The Japanese Experience of Long-term Finance

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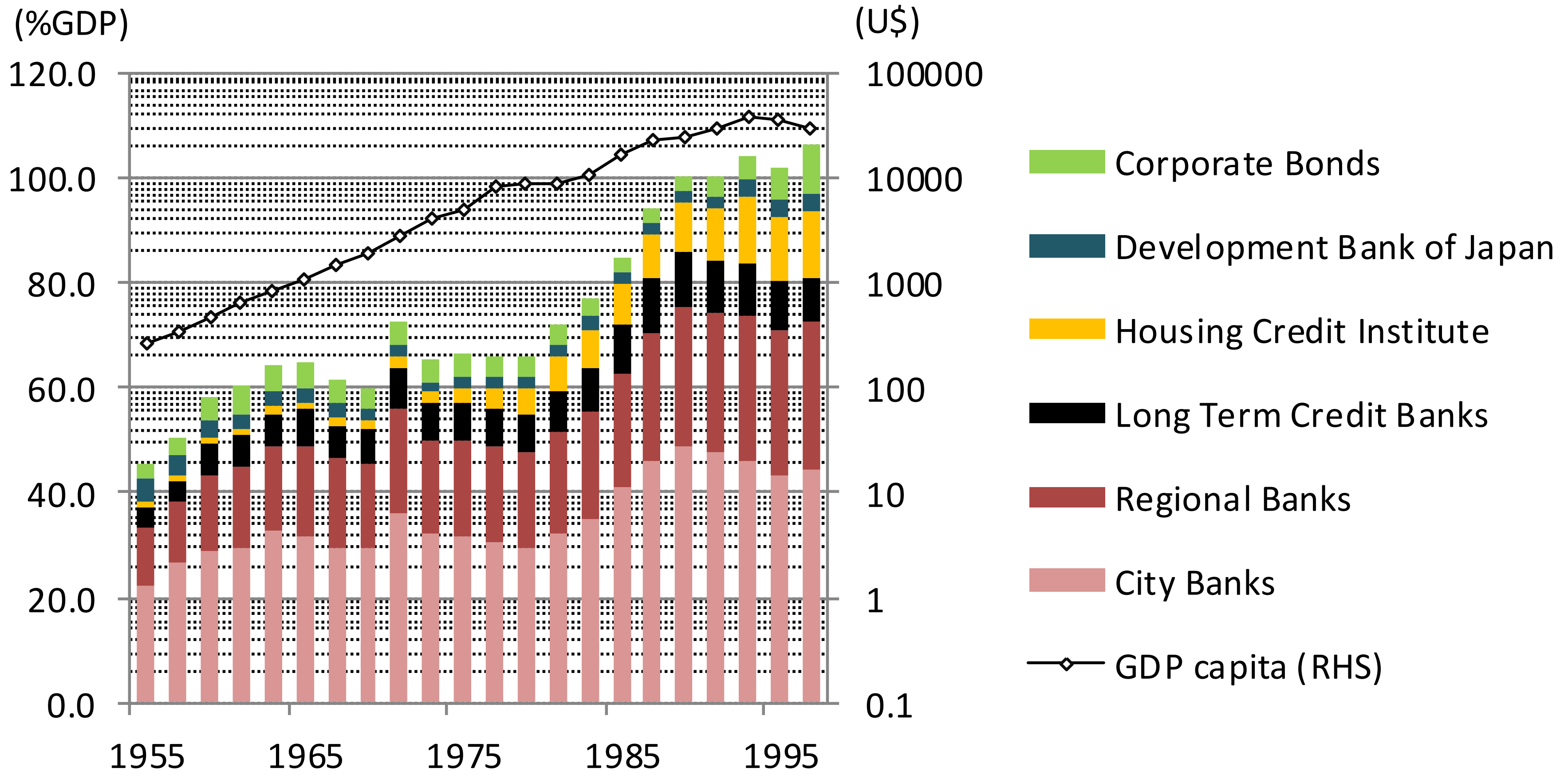
1. Overview

- As being observed in many countries, Japan's financial assets and liabilities increased as its national income rose.
- When the Japanese GDP capita was below 500 US dollars, the total outstanding of loans and corporate bonds are below 60% of GDP.
- The figure reached at a matured level, 100% of GDP, when the income level reached 20,000 to 30,000 US dollars.

