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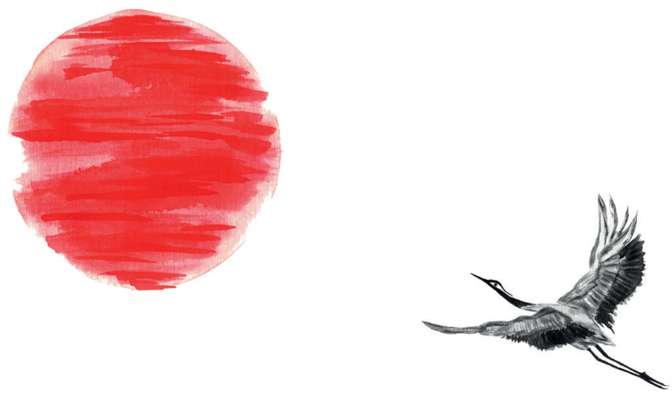

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Japan's reform failures make Covid era extra painful

Stagnating growth and pressure from the Covid crisis on the economy mean Japan needs to push out some large-scale structural reforms fast — or risk a much bigger economic fallout. **William Pesek** reports.

JAPAN'S GOVERNMENT and central bank have been fighting fires for years to revive the faltering economy. All with little success, however.

Prime minister Yoshihide Suga has paid the price for his ruling Liberal Democratic Party betting it all on the Tokyo 2020 Olympics, and resigned after less than a year in office.

The strategy unravelled spectacularly as Covid-19 arrived, costing Japan the 40m tourists it planned to welcome amid the Summer Games. Rather than a windfall, hosting the delayed Olympics during a pandemic left the most indebted major economy with even more debt on its book, risking the LDP's hold on power.

Worse, it put back at the starting line an economy that seemed set to sprint forward in 2013. And leaves the next government to pick up the pieces and devise a new plan to raise Japan's economic game.

This 2013 marker is notable for two reasons. For one thing, it was the year Tokyo unexpectedly scored the hosting rights for the 2020 Olympics. For another, it was when Shinzo Abe, then the prime minister, changed leadership at the Bank of Japan, part of a multi-faceted strategy to reflate Asia's second largest economy and rekindle Tokyo's innovative flame.

Or so global investors thought. In December 2012, Abe pledged to reinvigorate an economy weighed down by the deflation and political paralysis of the 1990s. Abe planned to reduce bureaucracy, loosen labour markets, catalyse a startup boom, empower women and attract more international talent — all while trimming a crushing public debt burden.

In September 2013, as Tokyo secured the Olympics, Abe visited the New York Stock Exchange to declare "Japan is back" as an investment powerhouse. He even referenced Gordon Gekko, the protagonist in the film *Wall Street*, to argue that Japan is a "buy" once again. That year alone, the Nikkei 225 Stock Average Index surged 57%.

Yet the blinding speed with which Japan flamed out in 2020 demonstrates how little the economy had really changed. As exports cratered, so did gross domestic product — with real annual growth last year standing at negative 4.8% — and with it, the myth that so-called Abenomics had whipped Japan into shape.

"Growth strategies did not really move forward, since deregulation efforts were really weak," says Yasuhide Yajima, chief economist at NLI Research Institute. "Going forward, the point is what kinds of deregulation the government will come up with."

'Painful' reforms needed

These failures can be traced back to 2013. Once Abe got his new BOJ governor in place, he left economic affairs to Haruhiko Kuroda's team. Kuroda, a former president of the Asian Development Bank, fired his monetary bazooka early and often. The Olympics, meantime, would unleash a burst of construction-driven activity that Abe argued would create enough new jobs and wage increases to shift the $5tr economy into a higher gear.

Covid-19 upended both assumptions. And then Abe stepped down suddenly in September 2020, citing health issues. That left Suga, Abe's chief cabinet secretary for his nearly eight years in power, to salvage the LDP's economic legacy as Japan's new prime minister.

It proved an uphill climb, as shown by Suga's quick exit. In mid-2020, the government rolled out a $2.2tr stimulus programme, equal to about 40% of GDP. The BOJ did its part to increase asset purchases too. As 2022 approaches, though, Japan is largely out of conventional ammunition.

The next government will have to push out supply-side reforms that have been delayed for decades.

"There has been strong pessimism in Japan about future growth prospects in both the household and corporate sectors," says Shin-ichi Fukuda, an economist and professor at the University of Tokyo. "If effective structural reforms can eliminate the pessimism, domestic consumption and capital investment will increase and the prolonged stagnation will be resolved. To turn things around, we need to impose rapid and sometimes painful structural reforms."

Japan is learning that what worked in decades past no longer does — especially when China is winning the lion's share of foreign direct investment, raising its competitive game and growing its economy rapidly.

It's not just China nipping at Tokyo's heels. Countries like Indonesia, for example, are pushing past far more developed Japan in producing tech unicorn startups. All this makes aging, high-wage Japan a very expensive property in a lower-cost neighbourhood that's veering upmarket.

"The implementation of effective growth strategies has become indispensable"

Shin-ichi Fukuda, University of Tokyo

The answer for Japan is to reinvigorate the reforms Abe and Suga promised, with some vital updates. Perhaps most needed is a pro-growth energy policy that creates millions of high-paying jobs and returns Japan to the status of regional leadership.

As China races ahead, South Korea makes inroads and Indonesia, Vietnam and others raise their technology ambitions, Japan is finding much of what it has long excelled at being commoditised in real time. South Korea alone has Japan feeling disoriented as Asia's fourth largest economy competes in cars, electronics, robots, ships and popular entertainment. K-pop bands like BTS and Blackpink are going global in ways J-pop never did.

While the Abe-Suga tag team dreamed of Olympics glory, Chinese president Xi Jinping invested trillions in electric vehicles, semiconductors, biotechnology, biomedicine, aerospace, high-speed rail, artificial intelligence, automation, cloud computing and renewable energy. Beijing is also miles ahead of Tokyo in building a central bank-issued digital currency.

China is also planning a unicorn blitz. Granted, the crackdowns on Alibaba Group Holding, as well as high-profile firms like Didi Global, Tencent Holdings and other peers, are grabbing global headlines, but few can refute the Silicon Valley-style setup that has already been created in the country.

Japan's rejoinder to all this? Hosting an Olympics with no GDP payoff. Had Japan spent the last eight-plus years remaking its economy instead, its status would be remarkably different.

Yoshihide Suga said that he would step down as Japan's prime minister, after less than a year in office

Startup focus

The Japanese government's best chance of regaining momentum starts with curbing Covid-19. Just like Korea and Taiwan which outmanoeuvred the pandemic at first, Japan got complacent about vaccinations. The emergence of the Delta variant, coupled with a post-Olympics infection surge, now has Japan playing virus defence.

When it comes the pandemic, views are mixed. After a slow start, Suga's government had rapidly ramped up vaccinations.

"As a result, we're cautiously optimistic that a strong recovery is just around the corner," says Tom Learmouth, Japan economist at Capital Economics. "Japan's vaccine coverage is now not far off the rates seen in developing markets where most domestic restrictions have already been lifted."

The next government must boost moves to revive structural reform.

On September 29, the LDP will choose a new party president to replace Suga. That successor will then represent the LDP in a general election expected to be held in October.

Candidates include Taro Kono, state minister in charge of administrative reform who also heads the national Covid-19 vaccination programme; Fumio Kishida, an ex foreign minister; Shigeru Ishiba, former defence minister; and Seiko Noda, a former internal affairs minister. Noda would be Japan's first-ever female leader.

Given that opposition parties are in disarray, the LDP is widely expected to maintain power. One wildcard: analysts wonder if Yuriko Koike, Tokyo's popular governor, might take a run at the premiership.

Japan's next leader will have to multitask right out of the gate. In the immediate term, Japan might need a jolt of conventional support. "In the short run, fiscal stimulus is needed," Heizo Takenaka, an economist and an adviser to Suga, said in an interview in July. "It's also very important at this moment to control Covid-19."

