Chapter 2 Rebuilding Finance and Enterprises

[Section 1 Problems Facing Finance and Enterprises]

1. Declining Function of Indirect Finance

- Japan's financial system depends heavily on indirect finance.

  Enterprises' fund-raising means → 39% for indirect finance, 36% for direct finance

  Considering financial institutions' equity and bond holdings → 50% are indirect finance-related, 26% are direct finance-related

  → The main bank system is at the core of Japan's indirect finance system.

- Factors behind Declining Function of Indirect Finance

  Problems at financial institutions: Non-performing loan problem → Reduced risk-taking capacity at financial institutions

  Problems at client enterprises: Excessive debt problem → Increased credit risks

  → Affecting corporate finance in terms of business investment and daily operations

2. Effects on Business Investment

- Listed Manufacturing Firms' Recent Business Investment Behavior (FY 1998-2001)

  Firms with high returns on assets → Encouraging business investment

  Firms with high capital costs (interest rates on liabilities) → Limiting investment and repaying borrowings

  Funding conditions (cash flow, long-term borrowings, bond issues) do not affect investment → Easier constraints on fund-raising, priority given to debt repayment

  The main bank system serves to restrict business investment (possible credit crunch).

3. Effects on Small and Medium Enterprises (SMEs)

- Present State of SME Finance

  Lending to SMEs has declined and financial institutions are reluctant to give loans to SMEs. Inter-company credit for SMEs has dropped relatively and substantially since the 1990s.

  → It is difficult for the effects of monetary easing to reach SMEs.

- Policy Measures to Facilitate SME Finance

  Measures include safety net guarantee and lending systems, loans backed by accounts receivable, and the Bank of Japan's purchases from banks of asset-backed securities such as CP backed by accounts receivable.

→ Diversification of fund-raising channels, prevention of decline in inter-company credit

Based on the above:

- Resolving the non-performing loan problem at banks → Rebuilding finance (normalizing indirect finance)
- Reducing excessive debt, promoting early business turnaround and enhancing profitability at enterprises → Rebuilding enterprises

Figure 2-1-1 Non-financial Enterprises' Business Investment (all industries)

Priority given to debt repayment

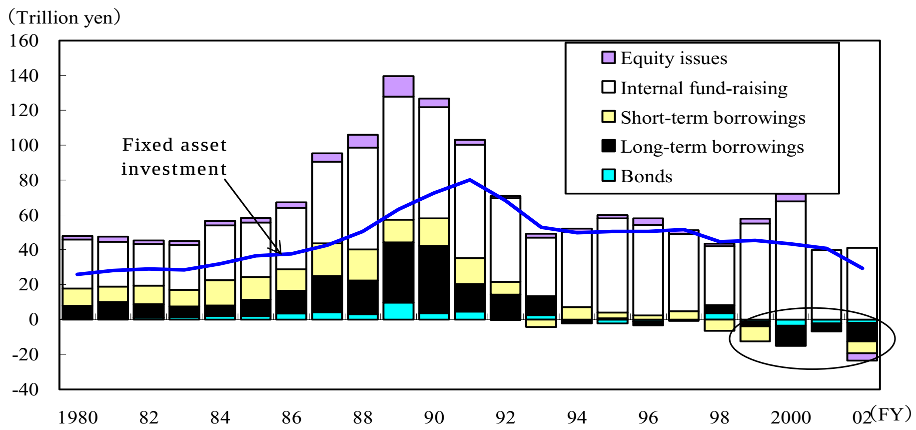


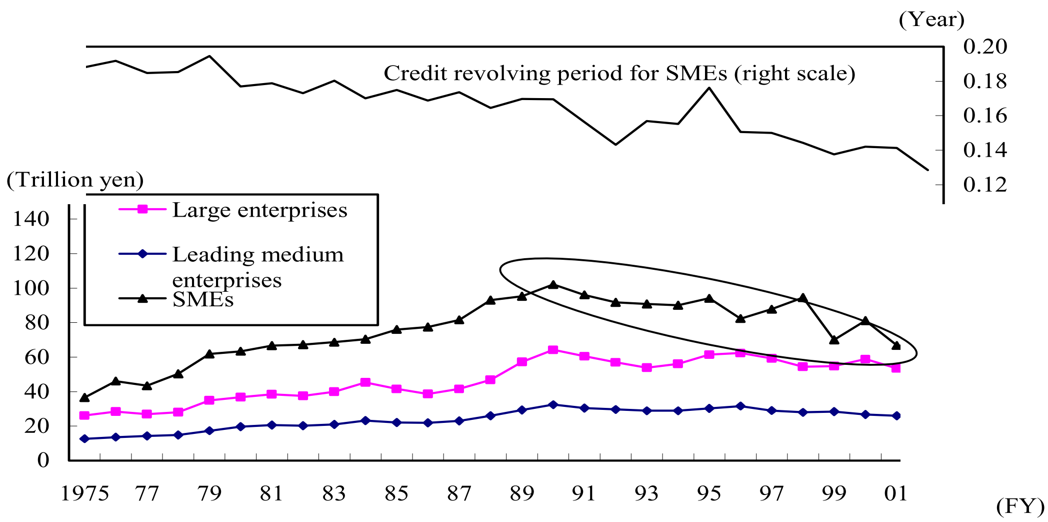
Table 2-1-2 Business Investment Behavior and Fund-Raising (Manufacturers)

Changes seen in roles of main banks

	1988-1992		1993-1997		1998-2001	
	Symbol	Significance	Symbol	Significance	Symbol	Significance
Return on assets (ROA)	+	**	+	**	+	**
Interest rates on debts	−	**	−	**	−	*
Capital stock	−		−	**	−	*
Cash flow	+	*	−	*	+	
Long-term borrowings	−		−	*	−	
Bonds	+	**	+	*	+	
Main bank dummy	+		+	*	−	*
Coefficient of determination adjusted for degrees of freedom	0.858		0.873		0.824	

Figure 2-1-6 Inter-company Credit for SMEs

The inter-company credit situation is severe for SMEs



[Section 2 Rebuilding Finance]

1. Present State of Disposal of Non-performing Loans (Year-on-year changes in parentheses)

- Disposal of non-performing loans was progressed in FY 2002: Major banks' outstanding NPLs at ¥20.2 trillion (down ¥6.5 trillion), share of NPLs at 7.2% (down 1.2 percentage points)
- NPLs regarding borrowers in danger of bankruptcy or below were actively written off from balance sheets. (up ¥5.6 trillion)
  → (1) growing liquidation of loans, (2) increasing reconstruction-oriented NPL disposals, (3) growing improvement in business performance
- NPL disposal costs declined (down ¥2.6 trillion), but exceeded core operating profit.