Financial Structure of Japan (Amount of Loans by type of Banks)



(Source) Bank of Japan

2. Long term Finance

- Long term loans, which are alternatives to bond finance, were provided by a public bank, the Development Bank of Japan (DBJ), at an early stage of post WWII reconstruction.
- The role of providing long term loans was gradually being shared by three private special banks (long term credit banks).
- Since mid 1970s, role of a public financial institution for housing loan increased.
- On the other hand, corporate bond market remained relatively small for most of the time.

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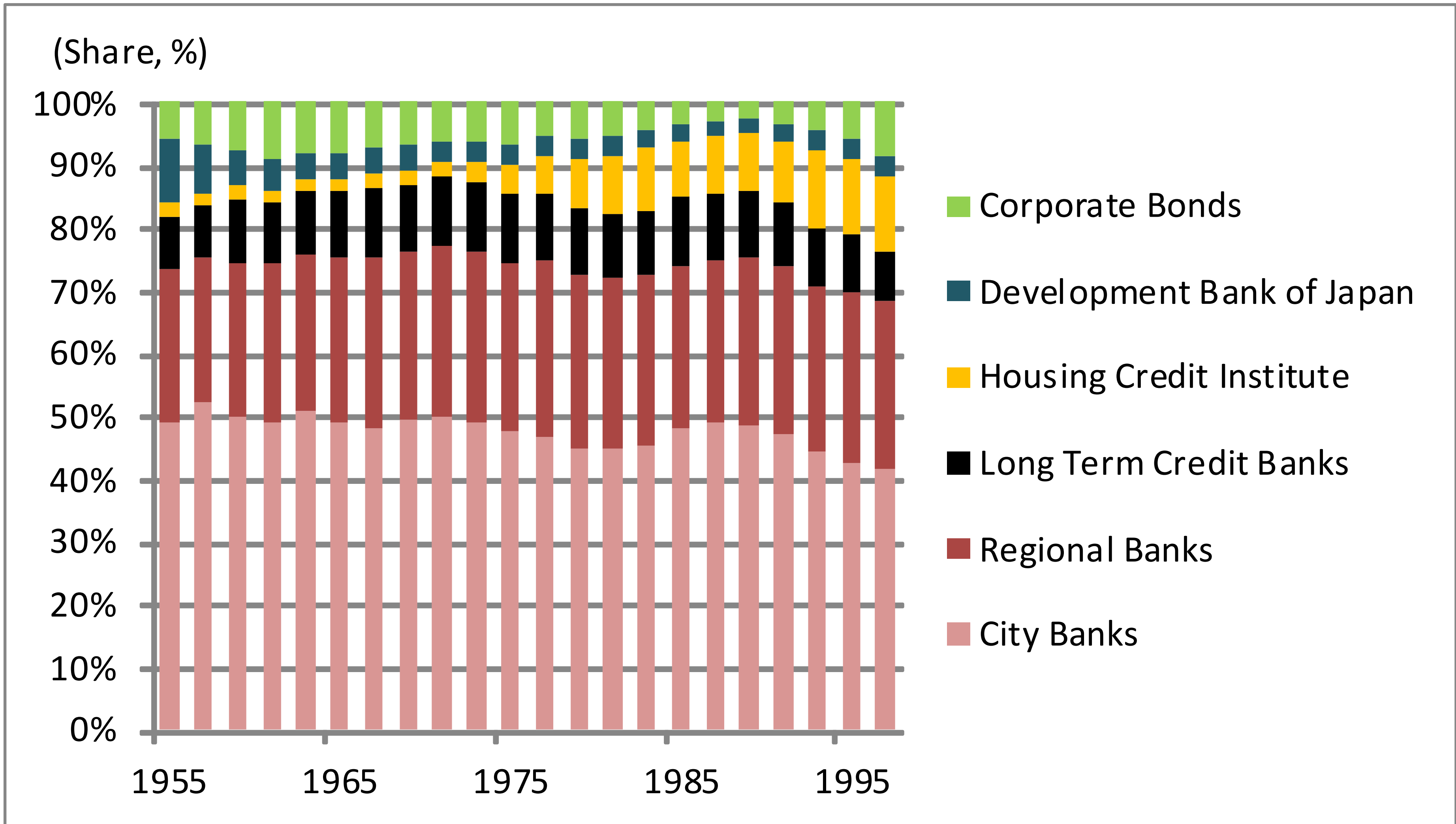