Japan needs more than just stimulus, though. The BOJ pioneered quantitative easing in 2001, two years after it became the first major central bank to cut interest rates to zero.

In 2013, Kuroda pushed Japan even further into uncharted territory. The central bank cornered the stock market via exchange-traded funds. By late 2018, well before Covid hit, the BOJ's balance sheet topped the size of Japan's entire economy. Since then, it's only grown bigger. At the end of 2020, the BOJ became the biggest owner of Japanese stocks, holding over $400bn.

Yet Japan has gone as far as it can with monetary easing. The problem is no longer the supply of yen sloshing around the financial system, but productive uses for them. The missing link is deregulation that gives businesses and households confidence that the next five years will be more vibrant than the last five.

"Advocating for a more middle class-friendly Abenomics — without calling it that — might well be able to take with the electorate," says Corey Wallace, an economist and assistant professor at Kanagawa University in Japan. "The focus would be on parents and SME owners. Essentially, find ways of relieving economic insecurity now so that these two groups would feel emboldened to spend. There are various ways that could be done, but I think the anticipated cost of education is a major concern."

Economists and Japan experts suggest other priorities. First, a strong Cabinet, something Japan has lacked for years. For example, Suga's deputy prime minister and finance minister, Taro Aso, was also Abe's. What, really, did Aso, now in his early 80s, achieve in eight-plus years on the job? The gulf between the advertised big bang and the modest tweaks Aso's staff achieved grew wider which each passing year.

Japan has also been slow to catalyse a startup boom. The latest leaders have made the same mistake as every Japanese government over the last 20 years: prioritising the interests of corporate behemoths at the top of the economic food chain over generating new economic energy.

Beginning in 2013, for example, the BOJ's main focus was a weaker exchange rate. It boosted profits at Toyota Motor, Nippon Steel, Mitsubishi Heavy Industries and Sony Corp — and the broader Nikkei index. It did little, though, to incentivise the other end of the economy: twentysomethings disrupting a change-averse economic system.

A new government could shift tax breaks to entrepreneurs and cut red tape to increase Japan's share of tech unicorns and boost competitiveness.

"This, unfortunately, is Japan's plight: a failure of its business institutions to make the needed adjustments from the analogue era to today's digital world," says economist Richard Katz, a Japan expert at the Carnegie Council for Ethics in International Affairs.

Among 34 rich countries, Katz says, Japan ranks a dismal 25th in overall digital competitiveness. "To be sure, Japanese companies spend plenty on information and communications technology," Katz says.

The good news is that two developments suggest change is coming. One: Kathy Matsui, Goldman Sachs' former Japan vice-chairwoman, set up the M-Power Partners venture capital fund. Its all-female board aims to support growth-stage startups that champion environmental, social and governance (ESG) values — a real rarity in Japan.

In late August, SoftBank Group, led by billionaire entrepreneur Masayoshi Son, said it's creating a post to focus on Japanese startups. Though SoftBank's $100bn Vision Fund lavished billions on entrepreneurs around the globe, it has essentially invested zero at home.

"We wanted to start a movement from the ground up to change Japan," says Yumiko Murakami, an M-Power general partner. "But we can't do it alone. So, the more the merrier."

There's concern, though, that Japan Inc more broadly squandered years of corporate welfare.

Nicholas Smith, Japan strategist at CLSA, says that of the 69 industries he tracks, Japanese companies trail the US and Europe in return on equity over a five-year period in 37 and lead in just six. "The need for industry consolidation and restructuring is pressing," Smith says.

Oddly, stronger corporate governance has long been thought to be the LDP's biggest reform win over the last eight years. This perception owes much to a UK-like stewardship code of corporate conduct imposed in 2014. Boards were encouraged to add outside directors, including welcoming more women into executive suites.

Yet the upgrades lacked clarity and teeth. They proved insufficient to head off the Carlos Ghosn drama at Nissan Motor in 2019 or the more recent dust-up at Toshiba Corp over board seats. It's the third scandal at the electronics icon in six years.

Antiquated practices still abound. "CEOs will often be on the nomination or compensation committee and chair it," says Chris Vilburn, head of Asia stewardship at Goldman Sachs Asset Management. "I would love to be on my own compensation committee, but there is clearly an issue with [this]."

Gender equality is fertile ground for change. Early on, the Abe-Suga governments talked enthusiastically about empowering women. It was a bow to the vast amount of research showing that nations which best use female workforces are most innovative and productive. But pledges to make women "shine" amounted to little.

In fact, Japan appears to have gone in the opposite direction. In the World Economic Forum's global gender gap report of March 2021, Japan ranked 120th, last among the Group of Seven nations. Within East Asia and the Pacific, Japan ranked 18th, just above Papua New Guinea and Vanuatu. After taking office in September 2020, Suga seldom even mentioned Womenomics, a policy introduced by his predecessor to boost women in the workforce.

"The policy priority definitely dropped," says Nobuko Kobayashi, a partner and co-lead of the consumer practice at EY-Parthenon, the strategic consulting arm of EY Strategy and Transactions. "It's very hard to snap out of it. So, we need some kind of a shock to the system."

Trouble is, the force with the patriarchy remains strong despite the rhetoric emanating from government circles, says Kumiko Nemoto, a professor of management at Senshu University.

"We need some kind of a shock to the system"

Nobuko Kobayashi, EY-Parthenon

Look no further than the myriad sexist-comment scandals that tarnished the run-up to the Olympics. Former prime minister Yoshiro Mori, at the age of 83, had to resign as head of the Tokyo 2020 planning committee for complaining women talk too much.

Nemoto says that was a microcosm of how "Japanese businesses and politics continue to be controlled by men in their 70s, 80s and 90s". After rising through the ranks of Japan's post-war growth, she says, the older generation seem reluctant to make changes to existing corporate systems, including gender-skewed customs.

The good news is that foreign shareholders are prodding Japanese corporations to embrace global standards of workplace gender equality. But Japan is still far from being a meritocracy.

Nemoto says that women still confront "an age-based system of hierarchy, pay and promotions, plus daily overwork are central to Japan's tradition of lifetime employment".

At the same time, she says, promotion chances are largely determined by age, not by individual skills or performance and it can take 20 to 30 years to become a manager. Long years of work before promotion and daily overwork, combined with caretaker responsibilities, make it difficult for women to coordinate career and family and reduce aspirations for leadership.

Transition finance

Japan also needs a pro-growth energy policy. One of Suga's boldest pledges was carbon neutrality by 2050. It falls to his successor to flesh out the policy.

These goals "are more ambitious than before," says Robert Feldman, chief economist at Morgan Stanley MUFG Securities. "However, questions remain on consistency, budgeting, implementation, and awareness of global technology and cost trends. Given these ambiguities in the basic plan, the key driver of energy transition in Japan will likely be the economics of new energy technologies, rather than government plans."

Regulatory tweaks are needed first, including tax incentives and perhaps even government subsidies.

In July, the BOJ set out plans for inducements that would channel lending toward greener pursuits. The hope is to prod the private sector toward greater investments in sustainability.

Perhaps, BOJ's policy innovation could even get Tokyo there much sooner by, say, 2030. Experts reckon Tokyo could broaden the BOJ's mandate so it can accelerate the transition away from coal, oil and other fossil fuels. This means prioritizing innovation in batteries, solar, wind and geothermal power sources to invent and commercialise ways to grow sustainably.

Right in Japan's backyard — China, India and Indonesia — are nearly 3bn people who risk choking on rapid GDP, Feldman notes. Governments throughout the region would pay generously to balance 5% growth with cleaner skies and rivers and better public health trajectories. Who better than Japan Inc to fill the void with — and profit from — new clean-growth technologies?

What's needed, though, is a clear government push in the direction of change and disruption. University of Tokyo's Fukuda says: "To revitalize the Japanese economy, the implementation of effective growth strategies has become indispensable." ▲

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February 2021	**April 2021**	**April 2021**
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International yen bonds face uphill battle

The international yen bond market has perked up this year, but deal volumes are still far below pre-pandemic levels — raising questions about what will happen next for global borrowers funding in the Japanese currency. By **Rashmi Kumar**

When it comes to yen-denominated bonds sold by international issuers, a lot can change in the span of a year. In the eight months to end of August 2021, non-Japanese borrowers had raised about $9.9bn-equivalent through 85 bonds denominated in yen, across the Samurai market, the Euroyen market and the global yen market, according to data from Dealogic.

