Tokyo Capital Markets Closed No More

By Satoshi Naito

"Citibank has been in Japan since 1902, and we're most gratified at the advances made by the Tokyo financial markets in the last five years. The markets have been opened up very quickly, and we do not feel at all hemmed in in our operations here now." Steve Brettschneider, vice president of the Tokyo Branch for Citibank, the United States' largest bank, is effusive in his praise of the liberalization that has taken place in the Tokyo market.

Merrill Lynch, the world's largest securities company, is no less enthusiastic. As Tetsundo Iwakuni, chairman of Merrill Lynch Japan and executive director at Merrill Lynch U.S., explains, "Both Chairman William Schreyer and Vice Chairman John Heimann have been very favorably impressed with the progress made in liberalizing Japanese capital markets. Heimann was U.S. Comptroller of the Currency and the man who masterminded America's financial revolution before he joined Merrill Lynch, so he knows what he's talking about. 'Excellent' might be stretching it a bit, but they agree that the Ministry of Finance's liberalization program is very credible. On a scale of one to ten, I'd say the authorities here get a strong eight for their efforts."

Japan's commitment to liberalization and internationalization dates back to promises made at the Yen-Dollar Committee meetings in May 1984. International pressure was a major force pushing Japan toward liberalization, but the tide of liberalization and internationalization has picked up so much momentum over the last two years that it is now an irreversible trend. Looking at just a few of the accomplishments to date, liberalization has meant greater flexibility for certificates of deposit (CDs) in the domestic market, the introduction of money market certificates (MMCs), interest deregulation for large-value savings accounts, a market created for yen-denominated banker's acceptances (BAs) and the issue of short-term national bonds with less than one year to maturity. Approval has also been given for banks to deal in public bonds, and securities companies have been given the green light for credit lines with public bonds as collateral. Foreign-capital banks are now allowed to team up with local trust banks, and the number of seats on the Tokyo Stock Exhange has been expanded to accommodate foreign capital companies. Internationally, there is greater flexibility in the issue of yen-denominated Eurobonds by nonresidents and Euroyen lending has begun. Banks have also started issuing foreign-currency-denominated convertible bonds.

Interest deregulation

According to Tatsuo Aoki, until just a few weeks ago vice president at Dai-Ichi Kangyo Bank (DKB–Japan's largest bank) and now chairman of the Seibu Saison Group, "Seen from the bank's perspective, interest deregulation has proceeded very smoothly for big savers. The problem now is what to do about smaller accounts. Interest deregulation will have major ramifications for the city banks, but this is something we will have to approach positively.

"The postal savings system is the main barrier to deregulation. Exempt from the normal banking requirements on taxation, reserves and deposit insurance, the postal banking system is able to offer very attractive ten-year term accounts for small-denomination savers. There is no way the banks could match the postal service's rates if they offered a high interest rate under deregulation, and deregulation will have to be premised upon putting the banks and the postal savings system on an equal footing.

"Although progress is being made in interest deregulation, progress is slower in dismantling the regulations that restrict the scope of operations. For example, unlike North America and Europe, Japan still separates banks and trust banks, and short-term and long-term interest rates are not linked. Japan also delineates between banks and securities companies, even though this separation is being reexamined in the United States where it started. Although the walls between fields are being lowered little by little, as in the approval for foreign banks to conduct trust operations or to move into the securities fields, these options are not yet open to Japanese financial institutions, which puts them at a disadvantage in international competition."

President Yoshihisa Tabuchi of mammoth Nomura Securities adds, "Overall, things are progressing very smoothly, but there is still a number of securities market or money market areas where change should come faster.

"My first area of concern is the way the money market works. The Japanese money market is now a little under ¥40 trillion. This is only slightly over one-tenth the size of the U.S. market. The interbank market aside, progress has been particularly slow in the open market. There are still a lot of restrictions on trading CDs, BAs and the rest, and the treasury bill (TB) market is still in a state of flux. There isn't even a market in commercial paper (CP).

"The other problem is that the corporate bond market is a hollow shell. Most of the trading that takes place in the primary and secondary bond markets is in government bonds, and corporate bonds account for only 4% of companies' capital procurement. There are a number of reasons for this, prime among them the lack of progress in diversifying periods to maturity and the many barriers to issuing unsecured debentures."

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Diversified corporate banking

With this deregulation and internationalization, the relations between corporate Japan and its financial institutions, mainly banks, are undergoing major changes. Looking just at companies' financial behavior, there is considerable diversification underway both in capital procurement and asset management as a result of the heightening awareness of cost-profit analysis. This is the burgeoning *zaitech* as everybody tries to manage assets for maximum yield.

The first ramification of these changes for financial institutions has been that the banks have now become much less important in capital procurement. In the big companies, borrowing from banks accounted for 42% of their total capital procurement, including the use of internal reserves, in 1975. In 1985, ten years later, this was down to 36%.

The second ramification, and one which stems from the first, is the drop in loan interest rates and the resultant deterioration in bank profitability. More and more loans are being made at or near prime. Six or seven years ago, only a little over 20% of the city banks' loans were made at prime. Today that figure is 60%, and 75% of the loans outstanding are at prime or near-prime. Balanced against this deterioration in loan interest rates, the banks are seeing their costs go up with the spread of deregulated-interest capital such as that provided by CDs and foreign currency sources.