2. Challenges Facing NPL Disposal

- NPL Share-Halving Target
  Share of NPLs at major banks in FY2001 are to be halved by FY 2004
  → Major banks' business plans reflect the target (cutting the NPL share to some 4%).
  Features of NPL disposal in FY 2002 compared with past disposal
  → (1) progress in NPL disposal (up), (2) New NPLs (down)
- Tasks to achieve the target
  Promotion of NPL disposal
  - NPLs to borrowers in danger of bankruptcy or below subject to 50%-80% rule
    → Major banks are already making progress
  - Loans to borrowers that need special attention
    → Business selection and early turnaround measures to make loans performing
  - Loans to normal borrowers and borrowers that need attention
    → Prevent degradation of loans to help reduce new NPLs

  Improvement of profitability
  - Setting interest rates at levels in line with credit risks of client firms
  - Deferred tax asset issue → Sufficient taxable profits are required.

3. Incentive Structure of the Financial System

- Significance of incentives for normalizing indirect finance
  From company-based loans to project-based loans (project finance)
- Advantage of loan liquidation (market-oriented indirect finance)
  → Transfer of loans to third parties that have risk-taking capacity

→ Contributing to facilitation of fund flows and stabilization of financial system

- Increasing asset liquidation

  Increase in liquidated assets held by (non-financial) enterprises

  → Enterprises purchasing such assets implying supply of funds , offsetting falls in bank loans

- Unwinding cross share holdings

  Equity buybacks, investor relations activities → Using direct finance

- Reviewing government finance

  It is required to review their operating field, under the principle 'Assign all that can be done by the private sector to the private sector'

Figure 2-2-1 Major Banks' Outstanding Non-performing Loans and NPLs' Share of Total Loans

Outstanding NPLs and their share declined in FY 2002

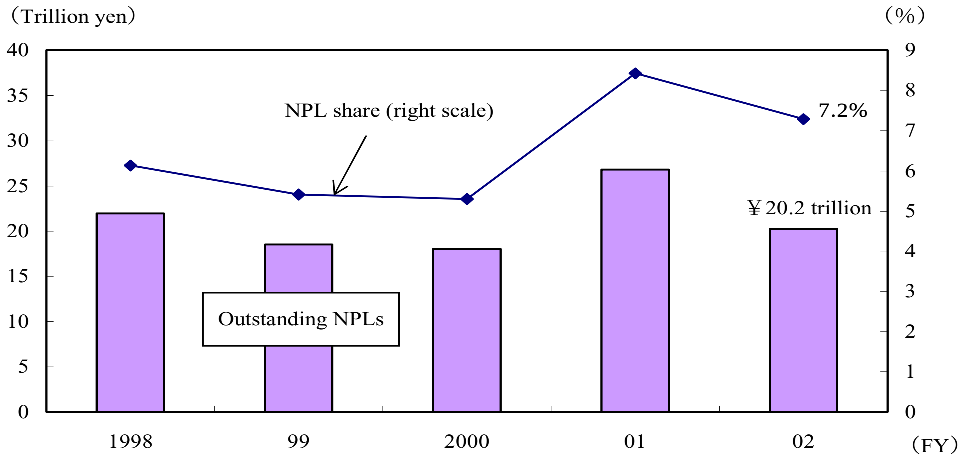


Figure 2-2-2 Major Banks' Measures to Write off NPLs

Loans to borrowers in danger of bankruptcy or below that could possibly go bunkrupt were actively written off

Measures to write off NPLs

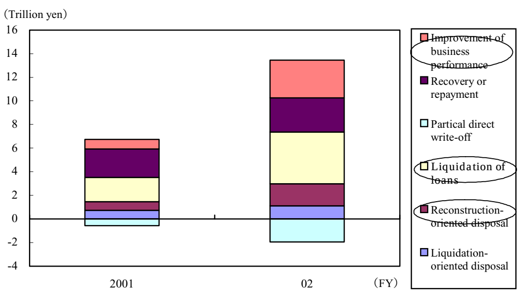


Figure 2-2-3 Major Banks' Effective Core Operating Profit and NPL Disposal Losses

