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JAPAN IN THE CAPITAL MARKETS

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TIMES HAVE changed since the West regarded Japan as a futuristic economy possibly about to overtake the US, but now the country looks like the future for a different reason: with its exceptionally loose monetary policy, it is several steps ahead of where other developed countries appear to be heading.

Western pessimists talk of “Japanification”, but this term implies that Japan’s monetary policy is somehow a fixed state to be reached. It is not: it must evolve amid renewed global growth fears and domestic pressure. How well it will be able to do so is unknown.

Amid the doom and gloom, it is easy to forget that Japan looks to have grown quite strongly in the first half of the year: by 0.6% in the first quarter and by 0.4% in the second (estimated on a preliminary basis).

“People’s forecasts are gradually being forced up in an environment where in the rest of the world everything is getting ratcheted down,” says James Malcolm, chief Japan economist at UBS in London.

Aside from global growth, the incoming rise in consumption tax is preoccupying Japan-focused economists. The rise from 8% to 10% is set to go ahead on October 1, after being delayed twice. While it is accompanied by offsetting measures, it is expected to dent demand.

Weak consumer sentiment after the introduction of the tax could well lead to two consecutive quarters of economic contraction across the turn of the year and force the government to turn on the spending taps, according to Yujiro Goto, head of FX strategy, Japan, at Nomura in Tokyo.

However, compared with the previous hike, the amount of frontloading in household spending “is likely to be limited”, according to a Bank of Japan report from July. This suggests it might not fall too much afterwards.

“There is still good reason to think that the drag won’t be as big as after the last two tax hikes,” says Marcel Thieliant, senior Japan economist at Capital Economics in Singapore.

Elsewhere, a spat between Japan and South Korea is also causing unease. It originated from a Korean court ruling against Japanese firms relating to wartime forced labour, and has now spread to trade policy.

Japan has restricted exports of certain chemicals and removed South Korea from its exports “white list”.

[President Shinzo] Abe’s playing a dangerous game, I’m not sure where it’s going to end up,” says Thieliant.

However, the short-term economic impact is likely to be muted. While ordinary Koreans have reportedly been boycotting Japanese imports, Thieliant notes that consumer goods impact is likely to be muted. While ordinary Koreans have reportedly been boycotting Japanese imports, Thieliant notes that consumer goods make up a small proportion of the country’s exports to South Korea, while Korean firms cannot easily replace what they import from Japan.

Pressure to ease
Although the economic picture in Japan is not catastrophic, analysts think governor Haruhiko Kuroda’s Bank of Japan is likely to ease conditions at its next monetary policy meeting on September 18 and 19. The timing of it gives it a chance to react to September’s meetings of the US Federal Reserve and the European Central Bank.

“The hope had been that the external situation would be improving around the middle of year and you’d get this immaculate transformation where the external environment picks up the slack from the domestic environment and everything would net off very nicely,” says Malcolm.

“But what’s clearly not happened is improvement on the trade war side, so those external risks have grown, which pushes back the whole notion of recovery and leaves you more vulnerable.”

An alternative view comes from Thieliant, who thinks the central bank could well wait for concrete evidence of economic weakening, which may come in only after the tax hike.

“Until then I think they will be very reluctant to ease even if exports are not doing well, as long as demand is holding up.”

Beyond exports and domestic demand, one pressure to change policy is that the government 10 year bond yield has been trading below the central bank’s perceived target range of 20bp to -20bp. And this contributes to a flattening of the yield curve, putting pressure on financial firms.

“The 10 year yield has fallen sharply and the curve has flattened so much that they require additional action of some shape or form,” says Malcolm.

At the same time, the yen has been appreciating (see chart) as investors pile in to what they perceive as a global safe haven. This can put downwards pressure on inflation.

BoJ’s Kuroda will be called to open box of tricks once more
An increase in the consumption tax rate will hit Japan’s economy, analysts warn. Alongside a strong yen and global growth fears, this is likely to push the Bank of Japan into further easing measures.

With banks creaking under the strain of low rates, Japan’s central bank, under governor Haruhiko Kuroda, will have to concoct a delicate mix of stimuli. Jasper Cox reports
Helping build vibrant regional communities

JFM, Japan’s sole municipal finance agency, raises funds from the global debt market to provide concessionary financing to municipal entities for vital public projects including water infrastructure, transportation systems, and healthcare facilities.

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Wholly owned by Japanese local governments
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“If dollar-yen looks like it’s going to be structurally lower from here, i.e. the yen appreciating significantly, the Bank of Japan has to be wary of what that does to their main target variable, which is inflation,” says Malcolm. “Below 105 and particularly below 100, you start to get into a situation where FX affects expectations a lot more domestically and weighs on profits a lot more.”

However, Thiébaut thinks that the yen would need to rise by 15%-20% more for the central bank to ease. If easing looks likely, the question then turns to how to do it. Particularly if the central bank wants to avoid too much damage to the banking sector, which has been hammered by falling net interest margins.

“The Bank of Japan’s view is that the side effects of loose policy on the banking sector build up cumulatively, so the longer you keep policy loose the bigger the side effects,” says Thiébaut.

One option for the Bank of Japan would be to accompany a rate cut with a new lending scheme at negative rates for the banks. “Our understanding is that the BoJ has been increasing dialogue with banks in recent weeks hypothetically around these kinds of issues,” says Malcolm.