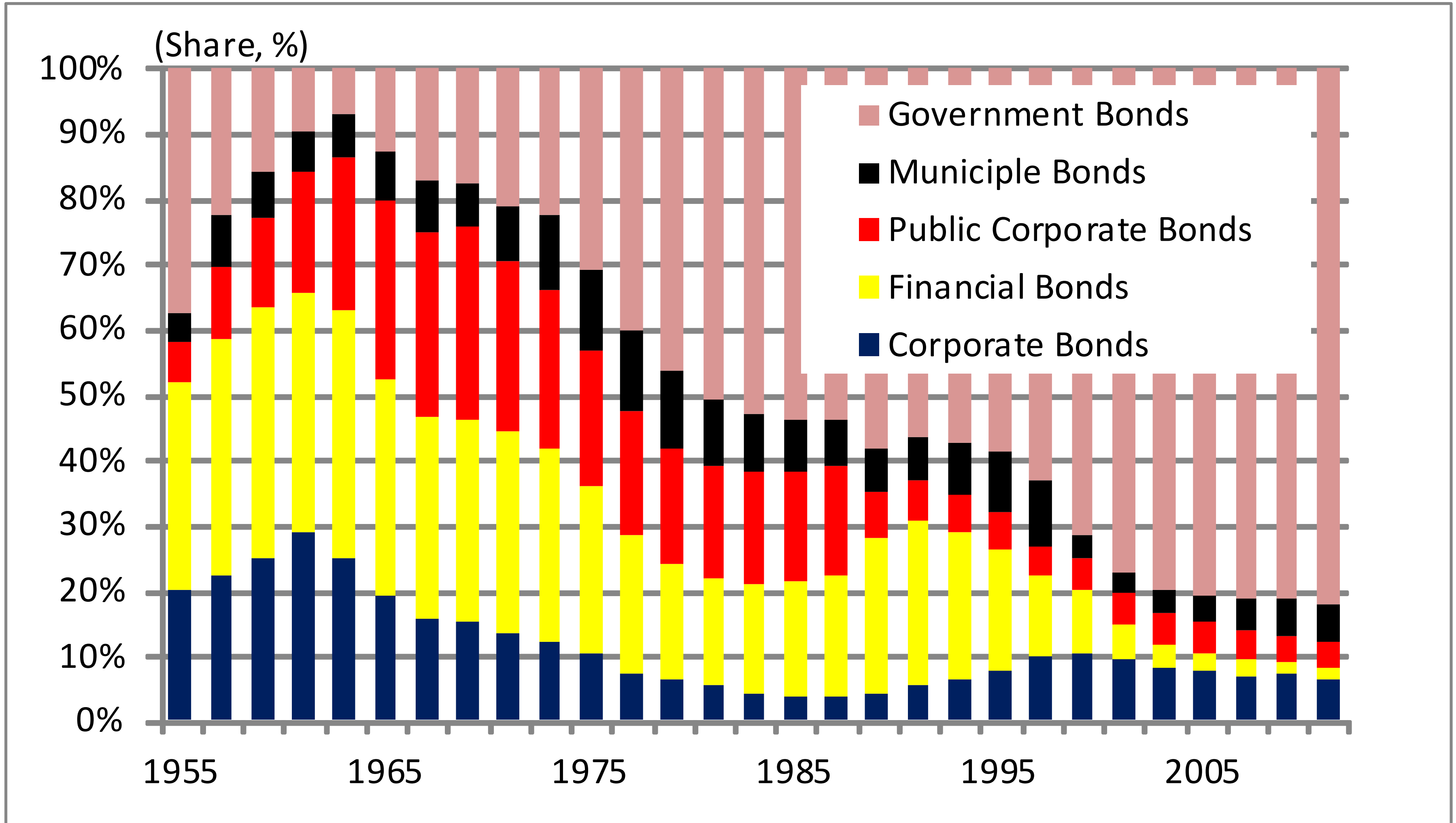
(Source) Bank of Japan

- Focusing on bonds, Financial Bonds (bank bonds) played a big role at an early stage in Japan. Financial Bonds had three types by maturity: 1 year, 3 years and 5 years.