NPL disposal losses declined,

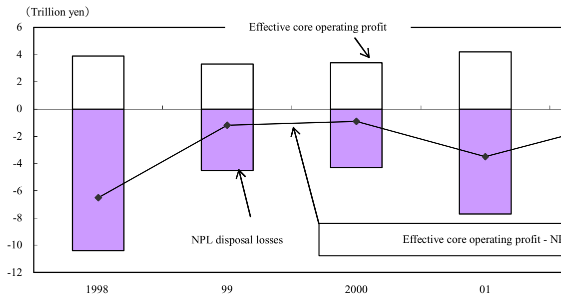


Figure 2-2-6 Firms' Creditworthiness and Fund-raising Cost

Interest rate gap widens according to credit risks

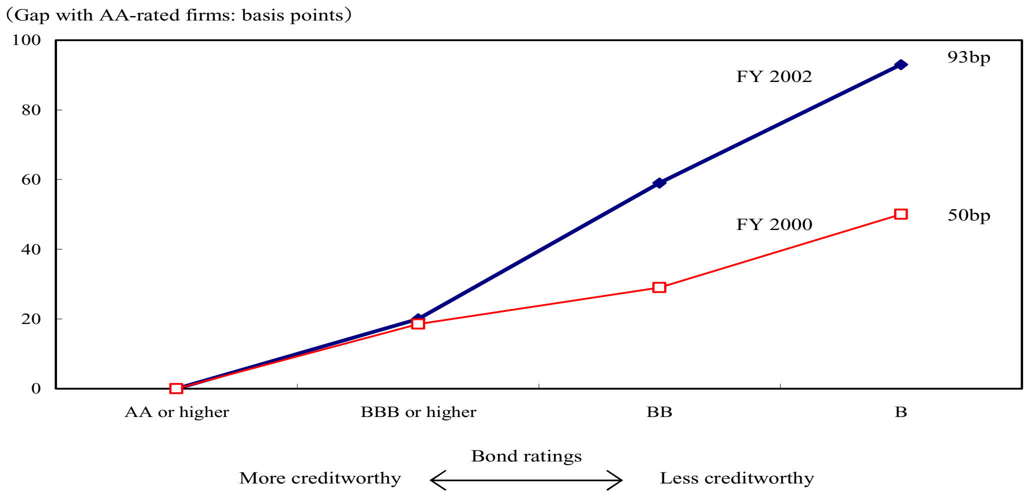


Figure 2-2-7 Breakdown of Major Banks' Core Capital

Deferred tax assets account for majority of core capital

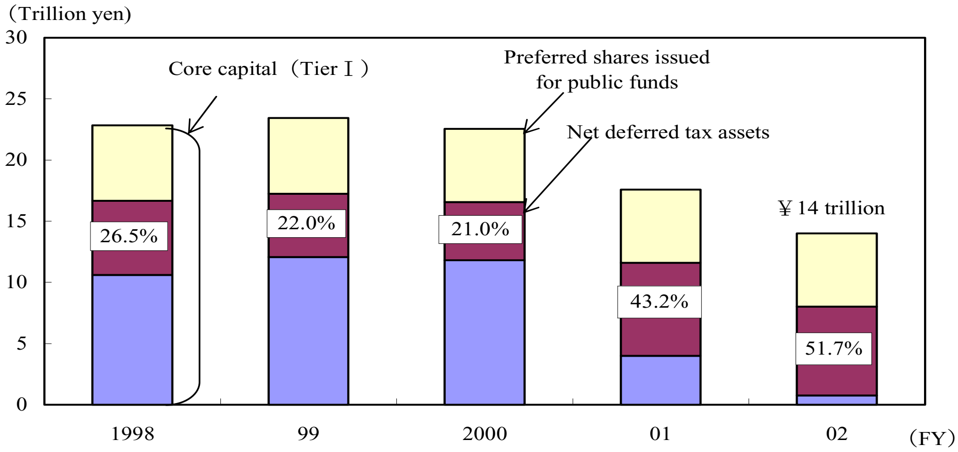


Figure 2-2-9 Bank Lending and Asset Liquidation

Asset liquidation helps offset a fall in bank lending

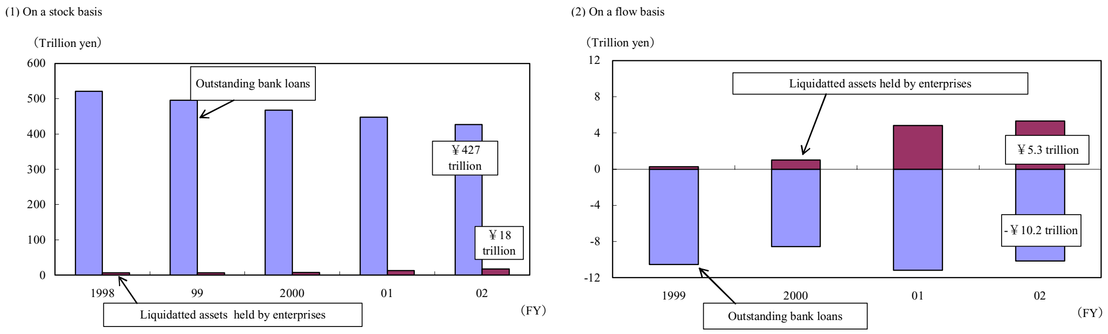
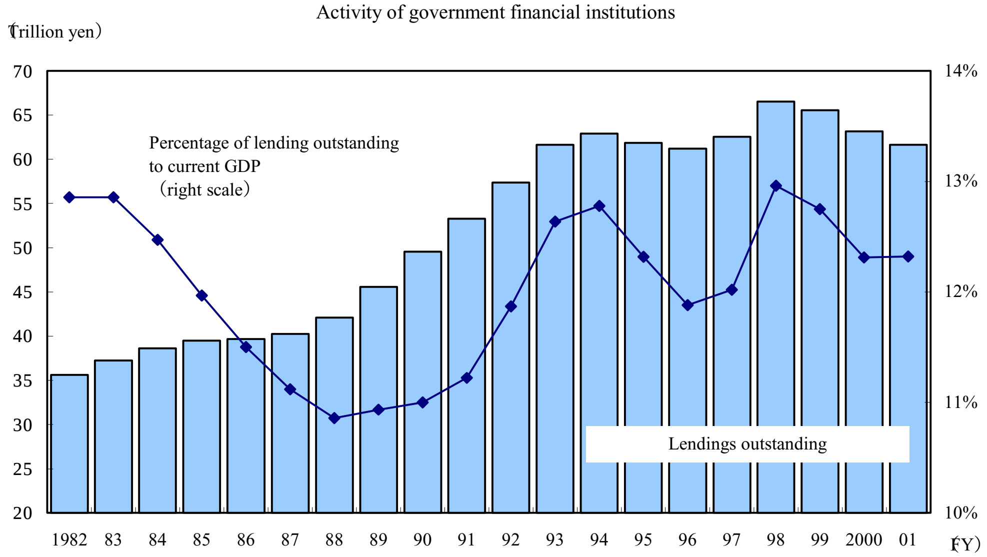


Figure 2－2－10 Lendings Outstanding of Government Financial Institutions

Activity of government financial institutions



[Section 3 Rebuilding Enterprises]

1. Challenges Facing Business Sector
- Restructuring of enterprises (effective utilization of assets, lowering of break-even points) has seen some progress.
- Balance sheet adjustment is a challenge still facing non-manufacturing enterprises.
  → (1) Excessively indebted firms' business turnaround and (2) redoubled efforts to improve profitability are necessary.

2. Excessively Indebted Firms' Business Turnaround
- Decline in main banks' enterprise-saving functions
  → Support is limited to enterprises that are heavily indebted out post robust core earnings.
- Mechanisms to facilitate early business turnaround are required
  About 15% of listed enterprises are required to implement consolidation.
  (About 8% have launched consolidation and about 6% are required to achieve early business turnaround.)
- Development of framework for workouts: Faster liquidation through transparency-enhancing measures and others
  → (1) Guidelines for workouts , (2) Guidelines for early business turnaround, (3) Creation of the Industrial Revitalization Corporation
- Examining effectiveness of workouts (features of banks' debt waivers)
  (1) Large enterprises showing relatively better performance are subjected to debt waiver.
  (2) Banks require enterprises to book special losses and cut personnel.
  → Such debt waivers are not called for as an easy way to delay liquidation of ailing enterprises.