However, the banks may not be the priority.

“Some on the [policy] board say: ‘Leave the banks to stew, there’s too much capacity, it’s a structural issue, there’s nothing that monetary policy can do. If anything, stimulative policy helps the economy generally and therefore indirectly supports banks much more than if you directly tried to help them by keeping front end rates higher,’” says Malcolm.

Focus on fiscal?
Perhaps the smallest change would be extending forward guidance out beyond next spring. Would this be enough? “Just extending forward guidance will suggest that the Bank of Japan has no policy options so markets see that the BoJ cannot do anything further,” says Goto. “That’s quite risky.”

As for the 10 year yield target, could a change be in order? Freya Beamish, chief Asia economist at Pantheon Macroeconomics, said in a recent note that Kuroda could overlook the breach of the target range.

She is less convinced than some other analysts that the Bank of Japan will do much in the way of easing.

“Most likely, the statement will simply ignore the reality,” she wrote. “It’s possible, however, that he could explicitly widen the band around the target, to signal that it is not completely out of sync with central bank moves elsewhere.”

Then there is the option of a short-term interest rate slash. A cut from the current level of -10bp would help steepen the yield curve. Malcolm thinks that around -50bp would be the absolute limit for where the policy rate could go before it starts becoming contractionary as opposed to expansionary.

He thinks steepening the curve may not require too much work. “You can support the back-end of the yield curve if the market has more belief in reflation. If you can convince the market that what you’re doing is going to be effective, you probably don’t need to do very much.”

Weighing on the Bank of Japan’s mind might be its experience of cutting rates in January 2016. Afterwards, equity markets cratered and the yen shot up, although this was also a rough period for markets around the world, at a time of fears about global economic growth.

Of course, different options — like short-term rates, the 10 year yield target, forward guidance and quantitative easing — are not mutually exclusive. The Bank of Japan may decide that a variety would work best. “They recognise there’s not a lot of scope in any of those items individually,” says Malcolm. “Their idea is if you combine them, you can create some offsets, you can create a synergistic effect between them.”

How Japan decides to react in the coming months is of interest to the rest of the world’s economists, given those Japanification fears. But, after years of focus on central bank moves, perhaps fiscal policy could now come into the spotlight.

“In the current Japanese environment, there is a strong case for continuing to run primary deficits, perhaps even to increase them and to accept a higher debt level,” wrote Olivier Blanchard and Takeshi Tashiro, fellows at the Peterson Institute for International Economics, in May. “Primary deficits help sustain demand and output, alleviate the burden on monetary policy, and can increase future output. In short, the costs of primary deficits are small, and the costs and risks of high debt are low.”

While Japan has an exceedingly high gross debt to GDP ratio of about 235%, its borrowing costs are light and inflation remains stagnant.

“If the government were to say: ‘We will increase spending every year by 5% or 10% until we get to the 2% inflation target,’ that’s an environment in which I think you would change market expectations very quickly,” says Malcolm. “And that would have global implications.”

The sceptical view of global central bank easing says that Japan is out of bullets. But there might be another caseload of ammunition marked “fiscal policy” to open up.

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**Proxies for easing? Dollar-yen exchange rate and TOPIX banks index**

Since May, the yen has strengthened against the dollar as global investors seek a safe haven. This could put pressure on the Bank of Japan to ease monetary policy. However, low rates harm the banking sector, which has witnessed a fall in share price since May.

*Source: Bloomberg*
Samurai no longer the only choice for international issuers

An explosion of international issuance in yen is being accompanied by a re-evaluation of traditional routes of access into Japanese capital markets. Euroyen deals and Tokyo Pro-Bonds are rapidly establishing themselves as viable alternatives to the Samurai bond market. **Tyler Davies** reports.

**THE TOKYO STOCK Exchange** had grand ambitions when it launched Pro-Bonds in 2011.

In outlining a framework for the new debt market a year earlier, the exchange had said to expect that Pro-Bonds would be “as competitive as the Euromarkets” and would eventually become “a central bond market for the Asian region”.

For the best part of the last eight years it has been difficult to support these claims.

**International issuers** have mostly stuck by the most traditional method of accessing capital in Japan: using local debt programmes to issue Samurai bonds.

But since 2018, this has started to change. Amid a boom in international issuance in the yen market, foreign borrowers have begun to embrace new ways of financing themselves in Japan.

Nearly a quarter of all overseas bond issues in yen have arrived in Tokyo Pro-Bond or Euroyen format in the last two years, according to Dealogic data.

This represents a steep increase compared with the years 2015-2017, when Samurai bonds made up about 90% of overall supply volumes.

“As with the introduction of all new formats, there is always going to be an element of inertia at the outset,” says Morven Jones, a managing director and head of debt capital markets for Europe, the Middle East and Africa at Nomura in London.

“But what has happened over the past few years or so is that issuer and investor familiarity with Pro-Bonds has grown to the extent that the Pro-Bond route is now more comparable with what can be achieved in Samurai format.”

The Pro-Bond market was designed to give both Japanese and international issuers a quick and simple way of accessing yen liquidity.

It is therefore easy to see why this route has proven particularly popular among first-time borrowers, who are often unsure about how local investors will receive them.

**CPI Property Group** is a good case in point. In late 2018, it became the first non-financial issuer to make use of the Tokyo Pro-Bond market when it launched its debut issue of yen-denominated debt.

