Source: Bank of Japan.

Figure 2 Total Value of Syndicated Loan Originations in Japan



Source: IFR database.

Similarly, local banks have also shown an interest in loan syndication—either by arranging loans for local companies or by participating in syndicates led by one of the major banks in order to diversify their investment portfolios.

Some banks have also begun to trade their own portions of syndicated loans on the secondary market. Mizuho Corporate Bank, for example, has been making a market in more than twenty loans since January 2004 and has been trading existing syndicated loans with regional banks in a major effort to develop a secondary market.

3. Importance of Syndicated Loans

The fact that, with syndicated loans, (1) borrowers know at the outset that the loans will be transferred and (2) a variety of information is disclosed means that syndicated loans are probably better suited to risk transfer than sales or securitizations of existing bilateral loans. They also stand a better chance than credit derivatives of becoming the main vehicle of risk transfer, given the limited number of participants and suitable companies in the credit derivatives market as well as some unresolved accounting issues.[3]

If trading activity on the secondary market in syndicated loans picks up in the same way as origination on the primary market, the market as a whole should become more efficient. This could boost activity on the markets in loan sales and securitization as

[3] One of these problems is the fact that, while credit derivatives used to hedge the credit risk of a loan are accounted for at market value, the loan itself is not.

well as credit derivatives and, in turn, lead to reform of bilateral lending and help to revitalize the securities markets.

Indeed, as the Governor of the Bank of Japan, Toshihiko Fukui, has suggested, the development of the syndicated loan market could well change the face of Japanese corporate finance for the better and go a long way to establishing a credit culture where return reflects the risk incurred.[4]

Therefore both the public and private sector need to make every effort to help both the primary and secondary syndicated loan markets to expand.[5]

II. What Is Needed to Help the Market Expand

1. Developments So Far

A number of efforts to encourage the development of loan syndication and sales in Japan are already under way.

One particularly important role has been played by the Japan Syndication and Loan-trading Association (JSLA), which was established in January 2001 and whose members include leading banks, securities companies and institutional investors. As well as producing standard formats for loan trading contracts, publishing disclosure rules for the secondary loan market, and conducting surveys of company attitudes towards loan trading and syndication, the Association tries to raise the profile of the secondary loan market.

In October 2002, the Financial Services Agency published a proposal for establishing a loan market as part of its Program for Financial Revival. This led to the formation of the Loan Market Council, with the Japanese Bankers Association acting as its secretariat. The Council examined the issues involved in trying to encourage loan trading and published a report on this in March 2003.

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[4] Mr. Fukui gave his speech ("Reforming Japanese Corporate Finance") on 17 November 2003 as part of a symposium on the contribution new approaches to corporate finance could make to reviving the Japanese economy.

[5] As well as fitting in nicely with the direction of public policy (towards reforming the financial system), the growth of syndicated loans also benefits all those involved. The participating banks benefit by being able to avoid an overconcentration of credit risk and free up funds for lending to new clients; the arranger benefits from higher fee income; and corporate borrowers benefit by being able to diversify their sources of capital and gain access to an alternative to bilateral loans and securities markets.

Since then, the Financial Services Agency, the Ministry of Economy, Trade and Industry, the Bank of Japan, the Japan Syndication and Loan-trading Association and the Japanese Bankers Association have been implementing the report's recommendations by drawing up new rules and revising existing ones, reviewing business practices and raising awareness of the need for a loan market. One example of this is the fact that the Bank of Japan began accepting syndicated loans as collateral for its market operations in November 2003.

2. New Recommendations

In April 2004 the Japan Syndication and Loan-trading Association published a set of practical recommendations for dealing with some important outstanding issues concerning the secondary loan market. The first of these was that the members of a loan syndicate could improve the procedure for their internal asset valuations by voluntarily sharing the findings of those valuations. At some point in the future, it would also be possible to avoid the current situation, where each bank carries out its own valuation of a loan asset and therefore the same loan asset is valued many times over, if the banks agreed to accept the findings of the Financial Services Agency's inspection of one bank.

