The International Scene

The New Industrial Revitalization Corporation of Japan Begins Operation

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Economic recovery in Japan has been hindered by delays in corporate reorganization procedures. The slow pace of corporate reorganizations is the result of coordination failures produced by various features of Japanese corporate governance.

Japanese corporate finance has been dominated by bank lending for a long time, and the large Japanese banks were primarily responsible for monitoring the management of Japanese businesses. When the banks extended credit, they looked at the valuation of the borrower's collateral (often the value of its real estate) as the most important indicator. This practice and high-leverage loans had a certain rationality in Japan's former high-growth economy. However, monitoring by the large banks became loose and tepid on the emergence of the bubble economy with its surging collateral values and expanding bond market.

The large Japanese banks also have been expected to bear a larger burden than would normally be required under legal procedures when borrowers enter into out-of-court workouts. (Out-of-court workouts have been preferred because legal procedures in corporate reorganizations were regarded as lengthy and cumbersome and could lead to deteriorating values). But this practice collapsed because several factors (including substantial amounts of non-performing loans, low lending margins and the exhaustion of unrealized gains on bank shareholdings) weakened the strength of Japanese banks. The large Japanese banks were no longer able to support corporate reorganizations by bearing proportionately greater shares of the burdens of reorganizations.

As a result of the collapse of bank-led corporate reorganizations and the fact that distressed firms were supported by fresh lending from the large banks (since the large banks were too fragile to allow large borrowers to fail), distressed firms neither failed nor undertook major financial restructurings. This failure in coordination has hindered the Japanese economic recovery.

The Industrial Revitalization Corporation of Japan (IRCJ) was created to tackle this coordination failure in Japanese corporate reorganizations. The plan to create the IRCJ was announced in October 2002 by the government of Japan, together with a new policy from the Financial Services Agency (FSA) for closer supervision of lending practices that would, through the introduction of DCF (discounted cash flow)-type methods, make it more costly for the banks to hold non-performing loan assets. The IRCJ was established on April 16, 2003, after the Diet (Japanese Parliament) approved the government's proposals, and the IRCJ started operations on May 8 of this year.

IRCJ: Its Activities and Functions

The IRCJ's primary activity is to purchase loans made to viable but debt-ridden companies by non-main banks after reviewing financial rehabilitation proposals that have been proposed by the distressed companies to their main lenders. The government sets and announces screening criteria to identify companies eligible for IRCJ support. IRCJ purchases loans at fair market value, taking into account its assessment of the rehabilitation prospects of the companies involved.

The IRCJ's purchases are limited by statute to the IRCJ's first two years of operation (until March 31, 2005). Loans made by the IRCJ to purchase loan assets will be guaranteed by the government up to 10 trillion yen. The IRCJ will monitor the progress of companies' rehabilitation plans together with the main bank(s) and will sell off its loan assets when it finds appropriate sponsors. The period between the purchase and the sale of loan assets should not exceed three years. Besides purchasing loans, the IRCJ has been given the power to carry out short-term lending, extend guarantees and provide short-term capital.

Key decisions of IRCJ will be made by its Industrial Revitalization Committee, the inner-Board of IRCJ formed under the auspices of IRCJ Act. The committee consists of seven members, with Dr. Shinjiro Takagi as its chairman.

There are three functions that the IRCJ is expected to provide.

1. *Coordination.* The IRCJ, as a semi-public and neutral body, will coordinate negotiations among financially distressed firms and their bank creditors and will facilitate consensus-building for financial rehabilitation plans including debt-reduction programs. While the IRCJ will try to achieve consensus among the creditors involved, it is entitled to issue standstill notices to bank creditors and to require them to abstain from loan-collection activities.

2. *Streamlining relations among the parties involved.* As a result of the IRCJ's loan-purchase activities, the numbers of creditors involved in particular situations will be reduced. In an ideal case, there would be three parties—*i.e.,* the distressed firm, its main bank and the IRCJ. This will facilitate the implementation and monitoring of corporate restructurings. The IRCJ is empowered to utilize turnaround managers to ensure that restructuring plans are strictly adhered to.

3. *Market creation.* Under the IRCJ's formal procedures, initiatives will come from financially distressed firms and their main banks. Since the IRCJ needs an exit strategy (*i.e.,* to refinance the loan assets it purchases within three years), it will invite "sponsors" (*i.e.,* private equity funds (PEFs) and investment banks) to participate in loan-purchase transactions between the IRCJ, the affected borrowers and the banks. The IRCJ will receive second opinions and/or proposals from PEFs and/or investment banks on financial rehabilitation plans, including recommendations on the pricing of loan purchases. These plans will compete with proposals tabled by the banks. This activity will create a "virtual" secondary loan market involving specific firms and will produce the best financial reorganization results. Additionally, because the IRCJ will purchase the majority of loan positions and will not seek a high profit, the parties involved in the deals will benefit as a result.

Editor's Note: *The IRCJ has been capitalized with U.S.$100B of financial resources to pursue its activities and is certain to have a great impact on major Japanese businesses in financial difficulty and on the economy of Japan in general. We are extremely pleased to report that Dr. Takagi has been honored by his appointment by the government of Japan to chair the IRCJ's key Board Committee, where he will guide the development and implementation of the IRCJ's policies and success.* ■