In comparison, during the same period last year, volumes were lower at $8.7bn from 58 transactions. Deal flow so far this year is already nearing the full-year activity in 2020 worth about $11.6bn.

A key reason for the lower deal flow in 2020 was the favourable conditions in borrowers' own domestic markets, say debt capital market bankers in Tokyo.

"At the time of Covid-19 last year, the frequent issuers in the international yen bond market focused on their home market currencies," says Kazuma Muroi, executive director at Mitsubishi UFJ Morgan Stanley Securities' debt syndicate team in Japan. "As a lot of central banks offered support through quantitative easing, companies could enjoy strong conditions in their own currencies."

In the US, the Federal Reserve slashed interest rates in March 2020 to almost zero, and stepped up its purchase of government and corporate bonds to prop up the economy. It also launched a $700bn stimulus programme to revive economic growth, but Fed chairman Jerome Powell did hint at the end of August that the central bank could begin withdrawing some of the stimulus this year if growth rebounds and inflation returns to the target of 2%.

In Europe, the European Central Bank has also unveiled large-scale stimulus measures in the past year, including big asset purchases.

The Bank of Japan has also put in place a long-running stimulus package. In a note in early September, analysts at UOB said they did not expect the BOJ to tighten anytime soon, and expect it to maintain its "massive stimulus" for the next few years, possibly at least until the 2023 financial year.

But the need for corporations to remain in their home markets for funding started to shift in 2021. Amid attempts to get businesses back to normal and diversify funding sources, the yen became one of the go-to currencies for borrowers.

That explains why a host of European, Asian and US issuers returned to the Japanese yen bond market for fundraising this year.

The two largest deals came from Warren Buffett's Berkshire Hathaway, which bagged about $1.5bn from yen bonds in April, and French automaker Groupe Renault, which took about $1.4bn this year. Issuers from Asia have included the Indonesian and the Philippine sovereigns, which raised about $920m and $500m, respectively.

"FIG issuers find value in keeping a diversified funding source"

Naoyuki Takashina, Nomura

Other high-profile deals have come from BNP Paribas, which tapped the yen market for just over $800m, French investment holding company SAS Rue La Boétie ($929m) and US insurance company Aflac ($749m).

The main interest international issuers have is around the cost differential between selling a yen deal and a bond in their local currencies, says Hiroshi Oikawa, head of Japan DCM syndicate in Bank of America's Japan global capital markets team.

"As most international borrowers swap the proceeds into their local currencies such as dollars or euros, we can't perfectly predict the swap rates with yen," says Oikawa. "Some issuers may be paying up versus their local currency markets, but if the spreads are still appealing, yen offers an opportunity for issuers to diversify their investor base and their funding currency."

Naoyuki Takashina, co-head of international DCM at Nomura, adds that FIG credits, in particular, can get tighter funding costs in local currencies versus yen-denominated bonds. But he adds that while local costs are "hard to beat", the yen levels are relatively in line with what can be achieved in the local market.

"Some of the FIG issuers didn't price through their euro curves but the premium was modest," reckons Takashina. "So they find value in keeping a diversified funding source."

Yen options

There are various ways by which global issuers can raise yen funding, but the main avenues used are the Euroyen, global yen, Samurai or Pro-bond formats.

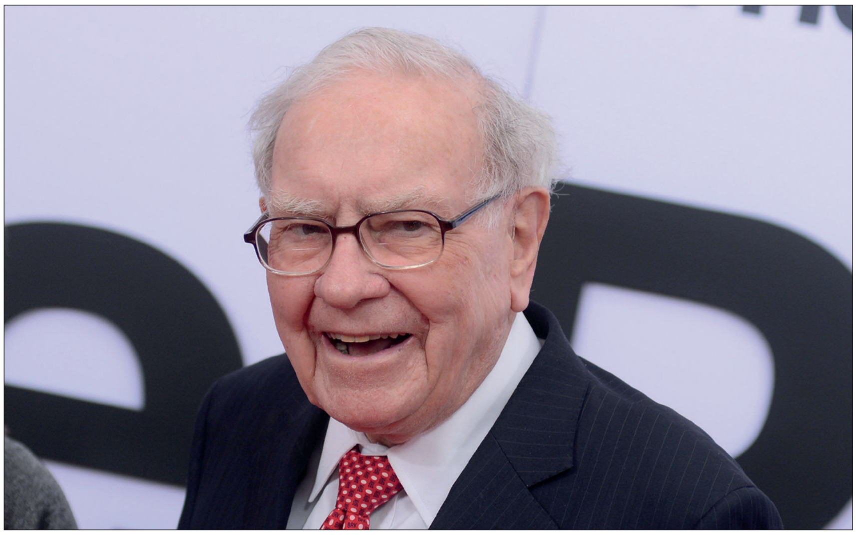
Euroyen bonds are yen deals issued in the Eurobond market by non-Japanese borrowers, while global yen bonds are denominated in yen but printed internationally. Unlike Samurai bonds, these deals are not registered with the Tokyo Stock Exchange and do not require the issuer to print their documents in Japanese — making them faster and easier to execute.

Pro-bonds give international issuers access to Japan's domestic investor base, but bar retail investors from buying the notes. Issuers can disclose their documents in English and/or Japanese, allowing for easier execution.

But increasingly, borrowers are making their preferences clear: dismissing Pro-bonds outright, sticking to Samurai in some cases, while leaning more towards the Euroyen or global yen markets.

In 2018, for example, of the $29.4bn raised in the international yen bond market, nearly 65% was taken from the Samurai debt market, about 29% from the Euroyen market and nearly 6% from the global yen market, shows Dealogic data.

The proportions have shifted since.



Berkshire Hathaway, led by Warren Buffett, sold a $1.5bn yen bond in April

In 2019, some 49% of the $29.6bn in total yen volumes came from the Samurai debt market, while the Euroyen market accounted for about 29% of the international yen deal flow and the global yen market took about 21%.

Last year, Samurai volumes totalled 38% of all international public yen bonds, followed by the Euroyen market at close to 30% and the global yen market at about 23%.

By August-end this year, the gap had narrowed further. Samurai bond volumes formed 41% of the international yen bond volumes, followed by the Euroyen market at 31% and the global yen market at 28%, shows Dealogic.

“Issuers have more options now,” says Oikawa at Bank of America. “For quicker execution, you go to the Euroyen or global yen formats, and for incremental orders, you can choose Samurai.”

MUFG’s Muroi adds that just a few years ago, many investors in Samurai bonds couldn’t buy Euroyen bonds, keeping them focused on the Samurai market. But when high-profile issuers like Apple and Walmart issued global yen deals, a rapid shift of the investor base was seen.

“They had to accept Eurobonds quickly,” says Muroi. “And now a big chunk of the market is more of non-Samurai bonds. But Samurai bonds will remain important among issuers that have a shelf registered already, so they can come back to reach out to broader investors in Japan compared to other formats.”

“Issuers have more options now. For quicker execution, you go to Euroyen or global yen, for incremental orders, you can choose Samurai”

Hiroshi Oikawa, Bank of America

But access to the yen bond market — be it in any format — comes with some caveats. Only the better rated issuers are welcome. A conservative investor base means only borrowers with at least a triple B rating or higher can tap yen bond investors. “We don’t have a sub-investment grade market in Japan,” says Muroi.

At the triple B level too, investors tend to show preference for short tenors, but that mindset can change depending on the credit and the industry of operation.

Bankers say there is some pressure among investors to go lower down the credit spectrum — especially as the low-rate environment makes fund managers even hungrier for yield — but the acceptance is still largely limited.

“Investors’ spectrum of credit acceptance remains broadly unchanged,” says Takashina. “They are not yet going to the single-B space, but remain comfortable at the triple-B level.”