The second recommendation was that it should be made clearer to assignors exactly what information about a borrower they can disclose to an assignee. While potential purchasers of a loan need to have certain information about the borrower's creditworthiness, the borrower is likely to object if undisclosed information is divulged to all the members of a syndicate. Banks' duty of confidentiality to their clients also means that assignors need to be careful about disclosing information about a borrower to a third party. In parallel to the Association's work on this problem, a study group was formed at the initiative of the Financial Services Agency and it published its findings in April 2004.

The Association's third recommendation was about how to encourage trading in nonperforming loans. Although the Association had previously concentrated on trying to provide the resources needed to encourage trading in performing loans, experience in the United States and Europe suggested that trading in nonperforming loans could act as a catalyst in the development of a market in performing loans. In its recommendations the Association therefore lists some of the practical problems that need to resolved.

First, in order to attract more investors, nonperforming loans purchased at a sufficient discount and at a fair market price should no longer be required to be disclosed. Also, clarification is needed of how purchases of nonperforming loans should be accounted for if the purchaser already owns loans to the same debtor.

Second, more needs to be done to ensure that the price formation mechanism functions properly. Finally, more resources (such as information on borrowers, standard contracts and rules of conduct) are needed if the market is to function properly.

3. Roles of the Private Sector and the Regulators

One of the problems that has been identified in trying to encourage the development of a loan market is the fact that the very failure of the market to develop has meant that participants have tended to be more aware of the various costs involved than of the potential advantages.

For example, companies would change their attitude towards disclosure if they realized that a greater willingness to disclose information would encourage trading and ultimately lower their cost of capital.

Even if a company is prepared to accept the additional cost of disclosure, the fact that the loan market is still relatively immature and illiquid means that the company cannot be sure of achieving a substantial reduction in its cost of capital. Although it is fairly certain that the market will expand once the disclosure problem is resolved, the current situation is reminiscent of the debate about "which came first, the chicken or the egg?" in that the problem remains unresolved and the market has failed to expand.

Anyway, most problems of this sort (e.g., the degree of disclosure a borrower is prepared to accept and the degree of disclosure an assignee expects) should ultimately be resolved by agreement between borrowers and syndicate members.

In addition to constant efforts of this kind by the private sector, there is also a role for the regulators to play in encouraging the development of a loan market. Hopefully, for example, the Financial Services Agency will follow up the recommendations it made as part of its Program for Financial Revival with some decisive action of its own and not simply leave things to the Japanese Bankers Association and other private-sector organizations.

One particular improvement that could be made by the regulators (and mentioned in the Japan Syndication and Loan-trading Association's recommendations) would be for the Financial Services Agency to allow syndicate members to use the results of the valuations it carries out as part of its own inspections. The next section examines this possibility in more detail and looks at US experience of such a scheme.

III. The Shared National Credit Program

1. The Program

In the United States, loans and loan commitments (including standby letters of credit and commitment lines) worth more than $20 million and involving three or more financial institutions are subject to a single inspection by the regulators if all the institutions involved use the same loan agreement. This arrangement is referred to as the Shared National Credit (SNC) Program.[6]

Although under this arrangement each syndicate member owns a different portion of the loan, there is, in effect, only one loan. Instead of inspecting each syndicate member separately, the regulators inspect only the agent bank and apply the same rating that they assign to its portion of the loan to those of all the other members.[7] The aim is to make the inspection process as efficient as possible and to minimize the administrative burden on the financial institutions involved. In addition, the process avoids a situation where each syndicate member's portion is assigned a different rating even though they are all part of the same loan.

In the United States there are three different financial regulators, depending on the type of institution involved: the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). If a loan is covered by the SNC Program, each regulator involved sends its own inspector, who then conducts a review as part of a team that decides by majority vote on a single rating. This also avoids a situation where the same syndicated loan is assigned several different ratings.

This arrangement also has the advantage from the regulators' point of view that it allows them to manage market risk more easily. This is because each financial institution's share of a loan may seem like a small credit exposure when viewed in isolation; but, if the total loan is large, it is better if the regulators can assess its overall risk to the market. The SNC Program allows the regulators to assess the risk of large multi-bank loans in aggregate.