3. Business Turnaround in Public Framework
- Role of the Industrial Revitalization Corporation
  The corporation is expected to mediate coordination of interests between creditors from a neutral perspective and make concentration of loans easier.
- Overseas precedents (efforts in Northern Europe and Asia) and lessons
  (1) Purchases of loans at market prices, (2) Considerations to equality between banks and to prompt loan purchases, (3) Utilization of know-how in private sector including foreign firms

4. Improvement of Enterprise Value and M&A

- Changing environment surrounding the business sector and features of M&A

  Changes in key business resources, greater emphasis on profit targets

  → Reorganization of business resources is required in a short period of time

  → Introduction of enterprise reorganization laws and emergence of investment funds

  M&A varieties: Acquisitions, capital participation → Greater emphasis on mergers and business transfers

  M&A purposes: Main purposes are to enhance existing businesses → Activation of business reorganization

- Market assessment of mergers and real effects

  The market is evaluating "industry reorganization," that has replaced "bailout-oriented mergers," more positively.

  Effects of mergers are uneven → Depending on business performances of individual enterprises

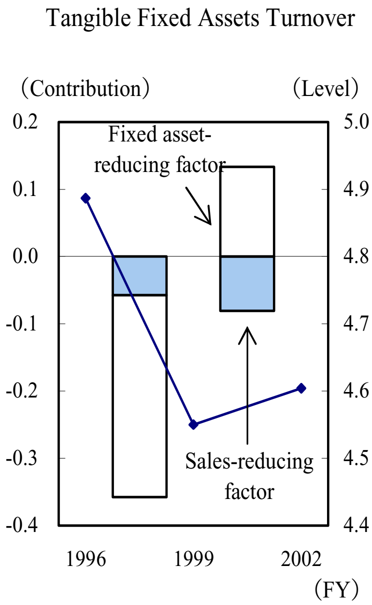
- Features and effects of business transfers

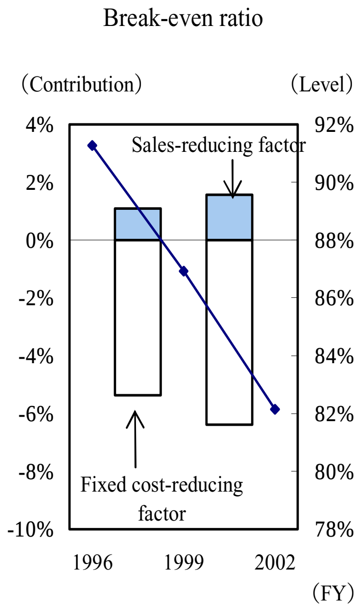
  Related to business transferees' enhancement of existing businesses and business transferors' withdrawals from certain businesses

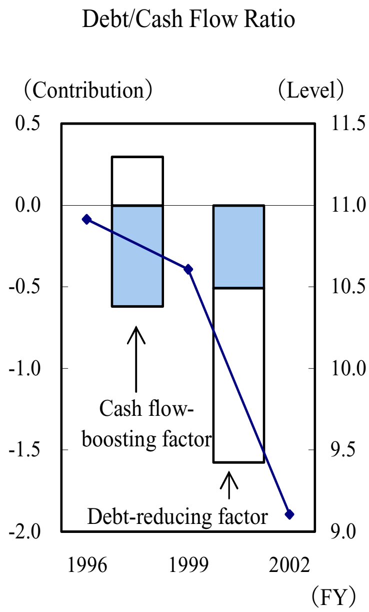
  Better effects seen for business transferees with lower-than-average ROAs → Possible revitalization of enterprises

Figure 2-3-1 Progress in Restructuring of Enterprises (all industries)

(1) Improvements are being made in the business sector







(2) Some problems are left in balance sheet adjustment

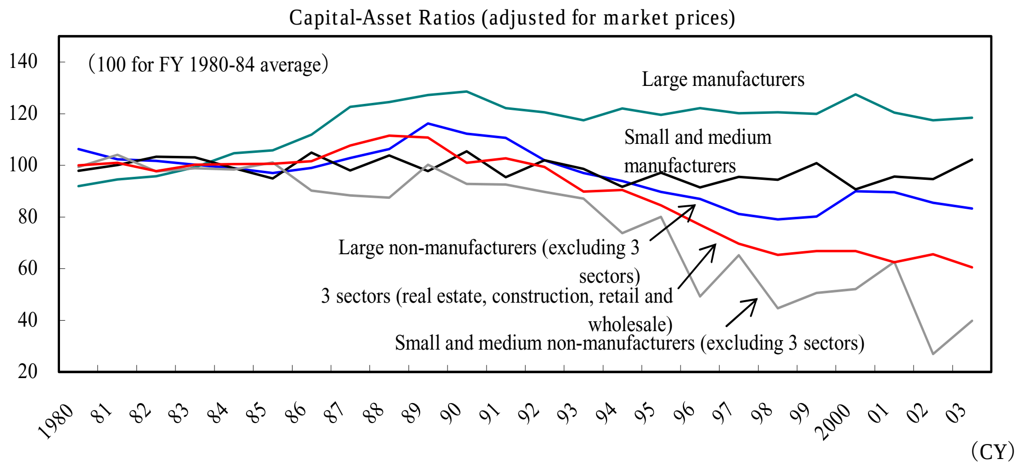


Figure 2-3-3 Changes Seen in Main Banks' Recurring Profit-Stabilizing Function

A total of 130 listed firms must be liquidated or reconstructed

Second half of 1990s

2,141 listed firms		Debt: Under industry average (1,131firms)	Debt: Over industry average (1,010 firms)
Profitability	Good (1,809 firms)	48% (1,026 firms)	36% (783 firms)
	Deteriorated (332 firms)	5 % (105 firms)	11% (227 firms)