There have been other changes in investor behaviour, however, given the disruptions caused by the Covid-19 pandemic on the traditional way of doing roadshows for transactions. Borrowers and investors in Japan — like their global counterparts — have had to rapidly adjust to virtual meetings and marketing.

Nomura’s Takashina says banks and investors have been able to adapt to using technology, be it a simple conference call or a video call, to communicate, offering a level of flexibility not seen before.

Some debut issuers may balk at attempting to sell a deal without holding face-to-face meetings with investors in Japan, but Takashina reckons there can be benefits to doing virtual roadshows for maiden transactions.

“Imagine if you’ve booked your flight tickets and hotel for a few days, but you’re going to travel all the way without knowing how many investors are going to turn up to see you,” he says. “So virtual roadshows can be helpful there.”

Libor transition

DCM bankers and investors in Japan are slowly but steadily readying for the rollback of dollar Libor at the end of the year, and as a result the yen Libor. Progress has been somewhat slow so far.

Bankers say that a handful of issuers selling callable notes are using the Japanese government bond rates to reset spreads. For example, in May, BNP Paribas sold its first Samurai bond that doesn’t reset to Japanese Libor, but will instead reset to a spread over the Japanese government curve.

The Tokyo interbank offered rate (Tibor) is still used domestically, while the Tokyo overnight average rate (Tona) has been highlighted as the successor to Libor for yen deals.

There is no domestic precedent yet for using Tona, but there may soon be one. Mitsubishi Corp was planning to sell a floating rate note benchmarked to Tona in mid-September, as *GlobalCapital* was going to press. The deal will be the first public bond tied to the replacement for the Japanese yen Libor.

Nomura’s Takashina reckons when the market for international yen bond reopens, the bank will pitch more issuers to use the new Tona swap rates.

“Things are moving in the right direction, but the market needs to become quickly focused on adopting the change to a new benchmark,” he adds. ▲

Covid crisis fuels ESG focus among Japan's top credits

Japanese issuers have had to adapt to an incredibly challenging market backdrop over the past two years, as the turbulence unleashed by the Covid-19 pandemic shows no signs of abating. This makes for an equally unpredictable future as corporations, financial institutions, government agencies and investors find ways to navigate difficult conditions.

But amid the volatility, opportunities have emerged, especially in the environmental, social and governance (ESG) market, which has received a huge impetus in Japan, as well as globally.

In this roundtable, *GlobalCapital* talks to some of Japan's high-profile issuers and investors about how they are preparing for the future — and the lessons learnt so far.

Participants in the roundtable were:

Yoshitaka Hidaka, director, capital markets and funding division, Japan Bank for International Cooperation (JBIC)

Shingo Kanatani, director, Development Bank of Japan (DBJ)

Jason Mortimer, head of sustainable investment, fixed income, Nomura Asset Management

Moderator: **Rashmi Kumar**, Editor, *GlobalCapital Asia*

GlobalCapital: It has been more than 18 months since the pandemic started. How have you adjusted your fundraising plans — and your business strategy — in response to the pandemic so far?

Yoshitaka Hidaka, JBIC: At the time of the outbreak of the pandemic, the market volatility was huge and so we changed our funding plans. We postponed our funding activities. Since then, things have changed. The US Federal Reserve, as well as the European Central Bank and the Bank of Japan, have been taking very dramatic monetary easing policy measures. As a result of such easing, the bond market has been very favourable for issuers. We are trying to maximize that favourable environment.

We conducted large scale funding activities, and tried to pre-empt the market to find low cost funding opportunities. In January, we issued $1.5bn worth of 10 year bonds, and in April, we issued three year bonds and 10 year bonds of an unprecedented size. It was our largest 10 year bond, worth $3bn. By doing so, our 2021 funding requirement was completed. We think the speed of increase in long-term interest rates will accelerate at the end of this year. Should that happen, the yield curve could flatten. We were expecting that, which is why we issued the long term 10 year bond at the lowest cost for us in history.

Yoshitaka Hidaka
Japan Bank for International Cooperation (JBIC)

JBIC also has a special programme to address the pandemic. The programme helps Japanese companies having difficulty in financing their businesses because of Covid.

Shingo Kanatani, DBJ: Business was greatly affected by the outbreak of Covid-19. Covid-19 was identified as a crisis in March 2020 by the government of Japan, and DBJ, as the designated financial institution under the government, provided liquidity to companies that suffered. In terms of funding, our bond issuance plans were not affected by the pandemic, as the necessary funds for conducting crisis responsibility were provided by the government, and we have offered support to numerous industries in Japan.

We are also supporting the government's carbon-neutrality project. In May 2021, we disclosed our fifth medium term management plan — the main component of which is the GRIT strategy. G is for green, R for resilience and recovery, I for innovation and T for transition and transformation.

Under the GRIT strategy, DBJ is going to focus on contributing to the achievement of a carbon neutral society by 2050 and supporting the construction of a strong and safe society, providing capital for innovation and to help transition. To drive the GRIT strategy, we will continue to issue both domestic bonds and international bonds.

GlobalCapital: What was the investor feedback and response like to your bonds — and what questions and concerns were raised?

Hidaka, JBIC: The questions to us mainly centred on our ESG related initiatives. In the overseas market, JBIC has extended loans to coal fired power plants, so investors had concerns about that. But we believe we have very good communication with investors. Rather than meeting them in person, we have been using WebEx and other digital platforms to maintain good communication with our investors in the past year. We have conducted 100 to 150 meetings with investors, both at home and abroad, which has meant that investors have come into our deals, and we were very fortunate to be able to expand our investor base, I think that's one of our major achievements in 2020.

Kanatani, DBJ: Last year, we expanded our sustainability bond framework, adding social assets to the framework as the outbreak of Covid-19 brought attention to sustainable finance, and especially to that of its social aspect. We explained this to international investors. We will continue issuing sustainability bonds internationally as a way to expand our international investor base using the ESG label.

GlobalCapital: What developments have you seen in Japan's ESG market — and how has Covid helped shape the asset class?

Jason Mortimer, Nomura AM: I recently co-authored a piece for the Asian Development Bank about Asia's social bond market and its development, with a globally comprehensive quantitative assessment of the impact categories funded by these instruments. A couple of interesting things became apparent. First of all, Covid really made clear that it was the time for social bonds, because until then, the focus had been on green, and social bonds were just a small part of the market. It had been difficult to put a finger on what exactly this market was trying to do, because issuance had been limited to mainly government agencies and lacked a unifying issue such as climate change. But with Covid, that changed, and I believe it will be the case going forward as well.

The market has diversified from almost entirely focusing on sustainability and climate change, which are very important issues, to also include the question of resilience during crisis. I think the goal of the social bond structure — and extending that into sustainability bonds as well — really seems to have proved its worth during this period. It's a type of product that a lot of issuers that perhaps were not well suited for green bonds can issue, which is why issuance volumes have gone up, and continue rising. We look at social bonds and the social part of the sustainability stack to be a compelling way for investors to diversify portfolios by industry exposure as well as impact project type.

As a Japanese investor, we're involved both in global credits as well as domestic credits in the Japanese market. One of the things that stands out is how we can direct investor capital into projects that are with a global scope, but also within Japan for Japanese specific issues. A lot of lending by banks and issuance by banks are for the SME sector, making it a very crucial social mission. We are interested in that sector, but also in building critical Japanese infrastructure with a focus on resilience. That's something that is coming to the fore.

Cybersecurity is also something that we are now focusing on and directly integrating into our ESG frameworks. It's not just about investing in companies provided cybersecurity services directly, but about looking at the cybersecurity risk profile and performance of every single issuer, which we can now do with the data that we have in hand.

GlobalCapital: How difficult is it to monitor the use of proceeds of social bonds? Are their concerns around social washing of bonds?

Mortimer, Nomura AM: Anytime the ESG market gets big and there's an issuance rush, these washing concerns do emerge. As ESG reaches mainstream proportions, people are — rightly — asking some serious questions about what exactly this means. Measurement is relatively easier on the green bond side because what's being measured in terms of impact tends to be physical quantities like tons of carbon, or gigawatts of electricity generated etc. So that's relatively cut and dried, although of course for many issuers it's a new type of data, but we can deal with that.