The company, which owns real estate in the Czech Republic and Germany, was able to raise ¥12bn through a placement of three and 10 year notes in December.

**Ground-breaking**

Though that only works out at about $110m in dollar terms, CPI Property Holdings said that it was very much pleased with the result of its ground-breaking transaction.

The firm was not looking to raise large sums of money in Japan, but it had nonetheless found a plausible way of diversifying its funding sources.

“Having a really unique and dedicated separate pool of capital that we can go to for modest size deals is really attractive,” says David Greenbaum, chief financial officer at CPI Property Holdings in Luxembourg. “The euro market is our core market: if we need to issue €500m or more, that’s where we’ll be going. But for smaller transaction sizes we would really like to be a regular issuer in Japan.”

In this respect, Greenbaum describes the Pro-Bond market as having been a “no-brainer”.

Setting up an issuance programme for Samurai bonds is famously complicated and expensive. There is a mountain of legal documentation that has to be completed in Japanese, and issuers also have to commit to translating all of their financial results into the local language.

But borrowers can simply use their euro medium term note (EMTN) programmes when selling a Pro-Bond. They only have to complete a short form in Japanese to ensure that they can list their deals on the Tokyo Stock Exchange.

It was this simplicity and ease of access that also appealed to Intesa Sanpaolo, which has completed two Pro-Bond sales in Japan in the last two years, for a total of ¥59.8bn.

“The Samurai market is the most liquid and the most prestigious in Japan,” says Alessandro Lolli, head of group treasury and finance at Intesa Sanpaolo in Milan.

“But given that we are a newcomer and investors are not yet willing to buy huge deals from us, the Samurai market is pretty much off the table. It would be too expensive and too complicated to set up a programme.”

But it’s not only newcomers that have been experimenting, even well-established issuers have started to look at alternative routes into the yen market.

**Sales of Euroyen deals** have shot up over the last couple of years, for example, supplementing the
usual run of Samurai bond issuance. Euroyen deals are very similar to Pro-Bonds: they mean that borrowers can launch new deals very quickly and cheaply, without setting up a new issuance programme and without having to translate vast swathes of documents into Japanese.

This format has proven particularly attractive for foreign banks, many of which have had good reason to want to access the yen market as quickly and efficiently as possible.

In June 2019 the Japanese Financial Services Agency raised the risk weighting that local bank treasury investors must apply to senior bonds that count as total loss-absorbing capacity — an international measure of a bank’s financial strength.

TLAC issuers getting in with new sales before the June deadline would therefore be better able to attract investment from Japanese bank treasury teams, who would still be using the old risk weight system.

This was a big driving factor behind a surge in Euroyen issuance in 2018 and early 2019, from the likes of BNP Paribas, Crédit Agricole, Goldman Sachs and Société Générale.

“Some issuers have gone for Pro-Bonds or Euroyen deals based on considerations around timing,” explains Shun Machiyama, a vice president in the capital markets department at Nomura in Tokyo.

“You have a lot more flexibility in terms of going out and marketing new transactions in either of these formats. So if the conditions look good, you can gain access to the Japanese market very quickly.”

Borrowers from overseas raised a whopping ¥2.9tr from 114 deals in yen in 2018, making it their busiest year for issuance in the currency since the financial crisis.

With the market on course for another big year in 2019 — deal volumes had already hit ¥2.18tr by the start of September — the value of being able to access yen liquidity quickly is unlikely to diminish any time soon.

This is something that was recognised by France’s Groupe BPCE when it raised €62.1bn with a Euroyen offering earlier this year, ditching the Samurai bond format for the first time since December 2012.

The deal came after the JFSA raised risk weights on TLAC senior debt in June, but Roland Charbonnel, director of group funding and investor relations at BPCE, says that it was still the “flexibility you can get in term of timing” that most attracted him to the Euroyen product.

“We wanted that flexibility because we were trying to avoid competing supply, which can affect the spread level and the size you are able to achieve in the market,” he explains.

Charbonnel found that switching to Euroyen had little impact on the outcome of the transaction.

“We only lost a small amount of demand because of the choice of format,” he says. “Whenever we consider doing a public issue in the Japanese yen market, we will either do a Samurai bond or a Euroyen deal.”

BPCE is unlikely to be the only international issuer that is now weighing up its options for how to approach the bond market in Japan.

If there is one thing that the recent boom in issuance of Euroyen deals and Tokyo Pro-Bonds has proven, it is that investors are more than willing to buy these kinds of deals as they broaden their hunt for yield.

Nearly 70% of all of the Euroyen and Pro-Bond issuance of the last five years has arrived in the last 20 months, as the products have rapidly begun to establish themselves as alternative to Samurai deals.

The wheels of change move slowly in Japanese capital markets. But there have been some very clear signs of evolution in recent years.

The Tokyo Stock Exchange’s claim that Pro-Bonds could end up becoming “a central bond market for the Asian region” may have seemed too punchy back in 2010.

Increasingly, however, it is easy to see how Pro-Bonds and Euroyen deals could come to play an essential role in the development of the Japanese yen market internationally.

Japanese capital markets: a sleeping green giant?

The Japanese government has made a series of moves aimed at promoting the development of a more vibrant market for socially responsible investments in Japan.

Many of the country’s big financial players are now starting to reshape their businesses to make themselves more sustainable and environmentally friendly.