- Only six financial institutions were licensed to issue Financial Bonds. They provided longer term loans than ordinary commercial banks (city banks and regional banks), corresponding to their bond maturity.

- This licensed “Financial Bonds” was transformed into ordinary corporate bonds issued by banks, after bond finance was permitted to most of credit institutions in 1999.

- The brand of issuers’ name is absolutely important for bond issuance. Most of issuers, therefore, are well known companies in local markets and they are usually big companies such as banks, utilities, railways, etc.



(Source) Bank of Japan

3. Role of Public Institution and Role of Private Institutions

In terms of industrial development after WWII, the Japanese financial system had a three pillar system as below.

	Banks	Purpose of loans
1	Development Bank of Japan (DBJ)	Long term finance for basic national infrastructure, development and modernization of core industries, supporting structural changes of industries and economy, DIP finance
2	Industrial Bank of Japan (~ 2000) Long-Term Credit Bank of Japan (~ 1998), Nippon Credit Bank (~ 1998)	Medium and long term finance for investment of equipment, machinery or structural facilities
3	city banks, regional banks (ordinary commercial banks)	Mainly short term finance for working funds After liberalization of banking system in 1990s, they are engaged in various kinds of loans including long term finance.

4. Housing Loans

- In addition to long term credit to industries and companies, housing loan is also a typical long term credit which most countries have.

- In case of Japan, a public housing credit institute played a big role in providing household sector with long term loans before many commercial banks expanded their business in this market since the mid 1990s.

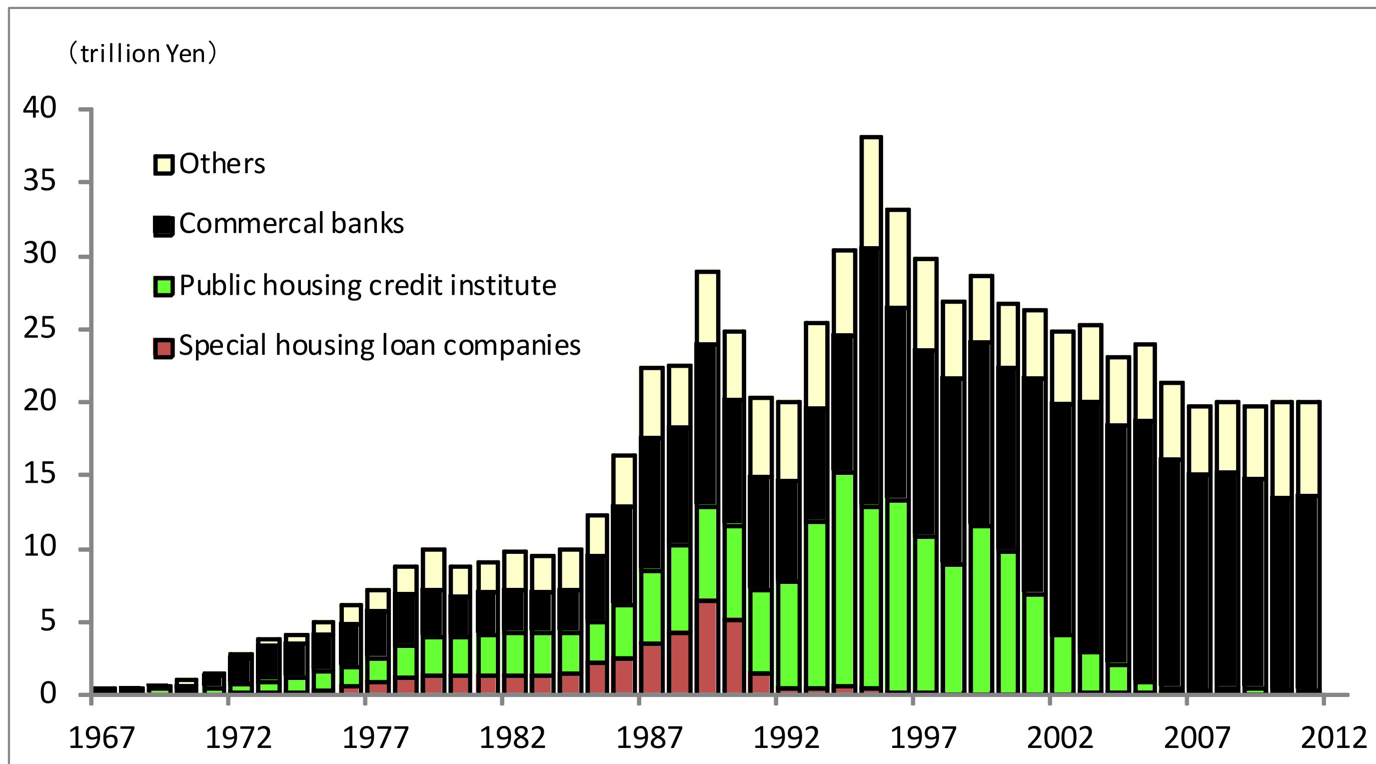
- Housing loans is one of the major sources for the development of bond market as collateral assets of securitization.