Social is significantly more complex to measure. You're basically attempting to measure the entire spectrum of human activity. It's very difficult to put those projects or assets into neat little boxes. What we are doing is assessing the impact issuers are having based on the types of projects specified in the underlying social bond frameworks. It may not be exact to the decimal point, but you can estimate the impact if you know the type of issuer and what's in their framework.

Based on that database, for both individual bonds and for portfolio bonds, we can see what proportional amounts are allocated to all the different ICMA social bond project categories for example. Based on that, we can choose what project types we want to be contributing capital to and build tailored portfolios and strategies from the bottom up around that.

GlobalCapital: For the issuers in this panel, how have you changed your ESG approach due to the pandemic?

Shingo Kanatani
Development Bank of Japan (DBJ)

Kanatani, DBJ: This year, we upgraded our sustainability framework to include social assets. Some important areas for DBJ are basic infrastructure like electric power cable, affordable housing, and healthcare.

Hidaka, JBIC: JBIC has not issued any of these so-called ESG bonds so far. Frankly speaking, I think we're pretty behind, especially as the volume and numbers of ESG bonds have increased substantially in the past year. We recognize that fully. In June, we came up with a new medium term business plan that covers the next three years. ESG is one of the core parts of our strategy. With respect to our funding plan, a similar approach is likely to be taken. More specifically, in the first quarter next year, we intend to issue a green bond. That's the first initiative on the funding side.

The measurement of social impact is difficult. Our organisation has been engaged in infrastructure development outside of Japan, through the provision of long-term funds. We have made large loans for greenfield development too. How we can add or incorporate the social and sustainability flavour to that is a very important challenge for our organisation.

GlobalCapital: Are issuers in Japan seeing any pricing benefits from selling a green, or ESG bond, versus a conventional bond?

Kanatani, DBJ: In the US, yes, we can find a small greenium on bonds. But in the domestic market, there is no premium right now, especially with the low interest rate environment.

Mortimer, Nomura AM: I have published a report though the CBI [Climate Bonds Initiative] and ADB [Asian Development Bank] based on a quantitative analysis of the premium or the performance of green bonds in US dollar and euro markets. During times of market stress is where we see the impact of the green coming through.

Using data from a period of market declines in 2018, we found that green bonds in general outperformed by about one basis point to two basis points on the same issuer curve. It's not game changing as it's really not large, but it was interesting that the distribution of the outcomes in which the green bonds outperformed versus the non-green bond counterparts, was overwhelmingly skewed towards the green bond outperformance. So you do get a secondary market effect in turns of greater stability that is welcome by investors.

Personally, I think these are the wrong questions to ask: how much is the greenium and who pays, the issuer or the investor? I think who pays is actually the investor who is not buying green.

That's how we answer it. That's the sustainable equilibrium going forward that will encourage the growth of this market, because if the issuer who issues green gets a benefit, and the investor who buys green gets the benefit, obviously someone has to pay for that. There's no free lunch. And I think the cost goes to the non-green investor. That's how we think it works, and the data seems to bear that out.

GlobalCapital: The Bank of Japan unveiled its strategy for climate change mid this year, while there are also new guidelines for climate transition finance from the Financial Services Agency (FSA). How is this expected to change Japan's ESG market?

Mortimer, Nomura AM: This type of announcement really reinforces that the government, the alpha type investors, the public pension funds and all the other investors and the ecosystem are really behind this kind of concept.

Certainly from our perspective, pretty much all the interest now has some kind of ESG component, especially in fixed income. It's the case for equities as well, but every single kind of question or interest or new idea that's coming through almost invariably has some sort of ESG component. I think we will be seeing more demand for this.

Jason Mortimer
Nomura Asset Management

On the transition side, I sense that the Japanese government and the FSA are quite keen on this. The messages we've heard in public forums like this seem to be that they're in favour of having even a Japanese style transition bond format. I think that is something that is not so common, and not so popular yet. But if you look at the kinds of issuers, who's issuing what and who's doing what kinds of projects, they think transition bonds may have more of a chance in Japan.

We may be looking at dark green, light green, or grey transition bonds. The way to really scale this up, to truly make it mainstream, will be looking at different gradations of that and price that risk accordingly.

GlobalCapital: Would DBJ and JBIC consider selling transition bonds in the future?

Kanatani, DBJ: Could be. But the government is still having discussions about the concept and definition of transition with Japanese companies. So we have to wait to see what happens.

Hidaka, JBIC: The possibility of transition bonds being issued by JBIC is relatively high. But what is difficult is that just issuing transition bonds does not warrant favourable feedback from investors. It really depends on what kind of KPIs [key performance indicators] we establish, so we have to be careful selecting the KPIs around fossil fuel development, oil, gas, coal, and downstream.

We have offered loans to coal fired power plants in the past, which has raised concerns among investors. But our governor officially noted that JBIC will not extend new loans to coal fired power plants. Under such circumstances, we have to carefully think what kind of KPIs for a transition bond from JBIC will be accepted by investors.

GlobalCapital: How have you shifted to online roadshows and bookbuilding for bonds? Is a hybrid roadshow model likely to play a big role in the future, post Covid?

Hidaka, JBIC: During the pandemic, I haven't had difficulties in having remote discussions with investors. It has actually been better. I had access to a great variety of overseas investors, and the opportunities have increased. Going forward, this hybrid type of investor relation activities will be necessary. But if we are going to meet an investor for the first time, we should first have the meeting in person, and then it can be followed up by remote meetings.

That would be the traditional way of communicating with people. After the pandemic we would adopt this hybrid approach and have good conversations with investors.

Kanatani, DBJ: I totally agree with that. For us, remote marketing is a very efficient way of communication. DBJ sells both domestic bonds and international bonds regularly, and therefore we need to cover a wide range of investors in various regions.

Sometimes, we have a couple of online meetings with Japanese local investors in the daytime for domestic deals, and then have a couple of meetings with foreign investors in the evening. So we think remote meetings are very convenient for us, but we also understand the importance of face to face meetings.

GlobalCapital: Jason, what is your take on this from an investor point of view?

Mortimer, Nomura AM: I agree with everyone that virtual meetings are quite convenient. But face to face meeting and the personal touch cannot be missed. And I think we're all looking forward to the time we can meet people again.

GlobalCapital: How has the low interest rate environment policy, from both the Bank of Japan and the US Federal Reserve, affected your funding plans? What is the future likely to hold?

Kanatani, DBJ: The Japanese market has been very stable, and we have all greatly enjoyed this extremely low interest rate environment. There is enough liquidity. But I think market stability is the most important thing for an issuer. We are closely watching how long the negative rates will last, and how the central banks, including BOJ, will change monetary policies to control inflation.

Hidaka, JBIC: We haven't issued any bonds in the Japanese domestic market in recent years. The Fed has been maintaining its expansionary monetary policy, and as a result of that for the past year or more, we were able to enjoy very favourable funding costs in dollars.

But just recently, Fed chairman [Jerome] Powell mentioned in the Jackson Hole meeting that by the end of this year, they will start talking about tapering, and gradually reduce the amount of bonds they purchase.

This means in the US at least, an interest rate hike is expected and, therefore, short term rates will start rising, and together with that long term rates might start increasing as well. However, I'm expecting a flatter yield curve. The cost of 10 year bonds that we would like to sell would start increasing. The kind of impact that would have on our funding plan, as well as the overall market conditions, are things that we will monitor very carefully.

GlobalCapital: What would happen if the BOJ stops its purchases of domestic corporate bonds?

Kanatani, DBJ: Maybe in the future, the BOJ could possibly increase interest rates. In such a case, we have to respond to that environmental change as quickly as possible.

Hidaka, JBIC: I find it difficult to comment on this issue. If the BOJ starts reducing its bond purchase, then interest rates will start rising. But the BOJ has responsibility to maintain stability of prices.