The spreads are much thinner for the banks today. Since 1977, the city banks have been running a negative spread when capital costs, personnel costs and other costs are subtracted from their yield on loans and other asset management.

How have the city banks responded to these changes? Yutaka Inoue, Economic Research Department general manager at the Taiyo Kobe Bank in Tokyo, says, "The first thing we've done has been to develop the so-called middle market of less famous but soundly managed companies. The second has been to vigorously expand housing loans and other personal finance operations. The third has been overseas lending and the fourth has been to expand our long-term lending. Along with expanding long-term lending, we have tried to procure more long-term capital so that maturities match. In addition, we are trying to do more spread financing to maintain long-term profit stability."

Interest deregulation started in Japan last October with deregulation of interest on accounts of ¥1 billion or more. This spring, the limit was lowered to ¥500 million and it is expected to keep going down—to ¥300 million in October and ¥100 million next April. At the same time, it will become possible to issue CDs of ¥50 million or more and MMCs of ¥20–30 million. In effect, interest will be deregulated on all accounts of ¥20 million or more in just one more year.

This deregulation of large-account interest rates is having a major impact upon the relations between companies and their banks. "I expect interest deregulation to drive saving interest rates up, and as such I find it a very welcome trend. In Hitachi's case, we do most of our asset management short-term with CDs and in the *gensaki* repo market, but we are also open to term deposits and somewhat longer-term management. Since different banks will be offering different interest rates, it is only natural that we will be looking to expand our deposits with banks that offer higher interest." So says Hitachi Vice President Yasuo Miyauchi.

For the leading city banks, 15% of their deposits are from 1,000 companies with ¥1 billion or more. But when this figure drops to ¥100 million or more, it jumps to 30% from 10,000 companies. Higher interest rates will clearly result in higher costs. However, very little of this is purely deposits, the bulk being debtor deposits or compensating balances linked to loans from the bank. In most cases, the bank will lend at the prime rate and then require that 30% or so of the total be deposited in a one-year term deposit. As a result, the actual lending rate is higher than prime and the bank can make money on the spread. With interest deregulation, banks wanting to make the same spread as before will have to either raise the rates on their loans or require larger compensating balances. Yet the long-term financial deregulation trend is toward lower interest rates on loans, and the banks are losing their clout with the big companies.

As Mitsui & Co. Vice President Seiichi Kito explains it, "For the trading companies with compensating balances, the issue is not so much whether savings interest rates go up or not but rather what they are actually paying over the market rate." Given this, spread lending may be expected to increase among the trading companies and other borrowers. Former DKB Vice President Aoki agrees: "Banks will have to do more spread lending and overseas asset management, or they will end up with no spread at all. Things are really going to get tough from here on out."

In the past, companies were closely tied to their main banks both in lending and in deposits, but as spread lending comes into its own, companies will prefer to borrow from the banks with the lowest interest charges. This means that companies will be looking to borrow from a range of banks, and compensating balances will become things of the past. Yet Aoki contends that, "The relations between the company and its main bank are not going to change all that quickly. The companies and banks are linked in more than simply deposits and loans. The banks also refer customers and perform a myriad of other services for their clients, and this underlying relationship is not going to go away overnight." Even so, we are moving into a buyer's market in financial services, and companies are going to be looking—and looking not just at banks but at the whole range of financial possibilities—for financing costs that are even one point lower.

Decollateralization

So far, we have examined interest deregulation mainly from the banks' standpoint, but what does this deregulation and internationalization of capital mean for companies?

Looking at how a large company capitalized at ¥1 billion or more goes about outside capital procurement, borrowing has dropped from 69% three years ago to only 43% as of the end of 1984. There has also been a major drop-off in impact loans. By contrast, corporate bond issues have jumped sharply, from 7% three years ago to 20%. Of this 20%, nine-tenths is foreign-currency-denominated convertible bond issues. New stock issues have also jumped, from 24% three years ago to 36%. Of these new issues, only 0.6% is in the form of depositary receipts (DRs) procuring capital overseas. In the total external procurement, the balance between yen and foreign capital is now 77:23. Yet it is borrowings from banks (including yen borrowings and impact loans) that have shown the sharpest change between 1981 and 1984, dropping off sharply even as companies have surged into foreign-currency-denominated CB issues and domestic current-price stock issues.

These same big companies are also changing the way they manage their assets. Comparing the different instruments' proportions of the total percent-

age increase in assets from the previous year in 1981 and again in 1984, cash and savings accounted for 37% of the 1981 increase and –33% of the 1984 increase. By contrast, CDs were only 12% of the 1981 increase but 41% of the 1984 increase. Likewise, foreign-currency savings were 9% of 1981's increase and 23% of 1984's and public bonds and other securities were up from 41% of 1981's increase to 68% of 1984's increase.

In terms of interest deregulation, the big companies' asset managers increased their holdings of interest-controlled instruments 37% in 1981 and decreased them 33% in 1984. Conversely, interest-deregulated instruments were up 31% in 1981 and 97% in 1984, and foreign currency was up 14% in 1981 and 45% in 1984. These are all striking changes.