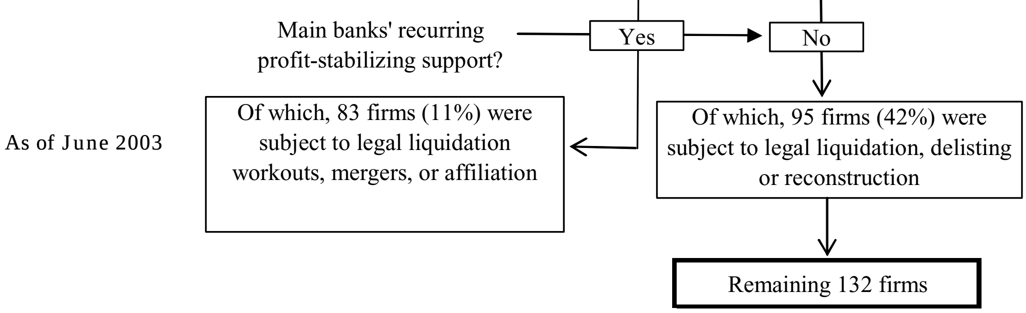


Figure 2-3-6 Breakdown of Debt Waiver Patterns by Business Size

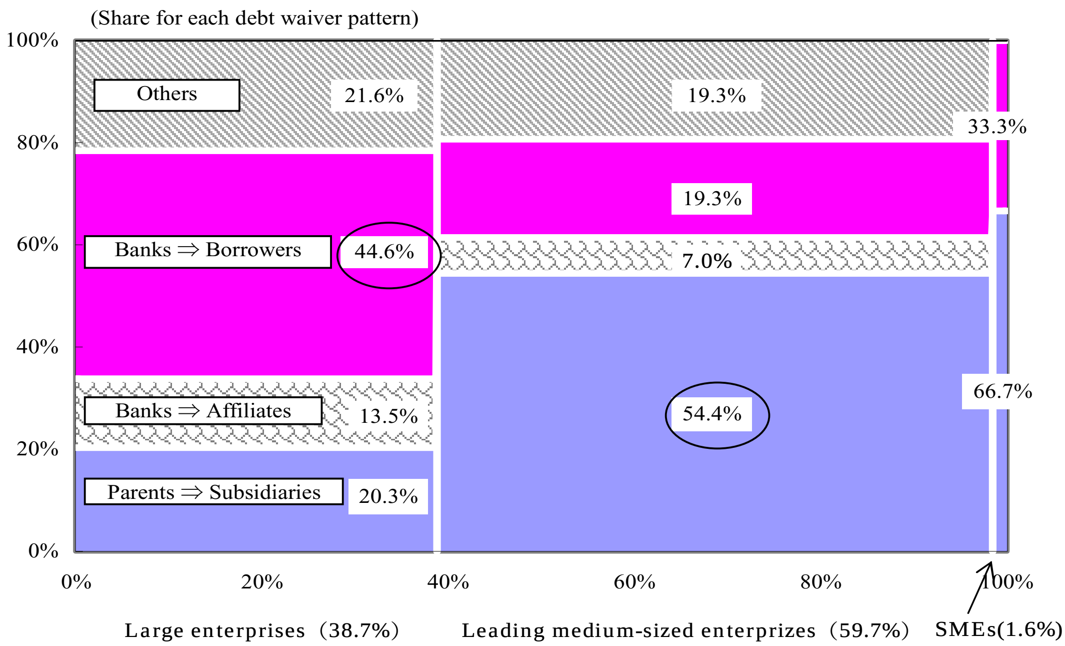


Figure 2-3-7 Features of Banks' Debt Waivers

Debt waivers are not necessarily called for as an easy way to delay liquidation of ailing enterprise