The BOJ has stated that it will continue with the current policy until the rate of inflation rises to 2%, or higher than that. Given the current environment, the BOJ will not be able to depart from the current monetary policy stance for the time being. ▲

Japan's ESG market receives policies and products fillip

Japan's environmental, social and governance (ESG) bond market is set to have another record year, buoyed by a change in sentiment and the launch of new products, writes Pan Yue.

THE ESG DEBT market in Japan appears to be on the cusp of change, thanks to a new initiative from the central bank.

The Bank of Japan unveiled its inaugural climate change strategy in July, a move that is widely expected to support the growth of the country's green bond sector.

There are different elements to the BOJ policy. First is simply encouraging Japan's largest banks to enhance their ESG disclosures and conduct a climate scenario analysis of their operations. Second is to kick off a new funding plan later this year, which will allow select financial institutions to borrow money at a 0% interest rate for up to 10 years — effectively allowing them to lower their cost of holding excess reserves with the central bank. The funds borrowed under this scheme must only be used for green, sustainability, climate change or transition financing efforts.

The third pillar of BOJ's framework is buying more green debt. Foreign currency green bonds from non-Japanese borrowers will become eligible for purchase as part of the central bank's foreign exchange reserves.

The strategy follows similar approaches from the European Central Bank and Bank of England, although BOJ's measure is being viewed as not quite as aggressive, says Koji Shimamoto, president of Société Générale Securities Japan.

"I feel the new policy is solid and concrete, but the direct impact on the market seems limited because BOJ's action [will not provide] direct exposure in the secondary market," says Shimamoto. "It's not as aggressive as some European central banks."

For example, the European Central Bank can make direct purchases of green bonds in the secondary market, while also using part of its funds to invest in green bond funds. The ECB has a sustainable and responsible investment strategy that aims to increase the share of green securities in its funds portfolio. It also announced an action plan to include climate change considerations in its monetary policy strategy in July.

Shimamoto is not alone in predicting a limited direct impact from the new measures.

But the consensus is that the move will have a strong effect on market sentiment, as the BOJ has long been perceived as having a reluctant attitude towards ESG issues. The BOJ has previously implied that climate change issues do not fall into its mandate of maintaining stability in the capital markets.

"[BOJ's new policy] provides lenders and investors financial support," says Reiko Hayashi, director and deputy president of Bank of America's Japanese subsidiary. "The size of the funding plan is not big, but the attitude from BOJ is a big change. It's a symbolic change, and I think it's quite meaningful that the BOJ raises its voice in this market."

While the BOJ's new policy is focused on green, or climate-related financing, broadly, many believe the uplift in sentiment will spill into the broader ESG market.

"BOJ's climate change-related measure will trigger interest from investors who have never been interested in ESG before," reckons Suzaki Kazuhiro, director of the fund management division of Japan Student Services Organization, which has been selling social bonds on a quarterly basis for the past two years. "We would also pay attention to the increased demand from investors who already invested in ESG, which will lead to further development of the entire ESG market."

Strong deal volume

Japan had a strong year of green bond issuance in 2020. Last year, the country's issuers sold $10.6bn of green bonds, according to the Climate Bonds Initiative

That allowed the country to rank seventh of all countries for green issuance in 2020, and second in Asia, falling only behind China, shows Climate Bonds Initiative. That is a jump from Japan's eighth place globally in 2019.

As of the end of August, 72 green, social and sustainability (GSS) bonds worth $17.2bn had been sold by Japanese issuers, a jump compared with the 51 GSS bonds worth $11.5bn raised during the same period in 2020, according to Dealogic. The numbers do not include sustainability-linked or transition bonds.

"The attitude from BOJ is a big change. It's a symbolic change"

Reiko Hayashi, Bank of America

The market has been helped by Japanese issuers' willingness to sell new products.

For instance, Japan produced its first transition finance deals this year.

In March, Kawasaki Kisen Kaisha, a transportation firm also known as K Line, raised a ¥5.9bn($53m) climate transition loan from Mizuho and Sumitomo Mitsui Trust Bank. Nippon Yusen Kabushiki Kaisha, a liner and logistics company, quickly followed suit, issuing a ¥20bn transition bond in July.

Transition bonds are not considered traditional green notes as they allow companies that do not meet the usual green standards to raise money to transition their infrastructure and practices to comply with the Paris Agreement.

More transition bonds and loans are expected to follow — especially as various government bodies are increasingly focusing on developing the transition finance market.

For starters, the Japan government has committed to reducing greenhouse gas emissions in the country to net-zero and achieving carbon neutrality by 2050. It has also said it will promote policies that contribute to growth focused on decarbonization, including carbon pricing.

In May, Japan's Financial Services Agency (FSA) and the Ministry of Economy, Trade and Industry (Meti) jointly published guidelines on climate transition finance.

Then in June, Meti said it will set up a taskforce to come up with a sector-specific roadmap for the transition to decarbonization, with the aim of promoting climate transition finance. It listed steel, chemicals, electric power, gas, petroleum, cement, and paper and pulp as target sectors for the 2021 fiscal year.

Meti is also asking the market for examples for a transition finance model with a deadline of January 14, 2022.

"After [Meti publishes the roadmap], issuers from those industries can make their transition plans and strategies based on the roadmap, and they're very keen to tap the market," says Sachi Li, head of the sustainable strategy development office at Mizuho. "I think we'll see more issuers come to the market, maybe by the end of the year or next year."

Next up could also be sustainability-linked bonds, which many liken to transition bonds. Sustainability-linked bonds are relatively new in the market, but they have been gradually gaining traction as they offer companies with limited green assets access to the ESG market.

These bonds do not rely on a sustainable use of proceeds. Instead, borrowers tie the pricing of their notes to their own efforts to meet sustainable goals, such as reduced carbon emissions.

"In the case of sustainability-linked bonds, we've seen a couple of SLB bond issuances with coupon step up structure and some other structures, such as ESG-related donation structure," says Bank of America's Hayashi. "Basically, these SLB issuances were well received by investors, but for coupon step-up structure, some investors are not used to such structures and might not be able to participate at this moment."

Taiga Nagao, vice president of debt strategy and issuance at Sumitomo Mitsui Banking Corp, adds that it also takes time for issuers to get ready for SLBs, as they must evaluate the bank's portfolio, like loans provided by SMBC to companies, and set up appropriate ESG targets.

"First, we need to understand how much [carbon dioxide] emissions are generated through our loan/investment portfolio... by engaging with our customers and then set up some targets regarding those emissions," he says.

Social bonds gain traction

Despite the hurdles, Japan's ESG market is heading in the right direction.

The country has also seen a shift in focus to social bonds since last year, when more social funding was required to support communities during the Covid-19 pandemic. Bankers say the market is likely to keep expanding as Japan is developing its own social bond guidelines.

The new guidelines, which are being developed by the FSA, will clarify what is considered social.

Hayashi, a member of the working group on social bonds, says the new guidelines will be in line with the international principles established by the International Capital Market Association, but they will provide more detail in terms of what kind of target corporations or social issues can be included — something Hayashi thinks is unique.

For instance, the draft version of the guidelines lists examples of categories and target populations that can benefit from social bond proceeds.

Some of the examples include welfare for an ageing population, companies and residents in geographically and socio-economically disadvantaged areas and the promotion of diversity.

The FSA sought public comments on the draft between July and August. The final guidelines were yet to be published at the time of going to press.

There are challenges, however, in satisfying investors about the real impact of social bonds from corporations.

"For green bonds, you can quantify the impact, like the reduction of CO2 emissions," says SMBC's Nagao. "For social bonds, the impact is a bit harder to be quantified. From our conversations with investors, some of them prefer to see the impact in numbers."

Yasunobu Katsuki, sustainable development goals primary analyst at Mizuho, says the purpose of Japan's guidelines on social bonds is to facilitate such issuance from private companies. As of March 2021, around 81% of social bonds in Japan had been issued by government agencies, according to FSA data. Corporations only accounted for 6% of social bond sales. The remaining 13% were issued by foreign institutions.