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6 The Program began life in its original form in 1975 and assumed more or less its present shape in 1977. Individual loans of less than $20 million are still covered by the Program if the combined total of all the loans governed by a common agreement and with the same participants is greater than $20 million. However, portions of loans owned by foreign financial institutions are not covered.

7 Classification ratings are defined as "Substandard," "Doubtful" and "Loss" (collectively known as "classified credits"). Adversely rated credits (also known as "criticized credits") are the total of loans classified as "Substandard," "Doubtful" and "Loss" plus loans rated "Special Mention." In 2003 classified credits accounted for 9.3% of total commitments, while criticized credits accounted for 12.6%. These ratings differ from those used by the banks themselves to classify their bad debts for disclosure purposes.

In a joint release published every September the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation analyze the large loans syndicated under the SNC Program. According to the September 2003 report, the SNC Program covered 8,232 credits totaling $1.6 trillion in loan commitments to 5,111 borrowers in 2003. The reports also contain an industry-by-industry breakdown of borrowers and an analysis of the overall trend.

2. The SNC Process

Every December the regulators ask agent banks to submit a list of all their loans that are covered by the SNC Program. The lists have to be submitted by the end of the following January. The inspection teams begin their first series of inspections of these loans in March.[8] On the first Monday in May the inspection teams officially vote to decide their ratings, which take into account data for January-March that become available in April. In June the provisional ratings are decided on the basis of these votes, and the agent banks are notified of the results. The banks then have the opportunity to comment on the provisional ratings, and the inspectors have the opportunity to re-rate any loans before a final rating is decided by 31 July. If a bank objects to a rating, the agent bank's chief executive officer can appeal. Finally, all the members of a syndicate are notified of the rating results in August. (Ratings are not disclosed to nonmembers, including borrowers.)

In September-October the inspectors re-review a sample of loans to identify whether there have been any changes in risk. Normally credits are re-reviewed if they amount to more than $50 million and if some portion of the credit was classified doubtful or loss at the previous review. The inspectors vote at the end of October on any credits that have been re-reviewed, and the participating banks are notified of the ratings at the beginning of December. The review cycle then starts again for the following year.

Re-reviews may, of course, be conducted regardless of this cycle if any event occurs that might affect a credit's classification.

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8 Rather than review all the credits covered by the Program, the inspectors use statistical sampling techniques and focus on particular credits (e.g., loans to industries that are expected to experience problems).

IV. The Adoption of an SNC Program in Japan

1. SNC and a "Single Shared Assessment"

The adoption of an SNC program in Japan has actually been discussed before. In September 2002, when Heizo Takenaka succeeded Hakuo Yanagisawa as Minister for Financial Services, the Financial Services Agency set up a project team to consider strategies for speeding up the process of dealing with nonperforming loans. According to some reports in the media, the team's draft interim report, the contents of which were leaked on 22 October, contained a proposal for a "shared national credit program" that would have enabled the regulator to intervene and oblige banks to accept a single rating for a borrower in the many cases where they had different ratings.

When the government's Program for Financial Revival was eventually published on 30 October, there was no mention of a "shared national credit program." Instead, the Program referred to the need for "a specific mechanism for ensuring that the major banks adopt more similar classifications for nonperforming borrowers whose assets have been properly assessed."

As was explained above, under the US SNC Program the inspectors' rating for a syndicated loan credit held by an agent bank is applied to the portions of that loan held by all the other participating banks. It is not the same thing as all the banks using the same rating for a borrower regardless of whether or not their loans to that borrower have been made under the same agreement.

There are some who take the view that Japanese banks cannot be trusted to conduct a proper internal risk assessment. Similarly, it has long been alleged that there is a wide discrepancy between banks that conduct a rigorous assessment and those that do not as well as between assessments carried out by the Financial Services Agency as part of its inspections and the internal assessments carried out by the banks themselves. It was allegations such as these that gave rise to calls for a "single shared assessment." It may have been at this time, as a result of comparisons with the SNC Program, that the misunderstanding arose that a system of single shared assessment existed in the United States.