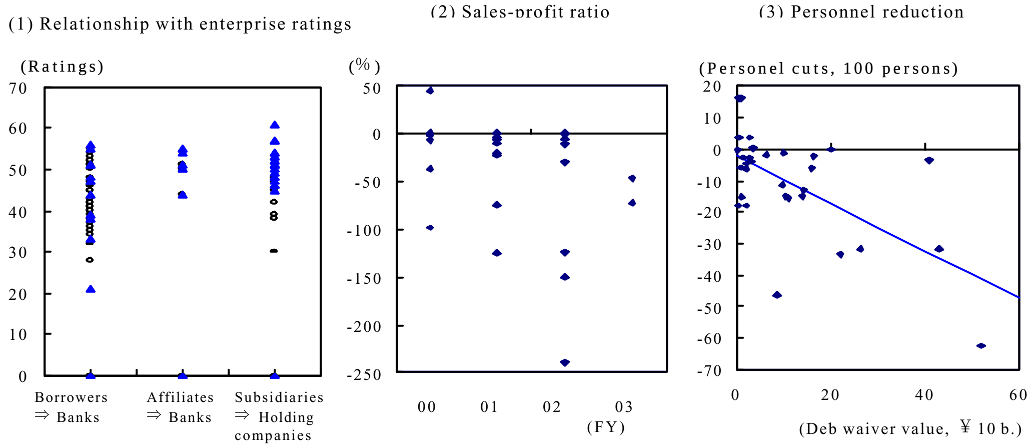


Figure 2-3-10 Breakdown of M&A Deals by Category

M&A deals have been increasing since 1992

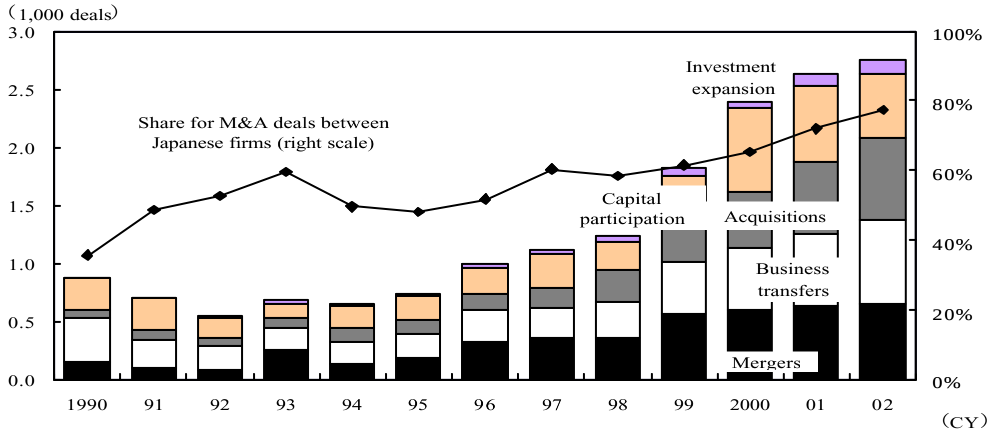


Figure 2-3-12 Breakdown of M&A Deals by Purpose

Enhancement of existing businesses is a dominant purpose of M&A purposes

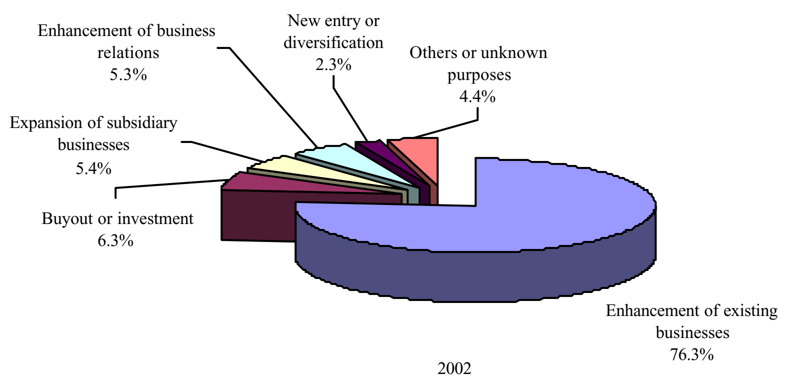


Figure 2-3-13 Stock Market's View of Mergers

The announcement effect has gradually increased

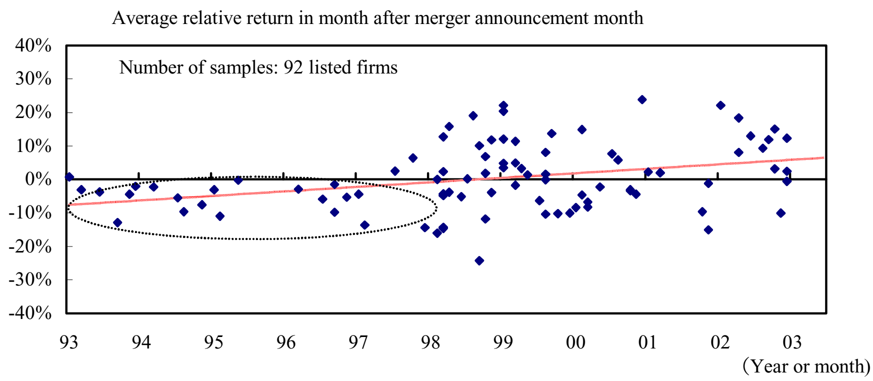


Figure 2-3-14 ROA-Boosting Effects of Mergers

Effects are various in the first and second years

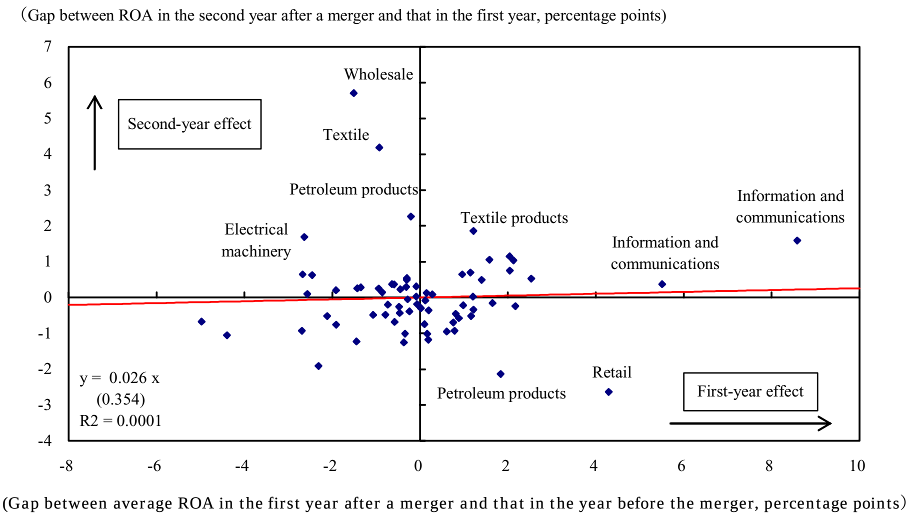


Figure 2-3-16 ROA of Business Transferee

ROAs rose for transferees below the sectoral average

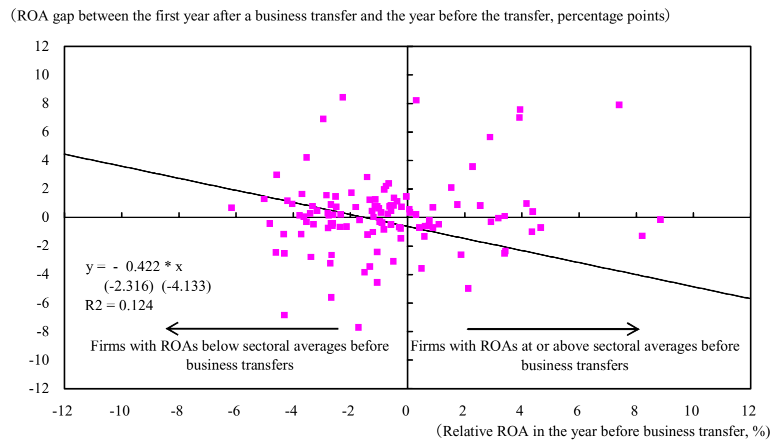


Figure 2-3-17 ROA-Boosting Effect for Business Transferee

Business transferees having positive first-year effects can have positive second-year effects

[Section 4 Impact of Structural Adjustment on Employment and Wages]

1. Adjustment Pressures on Employment

- Bankruptcies declined, involuntary unemployed persons leveled off
  ← Disposal of non-performing loan by reconstructing borrowing enterprises are increasing
- "Employment mismatches" are increasing
  → Unemployment coexists with unfilled job vacancies
- Young jobless people (aged 15 to 24) and long-term unemployment (one year or longer) are increasing

2. Adjustment Pressures on Wages

- Basic wages (scheduled wages) are being reviewed
  → Absence of basic wage increases, reconsideration of seniority-based wages, introduction of performance-based wages
- Sustained shift to part-timers
  → Downward pressures on wages

3. Desirable Employment Policy

- Expectation for maintenance of employment by public works was high
  → Labor productivity growth has slackened, labor share has remained high
- Europe and the United States are shifting from "passive employment policy" (including unemployment compensation) to "active employment policy" (including vocational education and training)
  → Smooth labor moves across different industrial categories
- Japan should put priority on vocational education and training
- Europe and the United States have experience in dealing with young unemployment (industry-academia cooperation and skill development)