Nippon Life Insurance Company has recently committed to investing ¥700bn (€6.53bn) into SRI bonds by 2021, for example.

But despite the year on year increases in the volume of securities issued to back environmental, social and governance (ESG) goals, there is still a dearth of relevant supply in the domestic market.

DCM officials suggest that, in this context, there is something of an open goal for international issuers in Japan.

“Japanese investors are especially interested in ESG bonds,” explains Shun Machiyama, a vice president in the capital markets department at Nomura in Tokyo.

“Whenever we consider doing a public issue in the Japanese yen market, we will either do a Samurai bond or a Euroyen deal.”

Roland Charbonnel,
BPCE
Banks face up to new TLAC investment rules in Japan

A surge in international bank issuance has carried on almost uninterrupted in the yen market this year, even after the Japanese Financial Services Agency raised the bar on investments in total loss-absorbing capital (TLAC).

TLAC has been a driving factor behind a lot of the debt issued by global systemically important banks (G-SIBs) in recent years. But in 2019 the JFSA made it more punitive for bank treasury investors to invest in TLAC paper from financial institutions. The agency introduced new rules from April that mean Japanese banks will have to put a 250% risk weighting against any TLAC-eligible senior debt they buy — the same as for subordinated tier two bonds. This is much higher than the 20% risk-weight the bank treasuries had previously had to apply to these TLAC senior bonds.

Despite the changes, foreign banks have remained very active in the yen market in 2019. They had supplied Japan with ¥1.22tr ($11.12bn) of debt issuance in the first eight months of the year, having sold a staggering ¥1.97tr in 2018. That’s partly because the new risk-weight system has not completely drained demand for TLAC paper in the yen market, as Japanese investors of all types continue hunting for new sources of yield. And smaller banks subject only to the minimum requirement for own funds and eligible liabilities (MREL) in Europe have also been able to benefit recently, given that MREL-eligible senior bonds have remained subject to a 20% risk weight in Japan.

Amid the healthy volumes of international bank debt supply in yen, some issuers have been experimenting with new approaches and formats. Newcomers have leaned on the Tokyo Pro-Bond market as a gateway to yen liquidity, while stalwarts of the Samurai bond markets have considered whether there might be value in complementing their funding strategies with Euroyen deals in Japan.

Finally, talk is also beginning to turn about the possibility of a burgeoning green bond market in Japan. GlobalCapital asked prominent borrowers in the yen market for their thoughts on what has been a very interesting period for international bank issuance in Japan.

GlobalCapital: How would you describe the financing conditions we have seen in the yen market this year? Would you say that it has been a good year?

Alessandro Lolli, Intesa Sanpaolo: Up until now I would say 2019 has been the year of the euro market. Many big US corporates have visited the euro market, for example. And at the end of June, consistent with Intesa Sanpaolo’s business plan presented at the beginning of 2018 by our CEO Carlo Messina, we issued a €2.25bn dual-tranche deal of five and 10 year bonds in euros, which was the largest euro transaction on record for an Italian bank and was priced between 30bp and 35bp, respectively through BTPs. That gives you some idea of just how compelling the euro market has been in terms of both size and cost.

In a sense it has taken some supply away from the dollar and the yen market. If I look at the numbers on the Japanese market — including Samurai, Tokyo Pro-Bonds and Euroyen deals — I see that in 2018 we had roughly ¥3.25bn in issuance and year to date we have about ¥2bn. So the volumes are lagging behind a little, though it is not a dramatic decline.

Roland Charbonnel, director of group funding and investor relations, BPCE: I would say that funding conditions have improved across the year in some ways. It is our usual policy in the public Japanese yen market to do two bond issues each calendar year. We did one transaction in January and one in June, but the spread levels were very different at these times.

In January spreads were quite wide because of issues around the US-China trade war and also partly because of the monetary policy of the US Federal Reserve. We would probably have postponed the bond issue, but we had not been very active in any currencies and we didn’t want to end the month without having done any funding. The resulting deal had five tranches, including both senior preferred and senior non-preferred notes.
It was our biggest ever bond issue in the Japanese yen market, at ¥163.6bn, and the demand was definitely tilted towards the senior non-preferred bonds. At the time we were paying a high single digit ‘diversification premium’ over our euro levels—except for the 10 year senior non-preferred tranche where we had an arbitrage versus euro.

Spread levels then tightened quite a bit between January and June. For our deal in June we paid a smaller ‘diversification premium’ compared with the January issue—it was in the mid-single digits rather than in the high single digits. The June bond issue was smaller though, at ¥62.1bn overall. Only ¥6.5bn was in senior preferred format and ¥55.6bn was in senior non-preferred, so again the demand was tilted towards the non-preferred notes because they give more yield to investors.

**GlobalCapital**: Lloyds and Société Générale have both been active in the yen market this year: how have you found funding conditions?

**Peter Green, Lloyds**: Overall, I’d describe the conditions in the Japanese yen market as supportive and pragmatic. Funding volumes seem to be lower, but the investor base continues to be supportive to trades despite the more challenging macro backdrop. For instance, when we did our trade it was against a backdrop of UK specific and global macro headlines. The investors stayed the course though and we were delighted with the outcome we achieved.

