

# At a Glance

The World Bank

FPD Note No. 32

December 1994

## Developing long-term finance in emerging markets

Using bank debentures: Lessons from Japan

Masakazu Watanabe



From the early 1950s until quite recently, the Japanese government took an active role in promoting a bank debenture market. This Note explains how the Japanese bank debenture market developed and what role these debentures played in establishing a bond market. The debenture market started life at a time when massive amounts of long-term capital were needed for reconstruction. Capital markets had not yet developed, and market-based long-term funding was seen as too risky by both investors and financial institutions.

Japan's government was especially successful in promoting a liquid debenture market. First, it created a uniform bank debenture instrument with the same coupon or discount rate. This debenture was adopted by six issuers, all carrying the same implicit credit ratings. Second, the government developed a strong investor base by providing incentives. The Japanese experience shows that it is possible to create a government-supported benchmark in the securities market even if the government itself is not borrowing to finance budget deficits. This experience should be of interest to developing countries looking for ways to

speed the development of long-term funding instruments, especially for infrastructure projects.

For example, the World Bank has recently helped to establish bank debentures in Argentina. The debentures are issued by prime domestic banks with a backstop facility as a safeguard scheme. The backstop facility stands ready to purchase the bank debenture in case of market difficulties. This kind of innovative support makes it possible to use the bank debentures to develop long-term funding with fewer government interventions than in Japan (see FPD Note 29).

### Creating the Japanese debenture market

#### Issuers

Bank debentures were introduced in 1952 with the designation of six banks by a special law.<sup>1</sup> Although all six were commercial banks, three specialized in long-term credit and the other three served specific sectors of the economy. The banks were broadly owned, with one-third of shares held by individuals and two-thirds by financial institutions and industrial corporations. None had a dominant



Financial Sector Development Department

Vice Presidency for Finance and Private Sector Development

shareholder: no single shareholding exceeded 5 percent. Along with implied support from the government, the broad ownership was an important factor in maintaining consistent creditworthiness across all six institutions.

All long-term credit banks issued identical securities that were identically priced, with no differentiation by issuer credit. These coupon bank debentures were issued on tap. Competition among the long-term credit banks took the form of distribution effort rather than price, which helped to expand the investor base.<sup>2</sup> With most bank debentures issued on tap, investors had a simple instrument to purchase. The bulk (70 percent) of the debentures issued were for a five-year maturity with a fixed coupon rate. The balance was in one-year discount debentures. These characteristics contributed to liquidity.

**Investor base**

There were three main phases of investor base development. In the initial phase, the Ministry of Finance purchased debentures using the deposits of the postal savings system.<sup>3</sup> By 1955, commercial banks had become major purchasers of bank debentures, supported by special incentives (described below). In later years, as these incentives for commercial banks were wound back, individuals became the main debenture purchasers. (See box on page 3 for a summary of support structures.) Individuals now hold more than half the bank debentures issued by long-term credit banks (figure 1).

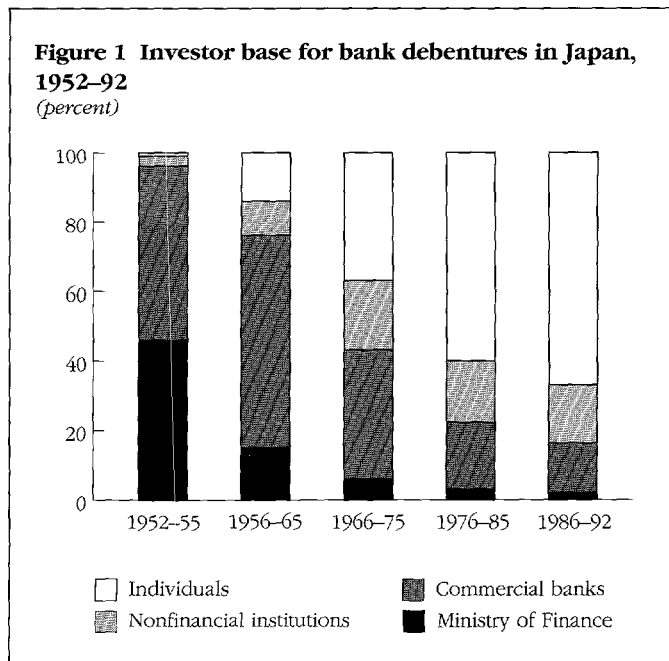
Over the period 1955–93, the volume of bank debentures rose rapidly—from ¥347 billion to ¥74,435 billion. While bank debentures accounted for the bulk of the bond market in the early years, they dropped to 20 percent by 1993 as other bonds were introduced.