Ryoichi Kawai, chairman of Japan's largest construction equipment manufacturer, Komatsu Ltd., and past chairman of Keidanren's Special Committee on Corporate Finance, says "I have the feeling that Japanese financial deregulation is moving along pretty well. Japan's postwar financial system was established with the primary purpose of getting industry up on its feet and providing low-interest capital from the banks and financial markets. Accordingly, there was a clear delineation between banks and securities companies, short- and long-term interest rates were unlinked, and interest rates were regulated. However, with the trade and capital liberalization in 1965 and beyond, the issue for industry has been how it can become more competitive internationally, and it has become imperative that our interest structure be roughly the same as in other countries. Komatsu found it was a real hassle to issue its first overseas CB in 1964. We were pioneering in this field, and the only other Japanese company that had done this was Sony, so we were pioneers in a way. Basically, we were trying to get the lowest possible interest rates, but interest regulations were still very tight, and the financial system was emerging as a barrier to Japan's industrial development. Things have loosened up considerably with the oil crises and all the other changes that have taken place in the two decades since then, but there is still a long way to go."

Specifically, Kawai calls for the following reforms. "First, the scope for unsecured debentures needs to be radically enlarged. Second, the domestic short-term financial market needs to be enhanced. It is true that a market was created for yen-denominated BAs last year, but the need for revenue stamps and all has meant that this is a high-cost source of funds and the market structures lie dormant. We need to have more ordinary corporate bonds issued on an unsecured basis. Manufacturers may have the machinery, facilities and other things to put up as collateral, but the trading companies and other service-sector companies do not always have collateral. With the service sector becoming an increasingly important part of the economy, we need to devise new systems to complement the secured debenture markets. This means more than just having credit-rating organizations, and it should eventually mean the issuance of CP. This is essential for industry, and these structures have to be put into place as soon as possible."

Hitachi Finance Director Nobuji Kamachi agrees. "Given the international acceptability of unsecured debentures and all, it is to our advantage to have as many options as possible, including CP issuance. Trading companies may want to issue CP as a means of raising short-term capital, but CP is not as important to manufacturing firms. Still, CP is very attractive for both capital procurement and asset management. In corporate bonds too, it would be better to have a greater variety available, from very short-term to very long-term."

There has, in fact, been a surge of interest in CP issues recently. Keidanren formed a Subcommittee on Corporate Finance in February with Hitachi's Vice President Yasuo Miyauchi as chairman and members drawn from the comptrollers of 37 leading companies, and this committee is now studying the whys and hows of introducing CP into Japan.

Securities companies are also interested. A working group has been formed around planning section personnel from Japan's Big Four securities companies (Nomura, Daiwa, Nikko and Yamaichi) that is busily preparing for the day when CP issues will be allowed. However, the banks have come out squarely against the creation of a CP market, arguing that Japanese finance is premised upon secured financing and that the introduction of unsecured CP would disrupt credit markets and undermine investor protection. Mitsubishi Bank Executive Director Tsuneo Wakai is concerned that the close relations between companies and their main banks may be destroyed. "Allowing CP will wreak fundamental changes in the relationship between bank and client. There will be no need for the bank to hold shares of its clients' stock, and we will have to liquidate some of our positions."

Despite the lack of agreement, it is clear that CP will rank alongside interest deregulation on small-amount accounts as a major issue in the next capital liberalization program.

Further demands

Yet even the foreign banks and securities companies, satisfied though they are with the progress made so far, are not entirely happy. The Tokyo capital market has come to rank with the New York and London markets, and they are making a determined effort to score big here. As Citibank's Brettschneider says, "The competition among banks, securities companies and other financial institutions has gotten much fiercer in the Tokyo market, just like in other international markets. I would not be at all surprised to see more cases like Sumitomo's salvage of Heiwa Sogo Bank. We think this is a major opportunity for Citibank, and we would like to acquire a Japanese bank. Citicorp has acquired a number of banks in Italy, Spain and elsewhere over the last couple of years, and we would like to use our experience to make Tokyo a major center for our retail banking operations."

Merrill Lynch was in the first wave of foreign securities companies to gain seats on the Tokyo Stock Exchange this February, and they are now working hard getting ready for their own listing on the exchange. According to Merrill Lynch's Iwakuni, "How can we urge other foreign companies to go for listing on the Tokyo Exchange if we aren't listed there ourselves?" Rapid-paced internationalization has come to the Japanese securities markets both with the admission of foreign securities companies to the exchange and with the foreign companies' rush for listing.

Yet Iwakuni argues that there will be still further demands for deregulation and internationalization. "To tick off just a few of the areas that need attention, there are (1) deregulating savings account interest rates, (2) CP issuance, (3) establishment of an orderly TB market, (4) dismantling restrictions on cash management accounts (CMAs) and other financial products that are used overseas, (5) approving the establishment of more foreign-capital financial institutions as local companies and (6) opening the corporate pension market."

Japan's capital markets have undergone major liberalization in recent years, but the party is far from over. ●