The main change in conditions this year has been the diversification in demand from investors for TLAC versus MREL. G-SIB issuers have met with lower levels of demand for senior non-preferred or holdco issuance, given the higher risk weights that apply to TLAC issuance versus MREL product—regional support for TLAC trades has generally been lower.

**Vincent Robillard, Société Générale**: This is true that the regulatory change introduced by the Japan Financial Services Agency in April this year had an impact on demand for TLAC eligible instruments, especially from regional accounts—regional banks, Shinkin banks and regional public funds. As a consequence, we have observed a decrease of the international Yen market so far compared to the same period in 2018.

Having said that, the participation from central accounts has remained strong and the yen market continues to offer solid financial conditions. As an example, we successfully tapped this market in February with the Group’s first Euroyen Senior non-preferred transaction: a ¥96.2bn five and 10 year offering, enabling Société Générale to broaden its investor base, especially with regional investors ahead of the FSA change of guidance.

**GlobalCapital**: Is it therefore fair to conclude that, overall, the introduction of new risk-weight requirements has weakened demand for TLAC paper in Japan? Since April, bank treasury investors have had to apply a 250% risk-weight to TLAC-eligible senior bonds.

**Robillard, Société Générale**: As expected, the introduction of higher risk-weights for TLAC has resulted in a decrease of the demand from banks, in particular regional banks. On the contrary, we have so far not seen any material change in the behavior of central investors or banks, who keep investing in public TLAC issuance.

**Roland Charbonnel**, BPCE: The introduction of higher risk-weights for bank investors in TLAC products had a negative impact on our deal in June. We could see that in terms of the number of accounts placing orders in January compared with how many placed orders in June—there was nearly a 70% drop in the number of bank investors in the book. That is pretty significant. But it was not the only reason we saw such a significant drop in demand. Spreads were much, much tighter in June than they were in January, meaning the yield was less attractive for all investors, including the bank investors. So the introduction of higher risk weights did affect our second deal, but it wasn’t the only factor. I would say it was 50%-50% between the two.

**GlobalCapital**: What about for issuers that are subject to MREL rather than TLAC? Japanese bank investors can still apply a 20% risk-weight to MREL paper, so are these types of bonds benefitting in the yen market in 2019?

**Green, Lloyds**: There has been a definite divergence between TLAC and MREL issuance this financial year given the different risk weight treatment given to loss absorbing product issued by G-SIBs versus D-SIBs. Bank—particularly regional bank—participation in TLAC trades has been lower than it was in the previous tax year, whereas for MREL issuance, regional banks have continued to support trades in good size.

**Lolli, Intesa Sanpaolo**: We are under MREL rules rather than TLAC, but up until now we have not had any need to issue non-preferred senior debt. Our knowledge about the risk-weight situation is therefore only second hand.

Nonetheless the message we are getting is that there will be some investors, particularly the regional banks, which are going to be hit by the new regulations in Japan and so they will move more towards MREL debt or preferred senior bonds. There are also going to be other investors like pension funds, life insurers and asset managers that will not be affected and will continue to invest in both MREL and TLAC.

**Charbonnel, BPCE**: I would say that there is definitely still demand for MREL but also for TLAC paper. It is...
senior preferred where we are seeing less demand, simply because the spreads are so tight and the yields are so low.

**GlobalCapital: With bond yields stuck at such low levels in Japan, are Japanese investors becoming less risk averse than they have been in the past?**

**Green, Lloyds:** I’m not sure we are seeing signs of investors becoming less risk averse but the challenges of a low rate environment are definitely being exacerbated. Japanese investors generally have a strong track record of staying the course despite increasingly difficult market conditions to navigate. Whether this makes them more risk averse is up for debate – I’d argue they remain reliable in difficult market conditions and supportive of credits they value and understand. The resilience of Japanese investors supports the investment we make in investor relations work both in Tokyo and the regions.

**Robillard, Société Générale:** Despite a more risk averse approach than in other regions, Japanese investors have progressively increased over the last years the volume of liquidity invested in TLAC eligible debt. Nevertheless, the current market headwinds and regulatory changes might potentially impact this past trend.

**Charbonnel, BPCE:** The introduction of new risk-weights has definitely been a big issue for bank investors, which has affected their appetite for TLAC senior debt. But yield is also a very big consideration for Japanese accounts. In general they will tend to be okay with senior non-preferred because of the yield on offer.

**GlobalCapital: How have Japanese investors responded to the recent uncertainty around the global economic and political outlook?**

**Charbonnel, BPCE:** Our experience is that the Japanese market is less sensitive to headlines compared with other markets. But they are not completely insensitive to what is going on. I remember Crédit Agricole was marketing bonds in yen shortly after the Italian election, which sparked a lot of volatility. But still they managed to print a deal.

**GlobalCapital: There has been a lot of continued uncertainty around the political situation in Italy. As an Italian issuer, what has Intesa Sanpaolo made of the perception of Japanese investors during this period?**

**Lolli, Intesa Sanpaolo:** Japanese investors are not particularly speculative. They prefer to buy and hold and they don’t like volatility, so they are (a bit) concerned about political uncertainty and the volatility that this can bring. This is perfectly understandable, especially given the small role that hedge funds play in this market.

For this reason we think it is very important to meet with Japanese investors and indeed over the past three years we have conducted non-deal roadshows on a regular. As a result of this we have seen Japanese investors putting in more work to try and understand the political environment in Italy. They have a growing willingness to analyse political developments in the country so that they can be ready to step in when the situation is acceptable stable. Their attitude towards Italy is very constructive.