Figure 1-1-23 Breakdown of Unemployment by Reasons for Seeking Jobs

The number of involuntary job losers has stopped increasing

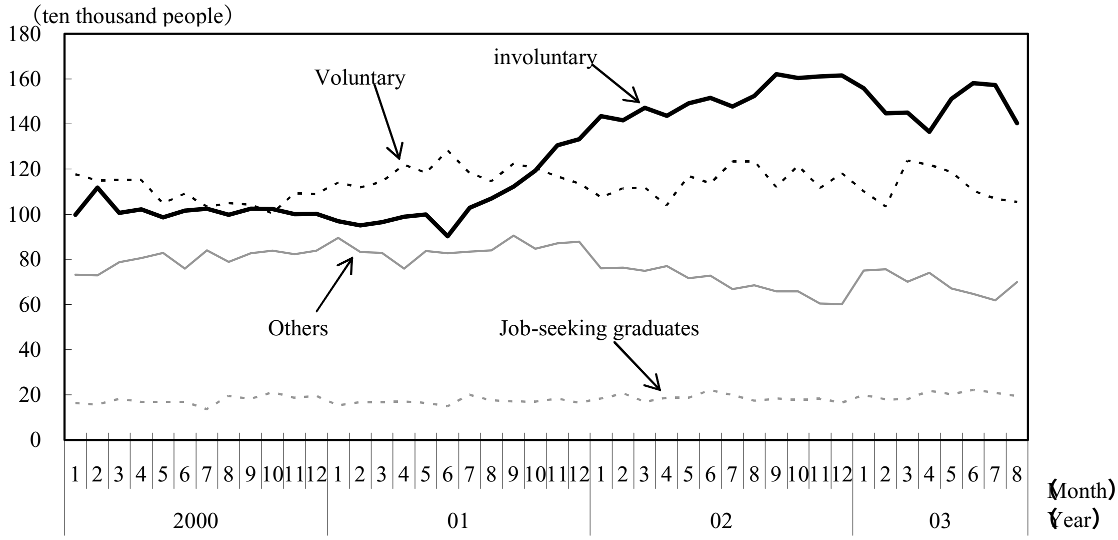


Figure 2-4-4 Unemployment-Vacancy Curve

Employment mismatches are increasing

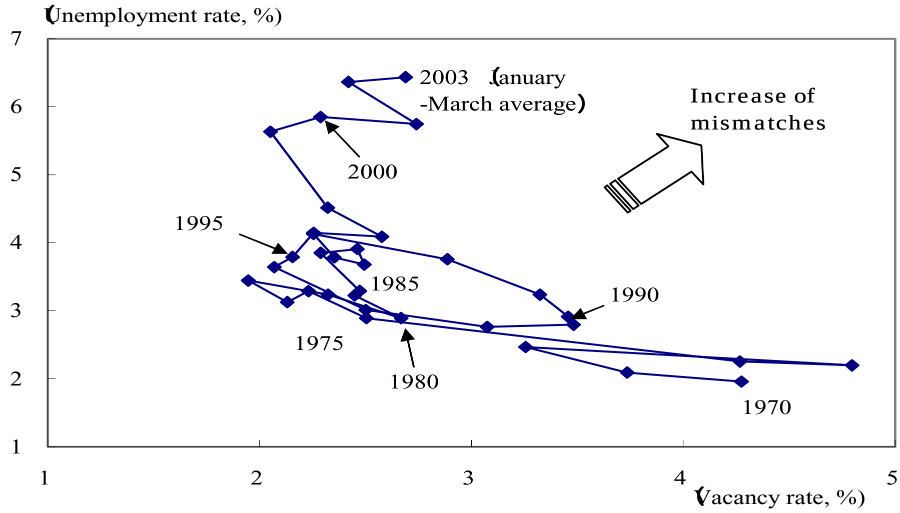


Figure 2-4-6 Breakdown of Unemployment Rate by Ages

The unemployment rate is high especially for the young

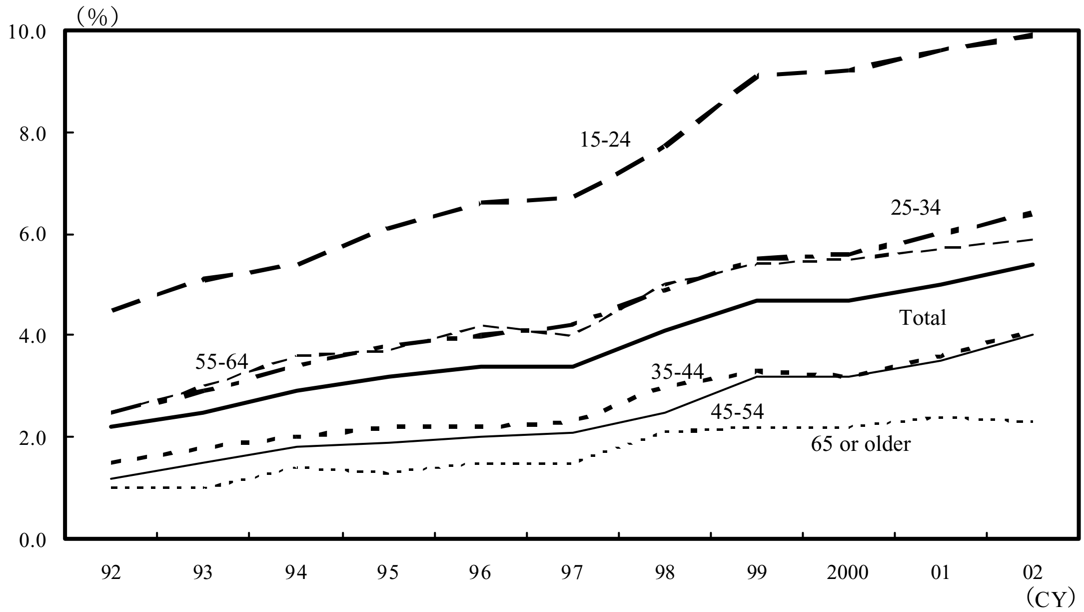


Figure 2-4-7 Share of Those Remaining Unemployed for One Year or Longer

The share of long-term unemployed has been increasing

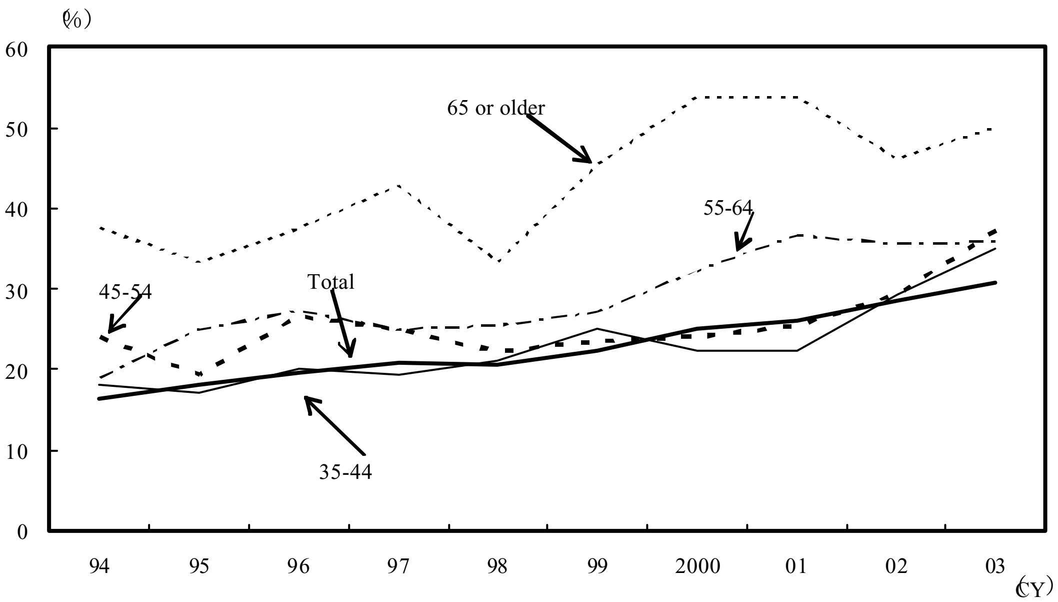
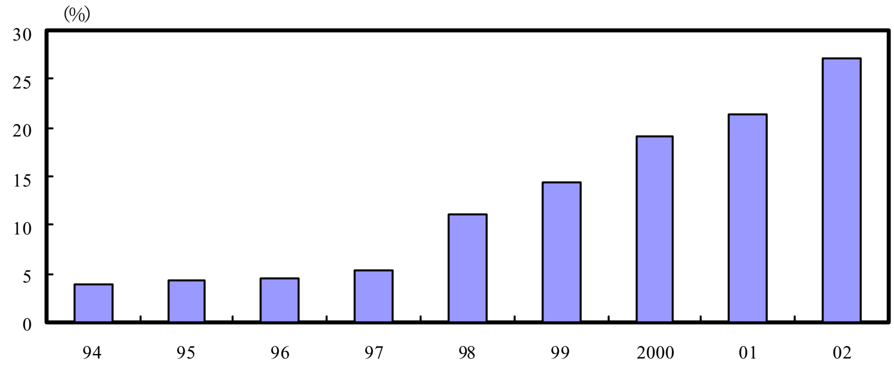