The numbers for green bonds were 20% and 74%, respectively, for government agencies and corporations.

There are some creative implementations of social bonds on the horizon, however. Japan International Cooperation Agency is planning to sell a gender bond in September. The government agency, which provides aid for economic and social growth in developing countries, will use the proceeds to enhance gender equality and increase women's access to schools. The deal will be the first of its kind from the country.

"I think we'll see more issuers come to the market, maybe by the end of the year"

Sachi Li, Mizuho

JICA's transaction, to be led by Barclays Securities Japan, Mitsubishi UFJ Morgan Stanley Securities, Mizuho Securities, Tokai Tokyo Securities and SMBC Nikko, will consist of a 10 year tranche and a 20 year portion.

Although the product is considered niche and will not be able to fit many other issuers' ESG framework, experts believe the deal will demonstrate the diversification potential of the market.

"Japanese investors and companies are focusing on carbon dioxide emissions, and more on the green and transition side," says Li. "The next topic will be diversification and women's issues."

That can bring about some much-needed change to Japanese culture, where women representation in company boards still lags its developed market peers. There's still a long way to go for large-scale growth and change in Japan's ESG market — but the foundation is getting stronger by the day. ▲

Japanese banks confront turbulence

Bank of Japan's negative interest rate policy is hurting profits at the country's banks — pressuring growth in the financial sector and tempering lenders' risk appetite. What can help revive their fortunes? **William Pesek** finds out.

JAPAN'S NOTORIOUSLY profit-starved banks face an embarrassment of riches as Covid-19 slams the economy: a record $3tr of excess cash.

For two decades now, Japanese banks wrestled with cash hoards and the side effects of ultra-low interest rates. They're not alone in the pandemic era, of course. With households around the globe spending less and paying down debt and governments handing out cash, banks everywhere are unusually flush.

Yet the equivalent of 60% of gross domestic product worth of excess cash is off the charts even for Japan — and it speaks to why the economy is walking in place as the US, Europe and China pivot toward steady growth.

In July, Japan's bank lending came in at the slowest pace in nearly nine years, growing just 1% year-on-year. The slowdown underscores the fragile nature of Japan's revival from the pandemic. It also gets at why the most aggressive monetary easing experiment ever known in history is failing.

Banks hoarding the combined GDP of Australia and Brazil is costing Bank of Japan the multiplier effect that makes monetary policy so potent. Since March 2013, BOJ governor Haruhiko Kuroda pumped trillions of dollars into the financial system. And yet, inflation never got more than halfway to Tokyo's 2% target. Today, the worry again is prices falling negative.

"Ideally, banks should get rid of deposits that are greatly in excess of the amount of loans and securities they are able to prudently buy, so there would be no need to hold trillions of dollars' worth of cash as a kind of plug," says Michael Makdad, a senior equity analyst at Morningstar. "It would be great, too, for banks if this could be accomplished by individuals moving their savings out of bank deposits into risk assets like stocks and mutual funds, which would give banks a revenue opportunity to sell."

Japan, though, has a collective confidence problem. Despite promises by the government to increase competitiveness, there's little demand for credit or courage by bankers to extend it.

The answer, analysts say, is for banks to deploy large chunks of this cash pile. In the year ending in March, deposits at Japan's top three banks alone jumped $375bn, with Mitsubishi UFJ Financial Group accounting for more than half.

Deployment options include the gamut of higher-yielding foreign debt: US Treasury securities; corporate bonds; real estate and other assets. MUFG, for example, is eyeing real estate trusts and private equity along with other alternative assets.

As MUFG chief executive Hironori Kamezawa said in May: "A growth in our deposits is proof of customers' trust in us. But to be honest, it's a tough challenge how to manage it."

Japan's biggest regional banking groups, including Concordia Financial Group, are pivoting to US Treasuries and mortgage bonds to pump up returns. Nana Otsuki, chief analyst at Monex — which operates retail online brokerages in Japan — says there's growing interest in non-traditional areas and illiquid assets that enliven returns.

To make the switch is easier said than done, of course. The news cycles of the last two years have been dominated by banks that took big swings — only to miss when things went awry.

The good, the bad and the ugly

In 2019, Mizuho Financial Group took a $6bn charge while writing down losses of overseas bonds as US yields spiked. In 2020, Japan Post Bank experienced stressful moments as bets on collateralized loan obligations went sideways.

In April, Nomura Holdings admitted it sustained a $2.9bn hit amid the collapse of Archegos Capital Management. The US-based hedge fund missed some highly leveraged margin calls, resulting in Nomura's worst quarterly loss since the 2008-2009 global financial crisis.

The good news: Nomura may already be getting its stride back, says Shunsaku Sato, a credit analyst in the financial institutions group at Moody's Japan. Though Moody's has a negative outlook on Nomura, Sato says things "could return to stable if the large loss in its US subsidiary is an isolated incident and the company returns on track, while improving controls to limit tail risk and large losses".

Mike Kanetsugu, chairman of the Japanese Bankers Association and chairman of MUFG, warned in a press conference in April: "We need to pay close attention to whether a second or third Archegos might emerge."

The bad news: the lesson many CEOs may have learned is that it's safer

"I don't see a reason to expect interest rates to actually start rising unless inflation appears in Japan"

Michael Makdad, Morningstar

to continue ploughing money into Japanese government bonds.

The key, says Kiuchi Takahide, a former BOJ official who is now an executive economist at the Nomura Research Institute, is finding a happy medium between higher risk and one's true tolerance. That way, banks can do their best to avoid nasty surprises. "Where there's mispricing," Takahide says, "financial chaos tends to follow."

Timidity seemed a virtue in the months and years after the Lehman Brothers shock 13 years ago. At the time, Japanese banks revelled in their lack of exposure to subprime debt — the toxic assets that were felling banking systems around the globe. Government officials touted Japan's insularity as a strength.

In 2013, finance minister Taro Aso said during a seminar, with full sincerity, that poor foreign language skills saved the day.

"Many people fell prey to the dubious products, or so-called subprime loans," Aso said. "Japanese banks were not so much attracted to these products, compared with European banks. Managers of Japanese banks hardly understood English, that's why they didn't buy."

Yet in the 12 to 13 years since the subprime crisis, Japan's interest rate environment has become even less conducive to healthy bank profits. In January 2016, the BOJ began an experiment with a negative interest rate policy (NIRP), part of its shock and awe effort to end deflation once and for all.

NIRP, in essence, aimed to level borrowing costs across the yield curve and incentivise banks to extend credit to companies. That, in turn, might empower chieftains to increase investments. In practice, though, the policy ended up being a threat to Japan's banks and corporates to mobilise their cash reserves in case they become eroded.

It backfired, too, because by wiping out spreads between short, medium-term, and longer-term JGBs, banks can't harness one part of the yield to profit by lending based on another. It means that the BOJ is still penalising banks without generating the expected revival of demand.

Along with the BOJ's large JGB purchases, NIRP helped deaden secondary trading activity. Within six months of negative rates, MUFG began threatening to scrap its domestic bond trading business.

In the years since, it hasn't been surprising to see peers refuse to go down the NIRP rabbit hole. Former Bank of England governor Mark Carney, for example, has said he's "not a fan" of NIRP. He worries the strategy punishes savers and make it hard for banks to make a profit.

Economist Daniel Gros, a fellow at the Centre for European Policy Studies, notes that the complexity of NIRP might reduce its effectiveness. This includes having to manage a "two-tier system", whereby excess bank reserves are exempted from the negative deposit rate.

"In Japan, the negative rate is still only negative 0.1%, a negligible magnitude, but even still, a large part of reserves is exempted," Gros says. "This shows that central banks in general have been concerned about limiting the impact of negative rates on bank profits."

Just not enough, as Japan's struggles show. Even so, the BOJ has stubbornly stuck to its guns. It is getting further away from generating 2% inflation. And structural headwinds will still be bearing down on the industry even if Tokyo ramps up vaccinations fast enough to generate steady economic growth.

Bank of Japan governor Haruhiko Kuroda's negative interest rate policy backfired

Covid pressure

For most analysts, it's hard to be optimistic.