**GlobalCapital: BPCE raised ¥163.6bn with a Samurai offering in January but switched to the Euroyen format for a ¥62.1bn deal in June. Why did you decide to issue a Euroyen deal instead of a Samurai for your second this year?**

**Charbonnel, BPCE:** We have been very loyal customers of the Samurai market. Since December 2012, we have only done Samurai bond transactions in Japanese yen.
The main reason for switching to Euroyen had to do with the flexibility you can get in terms of timing. There is a very lengthy process of legal documentation work you need to go through to do a Samurai bond, and so we wouldn’t have been ready to issue at the time we wanted to come to the market this June. Doing a Euroyen deal means you are issuing off of your EMTN programme, so you can be much quicker in coming to the market. We wanted that flexibility because we were trying to avoid competing supply, which can affect the spread level and the size you are able to achieve in the market.

GlobalCapital: Do you think you would have been able to issue a larger deal in June if you had decided to return to the Samurai bond market?

Charbonnel, BPCE: The fact that we switched from issuing Samurai to Euroyen in June had nothing to do with the fact that we ended up having to issue a smaller transaction. In our view we only lost a small amount of demand because of the choice of format.

Going forward, whenever we consider doing a public issue in the Japanese yen market, we will either do a Samurai bond or a Euroyen deal. We certainly won’t forget about the Samurai format — we have Samurai bonds outstanding so we already have to do all the disclosure work. It will simply depend on whether or not we need flexibility in terms of timing. But we don’t really see any specific advantage of the Pro-Bond format over Samurai or Euroyen deals.

GlobalCapital: What about other issuers, is the Pro-Bond format becoming more of interest alongside Samurai bonds and Euroyen deals?

Robillard, Société Générale: The Pro-Bond format with its English documentation definitely offers a less time consuming option than the Samurai market to issuers contemplating to access the yen market for the first time. However, the upsides are more limited for frequent issuers like Société Générale active in Samurai and Uridashi bonds with documentation already established.

Green, Lloyds: Ultimately, for issuers without Samurai capabilities, both have application but also limitations. Samurai docs remain the gold standard and give us access to the full extent of the Japanese investor base. In a good market, investors will accept Pro-Bond and Euroyen but in more difficult market conditions then the ‘gold standard’ is preferred. Clearly, it would be beneficial for international borrowers if some of the ‘idiosyncrasies’ of the Japanese yen market aligned more to the US dollar or euro market, but some changes can be glacial in the making.

GlobalCapital: Intesa has sold two Pro-Bonds, the first of which was for ¥46.6bn but the second of which was for a total size of just ¥13.2bn. Is there plenty of appetite for deals in the Pro-Bond market?

Lolli, Intesa Sanpaolo: The Samurai market is the most liquid and the most prestigious in Japan. But given that we are a newcomer and investors are not yet willing to buy huge deals from us, the Samurai market is pretty much off the table. It would be too expensive and too complicated to set up a programme. Our Tokyo Pro-Bond is quite similar to a Euroyen. The language is English and they are listed in Tokyo and Luxembourg.

The reduction we saw across our two Pro-Bonds is not due to the type of instrument we chose, it was more related to the political situation in Italy. But we were encouraged to see the diversification of our investor base in Japan, especially in terms of the regional, Shinkin banks. Last year one of them was involved but this year there were three. This is important because it is a sign that our name is better known in the country and it shows that there is a growing interest among regional banks to open their doors to new issuers.

GlobalCapital: How important is it for issuers to gain access to regional bank investors?

Robillard, Société Générale: Japan is a deep and core market with central accounts as anchor investors but also with many other important regional investors such as regional banks and Shinkin banks. Due to their number, having access to them is key to diversify the investor base and for the success of the transactions issued in Japan.

Green, Lloyds: As an issuer, we have seen no downside and only upside potential in terms of accessing regional investors in Japan. For the past few years, every roadshow to Japan has included days in the regions to update investors there on the Group’s credit story and funding plans. We have seen this as a worthwhile investment of time and effort and this has been rewarded in investor sponsorship for our deals.

Charbonnel, BPCE: It may not be so important for all issuers, but to us it is really important. Whenever we do a roadshow in Japan, we typically spend three days of the week in Tokyo and two days in various parts of the country to visit regional investors. We are the largest issuer in the Samurai market, so we have to look for further diversification. The Japanese market is obviously diversified from the euro market for us, but we feel we need to access regional investors so that we can also get some diversification within the yen market as well.

GlobalCapital: Are you happy paying a ‘diversification premium’ to do deals in yen?

Charbonnel, BPCE: We do not require an arbitrage when we are contemplating a bond issue in another currency because we value very much investor diversification, but we will only take the extra cost as long as it is in a single digit range.
GlobalCapital: How important is it for other issuers to gain a pricing advantage when going to yen?

Green, Lloyds: While we remain price sensitive as an issuer, we are more focused on the long-term benefits of investor diversification than short-term pricing arbitrage. We would rather be seen as an issuer that is invested in the strategic importance of the regional market and the local investors than one that is transient and is only focused on the pricing benefits that could be extracted from this market. The Japanese investor base is generally very reliable and stays the course on trades, even amid deteriorating market conditions globally, so we see pricing arbitrage as long term destructive to our engagement with this strategically important market.