*Phase 1: Inception.* The first step was to create an investor base. At the start, bank debentures were purchased primarily by the Trust Fund Bureau of the Ministry of Finance. This Fund invested the savings mobilized through the extensive postal savings system. This phase lasted only a couple of years. As the

Ministry of Finance gradually withdrew from purchasing bank debentures, it was replaced in the market by commercial banks encouraged by a range of policies giving preferences to the bank debenture instrument. Although the Ministry of Finance continued to refinance its previous purchases, and from time to time made new investments in bank debentures for sector-specific loans such as those for the steel and shipping industries, the share of its purchases declined significantly.

*Phase II: Maturity transformation.* In 1956–65, commercial banks were the main investors in bank debentures, holding 70 percent of the total amount outstanding. A number of preferences for bank debentures made them attractive to commercial banks:

- They could be used in Bank of Japan Loan and Open Market Operations. Bank debentures were specified as eligible collateral for commercial banks borrowing funds from the Bank of Japan. In addition, the Bank of Japan added bank debentures to its intervention account through which it sold or bought securities to carry out its monetary policy. Thus banks that held coupon debentures could raise funds whenever they wanted to, either by selling the debentures to the Bank of Japan or



### Market support structures

Since their inception, bank debentures have received strong government support through a variety of incentives and privileges. Strong official backing was the key support factor, ensuring that the long-term credit banks were perceived as highly creditworthy. Support mechanisms have included the following:

- Mobilization of the pool of savings in the Ministry of Finance's Trust Fund Bureau created the initial demand for debentures.
- The inclusion of bank debentures in the Bank of Japan's intervention account for open market operations encouraged commercial banks to buy them.
- Competing security issues were tightly regulated.
- Special tax preferences were given to individual investors to encourage them to buy debentures.
- Interest rate regulation and other policies assured a rising yield curve.
- Uniform credit was posted on all bank debenture issuers to provide simple product characteristics. This helped to build liquidity.

by borrowing from the bank while using the debentures as collateral.

- The purchase of debentures held the promise of leveraged cofinancing. In return for purchasing bank debentures, a commercial bank could ask the long-term credit bank to provide a long-term loan to an industrial corporation that it designated. As a matter of general practice, the long-term credit bank would provide that corporation with a loan for twice the amount of bank debentures purchased by the commercial bank. In addition, the commercial bank would obtain a flow of deposits from the client corporation that received the long-term loan.
- The coupon for bank debentures was set at about 200 basis points above the regulated interest rate for time deposits. Commercial banks thus earned a reasonable profit by investing in this low-risk asset.

*Phase III: Market broadening.* By the 1960s, the government was keen to develop the bond market. Thus it needed to help create a new investor base for debentures so that commercial banks would be

“free” to invest in bonds. The first (since World War II) government bonds were issued in 1966. The Bank of Japan removed coupon debentures from its intervention accounts, eliminating most of the benefits of buying bank debentures for the commercial banks. It was especially difficult for city banks to continue purchasing debentures because of the increasing burden of having to underwrite large amounts of government bonds. Long-term credit banks therefore had to broaden the investment appeal of bank debentures.