Figure 2-4-10 Basic Wage Increase and Bonus Payments

The share rises for offices with no basic wages and declines for those paying bonuses

(1) Share for offices without basic pay hikes



(2) Share for offices paying bonuses

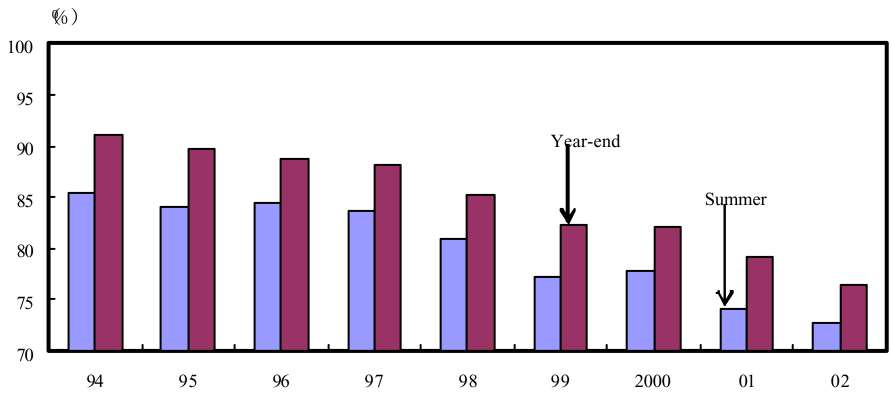
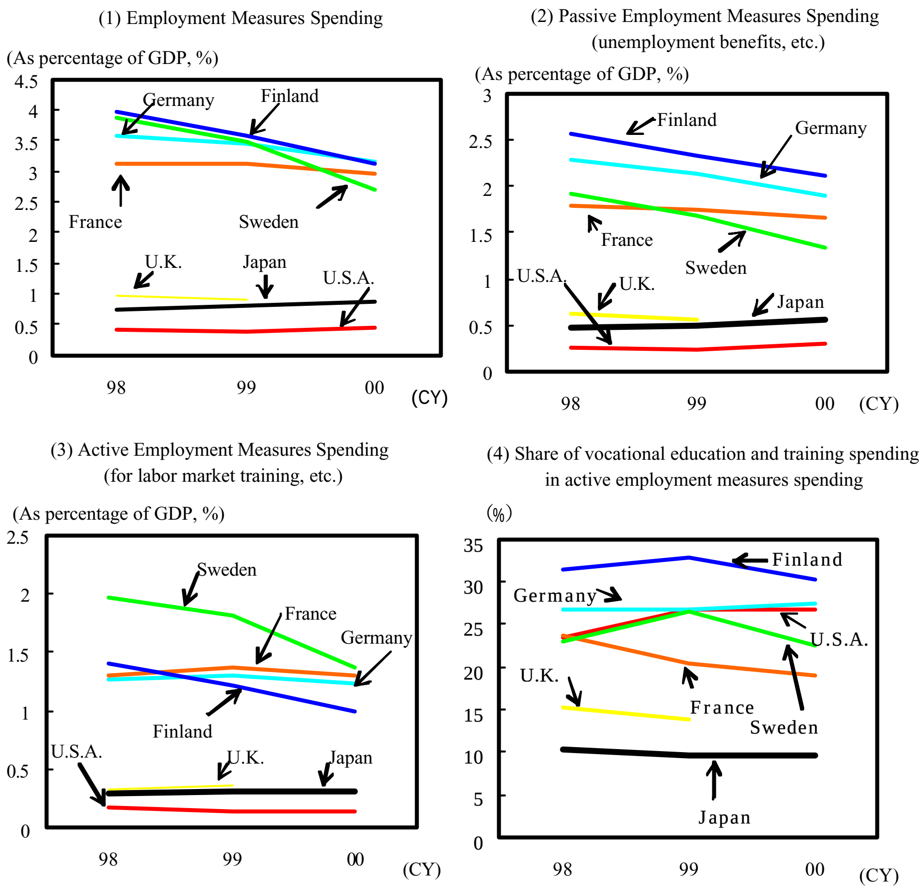


Figure 2-4-15　Employment Measures Spending as Percentage of GDP in Industrialized Nations



Notes:　Active employment measures = public employment services + labor market training + youth measures + subsidised empoyment + measures for the disabled

Passive employment measures = unemployment compensation + early retirement