Lolli, Intesa Sanpaolo: When you are entering a new market and offering paper with limited liquidity, it is perfectly understandable that investors want to have a bit of a pick-up in terms of yield. We have therefore cheaper ways of raising funding, but that is absolutely reasonable.

At the moment our purpose it is to diversify our investor base knowing that in the future, when we may be placing larger deals in yen, we could put more emphasis on the pricing. For now it is not important for us.

Charbonnel, BPCE: It is a strategic market for us. We see an incredible potential in yen and so we want to continue to make an effort to be there more and more, without being too focused on short-term results in terms of size or pricing.

GlobalCapital: What role does the yen market play in your overall funding plans?

Green, Lloyds: The Japanese yen market remains strategically important to the group as we look to maintain a diversified funding mix across investors, currencies and markets. The Japanese investor base is generally one that doesn’t traditionally participate in other trades that we do — with one or two exceptions — and pricing is normally in line with what we could achieve in other global markets so is additive without having to reprice our curve.

Charbonnel, BPCE: When looking at the unsecured part of our funding, we would typically be doing around 10% of our unsecured MLT [medium and long term] funding in Japanese yen. This year we have a much heavier weighting in the currency, with around 20% of our unsecured MLT funding in yen. One of the reasons for this is that US dollars have been a lot more expensive than euros for pretty much all of 2019, so we have issued much less in that currency than we would normally have done. We haven’t done any public issues in US dollars so far this year.

GlobalCapital: Alessandro, you mentioned earlier that this has been ‘the year of the euro market’. Has that changed the role of yen in your funding plans?

ALolli, Intesa Sanpaolo: The euro market cannot be as strong as it has been every year and though the dollar market is very reliable for size, it is structurally more expensive to issue there. So there is going to be room for Japanese market and we believe that this will only increase going forwards.

I have the feeling that the appetite of Japanese investors for international deals is growing. We have seen that these accounts have been buying a lot of French and German paper, but they have also now been buying a lot of debt from Italy. Given that yields are sinking globally, we can see there is going to be more demand for bonds issued by European peripheral countries, where the issuer is strong and the terms of the deal are fair.

GlobalCapital: Would you consider going down the capital structure to issue riskier products in yen?

Lolli, Intesa Sanpaolo: We don’t see any reason not to consider issuing non-preferred senior debt in Japan at some point in the future. But we are still on a learning curve in the yen market at the moment and we don’t want to go down the capital structure and force investors to take a bit more of a risk on our business. Our strategy is to have a long term relationship with Japanese accounts, so we want avoid pushing or pressuring investors to take decisions they may not be comfortable with.

GlobalCapital: Is there growing appetite among Japanese investors for bonds linked to environmental, social and governance (ESG) criteria?

Charbonnel, BPCE: We have been quite active in Japan with social bonds, but we haven’t done much in terms of green issuance. We are looking at the opportunity of doing green issuance in Japan but this isn’t really our top priority. We would probably consider the euro market before yen when doing green bonds. That’s because it looks like Japanese investors are more prepared to buy social bonds than some European investors, particularly in the Nordic countries, which are traditionally big buyers of green bonds. But in Japan we don’t see a clear difference in terms of demand for green or social bonds.

Green, Lloyds: Green bonds are not really a new concept for Japanese investors or the Japanese yen market, with this product having been issued by a number of issuers over the past few years. As we are seeing in other markets, there is definitely more of an awareness of green bond opportunities in the Japanese yen market and we are likely to see this becoming more popular as investors become more sensitive to investing specific SRI funds into bonds that adhere to the Green Bond principles, and also as issuers look at ways to diversify their investor base across markets.
Japanese business looks outward, funding follows suit

Japan’s mature, growth-starved economy has little slack for its banks and corporations to enjoy. Expansion seems possible only through the pursuit of opportunities abroad, and as a result, Japanese borrowers are turning to the international market in unprecedented numbers. The global economy, which has its own problems of slowing growth, brings new challenges and opportunities.

Lewis McLellan reports

Japan’s GDP growth, although back in positive territory after three quarters of contraction, is still lacklustre. Yield on its 10 year government debt is hovering around minus 26bp, and its base rate is minus 0.1%. Though still not as deeply negative as the European market, Japan’s eight years or so of zero or negative rates has been deadly for bank profitability.

Accordingly, Japan’s banks have been desperately looking offshore for opportunities to lend at better rates and, in late 2018, outdid US and European firms to become the top international lenders. Partially the top spot came thanks to a pullback from big players in the US and Germany, but there can be no denying that the torpor gripping the Japanese economy has driven lenders to look abroad.

“Banks are increasingly lending abroad to take advantage of the higher interest rates elsewhere,” says Tatsuya Maruyama, head of Japan DCM at Barclays. “The Japanese market is overbanked, so there isn’t much scope for growth in domestic lending.”

The situation is the same for Japanese corporations. “A lot of Japanese borrowers are internationalising their businesses,” says Maruyama. “Many are seeking new opportunities abroad because of the saturated Japanese market. That’s meant we’ve seen several significant M&A transactions.”

Nakayama Yasumasa, Japan DCM at Mizuho agrees: “Given the fact that the Japanese population will not grow, Japanese companies are looking for growth opportunities outside of Japan, and are pursuing M&A transactions.”