The following steps were taken to ensure that bank debentures would be attractive to individual investors and nonfinancial institutions:

- *Precluding competition.* The five-year maturity was reserved for bank debentures. The maximum maturity of bank deposits was set at one year (until 1976), and government and corporate bonds were issued at maturities of at least seven years.
- *Granting preferred tax treatment.* Starting in 1967, a 5 percent tax was levied on the discount element of discount debentures, much lower than the withholding tax rate on interest and dividend income, which was raised to 20 percent. That gave a tax advantage to discount debentures relative to other financial instruments, such as coupon bonds and time deposits. Because discount debentures were issued on a bearer basis, the tax advantage provided a strong incentive for individual investors to buy.
- *Providing a yield advantage.* The discount rate on discount debentures, closely linked to the call rate until the 1950s, was set at a certain number of basis points above the interest rate on one-year time deposits starting in 1967. Sales of discount debentures expanded rapidly as a result of the lower tax rate and relatively higher yield during 1966–75.
- *Developing new products.* New types of savings accounts were created at the long-term credit banks to encourage investors to buy bank debentures. An example is the “Wide” account, in which the interest rate is compounded semiannually and one complete payment is made at maturity. Most

---

new product development has occurred since the early 1980s.

### **Implications for developing capital markets**

The Japanese model for developing a successful bank debenture market is premised on a high savings ratio and the ability of government to regulate the structure of interest rates. While there is no doubt about the tremendous contribution of the long-term credit banks and bank debentures to Japan's postwar economic development, protecting the six issuing banks and promoting bank debentures had costly side effects. Interest rate controls favored financial institutions at the expense of depositors, the preferences for certain borrowers distorted loan allocations, and excessive protection of the bank debenture market slowed the development of corporate bond markets. Although the development process was essentially sound until the mid-1970s, after that time the government should have acted more rapidly to remove the preferences for the instrument and the six issuing banks.

Nevertheless, the experience of Japan shows that in countries where governments have not borrowed to finance budgetary deficits, it is still possible to establish a government-supported benchmark in the securities market. Until Japan started issuing government bonds in 1965, bank debentures were used by the Bank of Japan for open market operations and served as a market benchmark. This benchmark is crucial for setting the base rate for long-term lending and borrowing.

The Japanese experience also shows that official support can take a variety of forms without necessarily distorting the structure of interest rates. The slope of the yield curve remained positive throughout the market development period, while a variety of measures provided incentives for commercial banks and individuals to invest in bank debentures. These measures involved both fiscal and monetary incentives that could be calibrated to reflect the relative importance of bank debentures in the development of financial markets.

Finally, the evolution of the bank debenture market over four decades in Japan shows the merit of starting with a simple instrument and strong official support for market development. In later phases, official support was gradually diminished, forcing bank debentures to compete in a wider market.

---

<sup>1</sup> The six banks were the Industrial Bank of Japan, the Long-Term Credit Bank of Japan, the Nippon Credit Bank, the Central Cooperative Bank for Agriculture and Forestry, the Central Cooperative Bank for Commerce and Industry, and the Bank of Tokyo.

<sup>2</sup> Both the branch networks of the long-term credit banks and the securities brokers networks were fully utilized in marketing the bank debentures.

<sup>3</sup> The postal savings system is a nationwide banking system administered by the Ministry of Post and Telecommunications. About 19,000 post offices provide banking services. Total deposits exceeded \$800 billion in 1990. The system is the largest deposit-taking institution in the world and accounts for a quarter of all Japanese savings. The savings deposits are held in the Trust Fund Bureau of the Ministry of Finance and loaned to public corporations or invested in instruments such as bank debentures.

---

Masakazu Watanabe, Senior Financial Specialist, Financial Sector Development Department

This series is published to share ideas and invite discussion. It covers financial and private sector development as well as industry and energy. The views expressed are those of the authors and are not intended to represent an official statement of Bank policy or strategy. ♻️ Printed on recycled paper.

Comments are welcome. Please call the FPD Note line to leave a message: 202-458-1111; or contact Suzanne Smith, editor, Room G8105, The World Bank, 1818 H Street, NW, Washington, DC 20433, or Internet address [ssmith7@worldbank.org](mailto:ssmith7@worldbank.org).