When the government's Program for Financial Revival was being debated in the Diet, an opposition member asked (in connection with the proposal to ensure that banks adopted more similar classifications for borrowers) whether the government intended to adopt an SNC program. The response of the Financial Services Agency

was to point out, correctly, that the SNC Program worked in the United States because of the asymmetry of information that characterized loan syndicates there.[9]

2. Issues Facing the Adoption of an SNC Program in Japan

As was suggested at the beginning of this report, there has been a big increase in the demand for syndicated loans in Japan, and the time may have come for the regulators to consider adopting an SNC program similar to the one in the United States (and independently of any system of single shared assessment) in order to encourage this trend.

One of the reasons for having an SNC program in the United States is the fact that different types of financial institution have different regulators. However, even in Japan, where the Financial Services Agency is responsible for inspecting virtually every financial institution, the practice of inspecting all a bank's credits even though other banks may hold portions of the same credit is hardly efficient. Also, given the administrative burden an inspection places on a bank, the benefits of alleviating this burden are likely to be considerable. The same is true of the regulators: the effectiveness of the inspection process could be increased if the inspectors were able to use those resources for more important tasks.

If Japan were to adopt an SNC program, the regulators would have to review the existing system, where both the banks' internal risk assessments and the regulators' inspection of those assessments are done on a borrower-by-borrower rather than a credit-by-credit basis and classifications assigned accordingly. In the past, banks based their decision to extend a loan on the basis of an overall assessment of their relationship with a corporate client and the creditworthiness of its entire business. It therefore made sense for risk assessments and inspections to classify borrowers rather than credits.

However, the fact that loan syndication is based on a business model where banks assess and monitor credit risk using only the information disclosed by the borrower means that a different approach to the inspection and internal assessment processes is needed from one that is based on a relationship.[10]

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[9] During a meeting of the House of Representatives' Finance Committee on 19 November 2002.

[10] Loan Market Council report of 28 March 2003.

If the system of internal assessments and inspections used in loan syndication is to be based on credits, a different system of classification will be needed from one that is based on borrowers. Also, inspectors who are used to a system of classification based on borrowers will have to familiarize themselves with a new approach to inspection if they are to assess credits.

What the Japan Syndication and Loan-trading Association's April 2004 recommendations propose is not that banks should use the findings of the Financial Services Agency's inspections but that they should share the findings of their own assessments. The adoption of an SNC program similar to the one in the United States, where banks share the findings of the regulators' inspections, is viewed as a more distant prospect—perhaps because of a realistic assessment of the time it would take to introduce such a system.

If it is simply a matter of banks voluntarily sharing the findings of their own risk assessments, all that is really needed for this to be put into practice is for the banks concerned to agree. However, regional banks and smaller financial institutions find the administrative burden of inspections particularly heavy, so they are more likely to become interested in and actually use syndicated loans if the inspection process is simplified. From that point of view, there is much to be said for an early adoption by the Financial Services Agency of an SNC program.[11]

V. Conclusion

As was mentioned above, there are various ways for banks to transfer the risk that has tended to be concentrated on their books. These include loan sales, securitization and syndication as well as the use of credit derivatives. Unlike loan syndication, which involves dividing a large credit into a number of smaller credits, securitization involves pooling small credits in order to increase their liquidity and then tranching them to sell to a wide range of investors. Credit derivatives, on the other hand, simply reflect the relationship between lender and borrower and can therefore be used to transfer credit risk without the complications involved in transferring the underlying loan assets.

[11] In its March 2004 report "A Guide to Reforming Japan's Financial System" the Japan Committee for Economic Development (Keizai Doyukai) also recommended that an SNC program be adopted.

Hopefully, the private sector will use each of these methods to the best effect so that the risk to the financial system as a whole can be controlled properly, while, hopefully, the regulators will do their best to reform the system.[12]

[12] The Bank of Japan, acting as a secretariat, organized a Workshop on Securitization in November 2003 as a forum for different views on the subject. The results of the discussions were published as a report in April 2004. The Bank has also endeavored to encourage greater use of securitization by including asset-backed securities in those categories of securities which it may purchase outright (since 2003) as well as by plans to conduct surveys of the securitization market and remove the clause which prohibited it from transferring accounts receivable (i.e., the Bank's accounts payable).