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Importance of developing information infrastructure in credit markets

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A healthy credit market is essential to improving the financial system's stability and economic policy's effectiveness. Developing SME credit information infrastructure is important for improving liquidity in Japan's credit market.

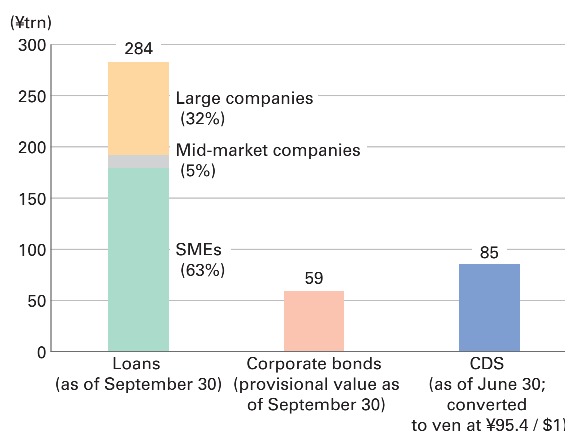
Since Lehman Brothers' collapse, Japan has continued to ease monetary policy through various measures, but liquidity has yet to resume flowing in the real economy. This largely reflects that banks have turned cautious about assuming credit risk, although another contributing factor is weak demand for funds by the corporate sector. Curtailment of lending to small and medium-sized enterprises (SMEs) in particular is cited as a key concern. One of banks' key missions is to stimulate economic recovery through credit creation. Meanwhile, banks are also charged with the responsibility of improving their financial soundness by reducing nonperforming loans. To fulfill all such missions and responsibilities, banks need tools to regulate their credit portfolios' risk by means other than reducing their outstanding loans. From this perspective, normally functioning credit markets are essential.

Importance of efficient management of credit risk exposure to SMEs

The Bank of Japan defines a credit market as a market that trades products that entail credit risk. Such products include loan receivables, corporate bonds, and credit derivatives, most notably credit default swaps (CDS). The accompanying graph shows the size of Japan's domestic credit market. Loans account for a predominant share of the overall market in comparison to corporate bonds or CDS. Moreover, loans to SMEs account for over 60% of total loans. SME loan exposure[1] is thus the biggest segment of the domestic credit market. Additionally, regional banks' loans to SMEs tend to be concentrated in certain industries and/or geographic areas, reflecting that regional banks typically pursue localized business strategies through relationship banking.

Another factor that has increased the importance of credit risk management is changes in accounting standards.

Exhibit. Japanese credit market



Source: NRI, based on Bank of Japan and Japan Association of Securities Dealers data

With banks required to carry loans on their books at fair value, they are at risk of fluctuations in loans' market value due to credit spread movements[2].

To manage such risks and better facilitate funding for SMEs, banks need techniques to hedge risks and reduce risk concentrations.

Information deficiencies and asymmetries diminish credit market liquidity

In managing credit risk, banks must reduce their overall risk exposure by lowering risk concentrations, implementing risk hedges, and reducing credit correlations within their portfolios. To do so, banks have three main ways to rebalance credit exposures: (1) sell loan receivables to a third-party, (2) sell corporate bond holdings, and (3) purchase CDS protection[3]. However, a lack of liquidity in the domestic credit market severely limits the feasibility of using these techniques to manage credit risk exposures to SMEs. The lack of liquidity is partly a consequence of

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the recent financial crisis, but it is also largely attributable to circumstances specific to Japan. Namely, credit-risk mitigation trades are difficult to execute because there are few willing buyers of loan receivables or sellers of CDS protection, or because loan receivable purchase rates or CDS spreads substantially exceed financing rates.

This difficulty largely stems from credit information deficiencies and asymmetries. When companies borrow from a bank, they disclose information to their banks to obtain a loan, but banks are required to keep such information confidential. They are basically barred from providing third parties with information obtained from corporate borrowers. As a result, the vast majority of information about the loan and borrower is sequestered at the bank that originated the loan. Meanwhile, parties seeking to assume credit risk by buying loan receivables or selling CDS protection need to analyze the underlying credit. In many cases, however, the information required for credit analysis of SMEs is unavailable or costly to obtain. This situation increases risk premia or precludes would-be counterparties from assuming credit risk.

Credit information infrastructure must be improved to expand the pool of market participants willing to purchase loan receivables or sell CDS protection, reduce risk premia to reasonable levels, and enhance credit market liquidity.

Improving credit information infrastructure with consensus spread indices

Currently, neither financial information nor credit spread information on domestic SMEs is readily available in many cases. Mandating company-by-company information disclosure by SMEs would require preparations and would not be immediately feasible from an operational standpoint. Many SMEs (particularly those not yet well established financially) are reluctant to disclose credit information about themselves and therefore shy away from doing so. Additionally, it is not necessarily efficient for banks to manage credit risk on a company-by-company basis.

As a first step in developing credit information, SMEs could be classified into certain categories and information disclosed by category. For example, one approach would be for banks to quote credit spreads by SMEs' credit rating, industry, or geographic region and have a data vendor compile the quotations to construct spread indices by category. Providing a variety of such consensus spread indices would increase available credit information and facilitate credit valuation and risk analysis. Banks' actual portfolios would still be subject to basis risk, but banks should be able to hedge risk for their overall portfolios through spread index trading.

If information availability increases, market participants should likewise increase, resulting in improved liquidity in the credit market. Such an outcome should enable more efficient risk management and, in turn, lead to growth in funding for SMEs.

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Note

1) "Credit exposure" refers to assets or notional principal balances exposed to credit risk.

2) A credit spread is a measure of credit risk. Discount rates used for discounting cash flows to present value incorporate a credit spread in addition to a risk-free rate. Loans' present value is at risk of fluctuating due to credit spread movements.

3) In exchange for paying periodic premiums, a bank that purchases CDS protection is indemnified against losses in the event of default on its loan(s) hedged with the CDS.

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