- This was observed in particular in the US which later caused the sub-prime loan crisis in 2007-2008.

- Asset backed securitization did not so developed in the Japanese market because of a weak market appetite for housing and general property assets after the burst of real estate bubble in early 1990s.*

＊ Securitization of housing loans started in the US market, based on a motivation of banks who had many non-performing housing loans after the collapse of the housing market in early 1980s. They securitized housing loans with a support of Government Sponsored Enterprises such as Fannie Mae and Freddie Mac who guaranteed the securitized bonds.

Housing Loan Disbursment by Creditor



(Source) Bank of Japan

5. Bonds or Bank loans

- Japan is a case that the industries and economy was developed under a bank dominant financial system.

- Long term money was mainly provided not by bond issurances but by specialized long term credit banks which was established under special laws.
- Also they themselves became major bond (Financial Bonds) issuers at an early stage of the development of domestic bond markets.

What makes a difference in bond finance and bank finance?

Very roughly speaking . . .

- Bond finance is for large companies who are;
  - (a) well known among investors,
  - (b) in need of large scale funding and
  - (c) capable of disclosing their credit information by publishing reports or exploring road shows.

- Bank finance is suitable for SMEs who need bankers' support for manufacturing their credit information for creditors.

The below is a table of Pros and Cons of Bonds and Bank Loans.

	Pros	Cons
Bonds	Debtors can collect money at lower costs (in theory). Bond issuance contributes to the issuer's brand strategy. Therefore bond finance is often a funding measure for large companies rather than SMEs. Investors can earn higher yield. Investors have less problem of liquidity as they can sell bonds in the secondary market whenever they like. Bond markets contribute to the development of transparent and appropriate pricings of credit in the local financial market.	Many issuing and investing conditions are strongly influenced by general sentiment of whole financial markets instead of risk profile of each debtor. Financing conditions tend to go to an extreme end from euphoria to panic. Once the issuer default, it is more difficult to minimize the economic loss for whole economy because there is no leadership to settle down the panic, whereas we can often expect the main bank to take a leading role in case of bank finance.

	Pros	Cons
Bank Loans	Debtors can collect money at higher cost but in a steady way based on a continuing relationship development with creditors. Depositors are protected from the direct loss of debtors' default as the bank absorb the loss. Depositors are also protected by deposit insurance system run by governmental organizations. In early stage of national development, scarce domestic savings can be efficiently allocated in line with the priority of industrial policy through close communication between relevant ministries/regulators (MOF, MOEF) and public/private banking sectors.	Pricing of credit can be sometimes untransparent and inappropriate. In particular, in time of rapid economic growth, shortage of credit is often covered by property collaterals (e.g. real estate), which may often cause inappropriate pricing of each loan. Long term relationship between banks and borrowers can become sometimes an obstacle for drastic restructuring of weak companies/industries. After a country becomes a matured economy where the policy priority is not clear, institutional decision-making for long term credit is not necessarily efficient and it should be modernized or liberalized.

- ✓ *Many things such as pricing, issuing and placement are more convenient in bond finance than bank finance, in time of good economy and the sentiment of financial markets is optimistic.*

- ✓ *The same things turn to be inconvenient in time of economic downturn and the sentiment of financial markets is cautious and risk-averse.*

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