The pace of Japanese M&A is staggering, with almost $200bn of deals in 2018 and a 30% year on year increase in the first half of 2019.

One standout example is Japanese drinks manufacturer Asahi’s purchase of the Australian business of AB InBev for $11.3bn in July this year.

Asahi’s purchase of AB InBev’s Australian operations came soon after its acquisition of the Pilsner Urquell brand, also from AB InBev, and Peroni and Grolsch from SABMiller in 2016 and 2017.

Another is Takeda, which finalised its $62bn merger with fellow pharmaceutical manufacturer Shire of the UK in January this year, creating one of the world’s largest pharma groups.

The increase in activity overseas has resulted in a commensurate increase in the demand for foreign currency funding.

Banks, as well as lending to international clients, find themselves lending more in foreign currencies to finance the global expansion of Japanese corporates. “With Japanese companies expanding overseas, they have a much larger natural need to tap dollars and euros,” says Maruyama. “The banks are supporting that expansion, which means they have to fund internationally too.”

Dealogic data shows that Japanese borrowing in the international market has climbed steadily since the global financial crisis, jumping up rapidly to a peak in 2017, when there was $120bn of international borrowing.


We could be in for another heavy year of borrowing from JBIC, which is set to face $9.6bn in redemptions in 2020 — its biggest year ever, according to Dealogic.

Indeed, Japan as a whole is set for...
OFFSHORE BORROWERS

a torrid redemption schedule. After $60bn of redemptions in 2019, the biggest year ever, Japanese borrowers will face $75bn of international maturities in 2020, and $77bn each in 2021 and 2022. By contrast, 2017, which had the highest level of issuance, had only $57bn of redemptions. Much of this is concentrated in the public sector.

However, with global growth flagging, the corporate M&A-driven borrowing could take a hit. “It’s true, slowing global growth could prevent us seeing some of the big transactions that have made up a lot of corporate supply.”

Supply from banks and the public sector is unlikely to slow down in line with global economic growth.

“The public sector institutions will keep borrowing and lending,” says a syndicate banker focussed on the region. “And the banks will continue to meet their TLAC needs internationally.” Since Japanese banks have a requirement to demonstrate stable sources of long term foreign funding, their demand for dollar capital remains steady.

**Growth on the decline**

Japan isn’t the only country dealing with flagging growth. All over the world, forecasts of economic activity are shrivelling thanks, in no small part, to US president Donald Trump’s trade dispute with China. Accordingly, investors have piled into rates products, pushing US Treasury yields down 50bp in the month of August alone.

For Japanese borrowers, who tend to cluster around the upper end of the credit spectrum, this has been a blessing. “Recently, given the trade war and economic slowdown, we’re seeing investor demand to diversify their portfolios to mitigate geopolitical risks,” says Yasumasa. “Japanese credit is a good fit for diversification purposes.”

Guy Reid, head of public sector DCM at Mizuho, agrees. “Japanese issuers have access to investors all across Europe and the US. Those investors don’t have much opportunity to purchase highly rated Asian and Japanese names, so they’re in hot demand.”

Around 90% of the proceeds from international funding operations meet a natural need in the currency, according to research analysts. Many of these issuers are focussed on the absolute yield, so with fears around falling growth bringing yields down, the international market appears cheaper for those borrowers. “So far, the rush to safe haven trades has not blown credit spreads much wider. However, if the global economy falls into recession, spreads could widen rapidly. “As long as the market remains competitive, Japanese issuers will access it,” says Maruyama.

Reid adds: “For Libor-based issuers comparing US Libor to Japan Libor, there has been a reduction in yield, but far less than there has been in the underlying rates market.”

For borrowers choosing between issuing domestically and issuing internationally, sometimes the answer does not come from where the best cost of funds is. “Issuers can raise money in the domestic yen market at a very low cost, but size is limited to around $100m-$200m per tranche,” says Yasumasa. “Issuers needing larger amounts generally have to look at the international market.”

The value equation for the deals raising cash to swap into yen is more complicated. While the yen market is a stable and reliable source of financing for Japanese borrowers, the low rate environment in Japan is causing problems.

“Rates in Japan are very deeply negative, but so far, it’s very difficult to issue bonds with a negative yield, which means there’s a yield floor,” says Maruyama.

Outside of Japanese government bonds, very few assets have been sold with a negative yield. “There was one government agency that did a negative yielding two year, but it’s very rare,” says Yasumasa.

With the zero floor effectively shattered in the euro market, and yields still comfortably positive for dollar debt, on a swapped basis, dollar or euro transactions can frequently offer Japanese issuers cheaper funding than would be available domestically. The scale of that segment of Japanese borrowing will likely be determined by the cross-currency basis swap market.

“Japanese investors’ reluctance to buy negative yielding paper can make international markets more attractive and open up opportunities for arbitrage,” says Reid.

“The cost difference between the domestic and the international market is a big factor for issuers swapping the proceeds,” says Maruyama.

The expansion of the Japanese presence in international bond markets is likely to continue. Neither Japan’s sluggish domestic economy, nor its international debt burden will permit it to retreat. While corporate activity may slow in line with global growth, the appetite for international investors for high quality Japanese names will likely ensure a warm welcome for those issuers that seek to access the international market.

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Japanese offshore borrowing since 2011

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Applying Financial Expertise to Design the Future

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DBJ Development Bank of Japan

www.dbj.jp/en/