"There is a good chance that loan interest rates — which have been falling since 2008 — are finally starting to bottom out and stop falling further," Makdad says. "But I don't see a reason to expect interest rates to actually start rising unless inflation appears in Japan. For banks, the risk is that credit costs start to rise before loan interest rates do."

Kaori Nishizawa, a director at Fitch Ratings, expects profitability to "remain weak in the short term". Generally, she expects "lower trading revenue and somewhat elevated credit costs will constrain profitability while the banks continue to address structural challenges".

As of reporting up to June, the "deterioration in non-performing loan ratios was contained, despite increases in NPLs and special-mention loans in the financial year ended March 2021," Nishizawa says. Fitch, she adds, expects NPL ratios at Japan's banks to remain below 2% "although the ratios could rise further when temporary government relief measures expire" or when some special-mention loans "transition into NPLs".

It remains an open question whether the incoming government might be forced to increase Covid relief measures. Japan was set for a leadership change as *GlobalCapital* went to press, after prime minister Yoshihide Suga said in early September that he would not run for another term as leader of the ruling Liberal Democratic Party, throwing open the race to find Japan's next prime minister.

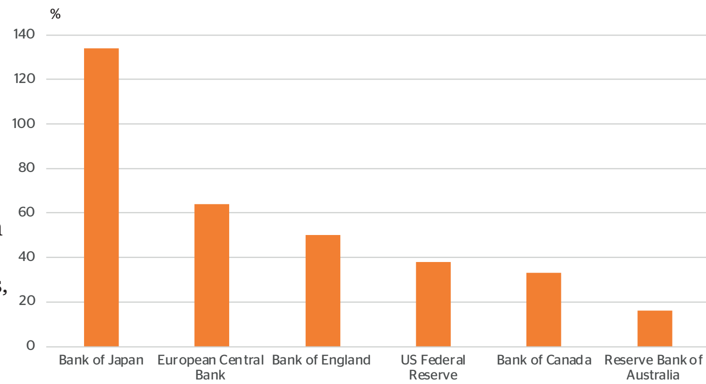
Among Suga's possible successors are former foreign ministers Taro Kono and Fumio Kishida, as well as former defence minister Shigeru Ishiba. Of them, Kishida has called for a new stimulus package worth several tens of trillions of yen as soon as possible.

Japan is seeing record Covid-19 infection rates — and broadening local government state-of-emergency decrees. Some of the government's Covid mitigation efforts have irked the financial industry. Case in point: lawmakers asking financial institutions to lean on clients in the hospitality industry. The idea, detailed in July, was for financiers to help cajole bar and restaurant owners to comply with restrictions on serving alcohol at night.

Unsurprisingly, banks pushed back, arguing it's not their job to enforce compliance with government safety measures. Soon enough, some members of the cabinet were issuing apologies. Lower house parliament member Masanobu Ogura spoke for many when he said: "This tops the list of bad moves that you must not do."

Along with Covid, Makdad adds, the "biggest problem for Japanese banks for the past decade has been super-low and falling lending rates in part reflecting the presence of too many banks in the banking system. It's possible that Covid will result in fewer regional banks a decade from now. But there are also too many cooperatives and other" vested interests around the nation, particularly the politically powerful agricultural industry.

BOJ’s balance sheet towers over its peers’



Source: Bank of America

This so-called Norinchukin Bank system is a microcosm of how rural Japan can often seem like the tail wagging the proverbial dog. It’s a financial institution created by laws dating back to 1923, grouping together the Japan Agricultural Cooperatives, Japan Fishery Cooperatives, Japan Forest Owners’ Cooperatives, and other rural members.

Using deposits from its various individual members and customers, this umbrella bank lends funds to members and related industries. Along with funding businesses, this includes housing loans, auto loans and education loans. Any industry consolidation would imperil local financing and political dynamics.

Such arrangements, and the way they’re seen to be part of rural tradition and culture, demonstrate why change can be so difficult in Japan.

At the same time, Makdad says, “if credit costs were to rise from their very low levels, there is room for profitability to decline further or even for the sector to become loss-making. In short, the environment is such that Japanese banks are not even close to enjoying economic moats.”

Soon after taking office in September 2020, Suga had said there are “too many regional banks” and pledged to revitalise rural economies facing shrinking populations. In November, his team telegraphed subsidies to encourage Japan’s 100-plus regional institutions to merge, increase productivity and raise their technological games. Since then, the reforms fell by the wayside.

Ikuko Fueda-Samikawa, principal economist at the Japan Center for Economic Research, wrote in a note this year that a “multifaceted examination of the degree of financial excess” reveals regional differences in the degree of overbanking. “If current trends continue, the financial excess will increase nationwide in 10 years, except in the major metropolitan areas,” she adds.

A workable solution, she stresses, requires the public and private sectors to cooperate to raise the industry’s competitive game.

“Based on past cases,” Fueda-Samikawa says, “the realignment can be expected to have a cost-cutting effect, but it is unlikely to be a fundamental solution for improving profitability. [The need for] collaboration with different industries is gathering momentum, with initiatives going beyond just realignment to improve profitability and diversify profit sources.”

Loosening control

Technology remains a chronic problem for the largest of Japanese institutions.

On August 20, Mizuho suffered its fifth digital glitch in six months, disrupting over-the-counter services at 460 branches nationwide. The outages, which the bank blamed on backup hardware failing, came just as regulators were finishing on-site inspections related to a system snafu earlier in the year. Mizuho’s ATMs were swallowing thousands of cash cards.

The Tokyo Stock Exchange has also had its run of tech stumbles. Exhibit A is an October 1, 2020, hardware failure that brought all trading to a halt.

The TSE’s first full-day suspension of dealing since 1999 was a blackeye for the government’s pledge to prioritise digitalisation and increase Tokyo’s role as a global financial centre. It was a setback, too, for Tokyo’s hopes of wooing investment banks and fund managers from Hong Kong as China ended the city’s autonomy from the mainland.

Yet one reason financial change in Japan is so hard is that the banking system has, for decades, often acted more like a safety net than a vibrant for-profit industry. Rarely has that been truer than over the last 20 months of pandemic-related disruption.

Sean Campbell, an economist and head of policy research at the Financial Services Forum, can’t help but marvel at how Japanese “large banks acted as the fastest-growing supplier of credit to the real economy from the start of the Covid-19 pandemic.”

The first nine months of 2020 saw an annualised 7% surge in loan growth, which he notes is three times the average annual rate of increase over the previous five-year period.

A report published jointly in May by the FSS, the Institute of International Finance and the International Swaps and Derivatives Association, said the large increase in bank deposits during the pandemic shows the strength of large banks, as they entered the health crisis with high levels of capital and liquidity, underscoring their safety and soundness.

“Banks in other jurisdictions saw similar rates of increase in deposits,” adds the report. “In Japan, while deposits exhibited a steadily rising trend in the period leading up to early 2020, the initial months of the pandemic saw a dramatic spike in bank deposits.”

Yet Japan’s aptitude for navigating crisis is of little use to sort out its $3 trillion dilemma.

In reality, says Jesper Koll, a longtime observer of Japanese markets, Japanese companies are more globally exposed than many realise. He notes that roughly 64% of profits of companies listed on Japanese stock markets come from global sales and operations. So, from a top-down macro perspective, global events matter more than local zigs and zags.

A decade ago, Koll says, about 50% of Japan Inc’s profits came from the external sector. It is now 60% thanks to Japanese banks and financial firms going global.

“It’s a little-known fact that Japanese banks have been the largest provider of credit in non-China Asia for three years running,” Koll says. At home, though, banks’ profit margins are being squeezed by the BOJ.

“If interest rates are not allowed to rise, banks can’t grow their profit margins,” Koll says. “To get bullish on Japanese financials in general, and banks in particular, we need to see an end to the Bank of Japan’s current policy of yield-curve control.”

In particular, he says, the BOJ must let 10-year yields rise. The spectre of greater profits, Koll notes, would give bankers more confidence to take risks — and deploy their cash hoards. ▲