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Banking & Finance

Japan: Trends & Developments

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Trends and Developments

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Economic Trends in Banking in Japan

Prior to March 2020, economic trends in the Japanese banking sector had been relatively unchanged from previous years. Due to the accommodative monetary policies continuously implemented by the Bank of Japan (BOJ), the margin for loan transactions had shrunk and banks had been showing their willingness and ability to stretch lending amounts in each transaction. However, trends have begun to change since the outbreak of COVID-19.

While many corporations are trying to secure working capital by borrowing from banks, banks' risk departments have started to take a stricter approach in their credit evaluation as forecasts for corporate earnings become increasingly uncertain. As a result, lending margins have improved slightly. In some highly leveraged transactions, such as leveraged buy-out transactions, banks have struggled to provide the loan commitments that could ordinarily be expected in previous similar transactions, including where the sponsor ultimately was forced to seek mezzanine finance or abandon the transaction.

Civil Code Amendment

On 1 April 2020, an amendment to the laws of obligations (*saiken-hou*) in the Japanese Civil Code entered into effect. The laws of the obligations include rules concerning receivables, guarantee and contract. Although the amendment is expected not to change existing practices significantly in banking and finance in Japan, there are some important implications worth noting.

Guarantee

Traditionally, Japanese creditors value, and tend to require, a guarantee from a relevant individual when lending to small- or mid-sized businesses to ensure that a business owner commits fully to the business operation. Although this practice might make it less difficult for a small- or mid-sized business to borrow money as it enhances the creditworthiness of the business, it also sometimes produces an unfortunate situation where the guarantor, who is an individual family member or friend, also faces financial collapse when the business fails. The amendment has introduced new rules to protect guarantors, particularly those who are natural persons.

Requirement of notarial instrument

Article 465-6 of the amended Civil Code states that a guarantee to secure a Loan Obligation (defined below) owed in connection with a business does not become effective unless the guarantor expresses their intention to perform the guarantee obligation by means of a notarial instrument prepared within one month prior to the date of the guarantee contract. "Loan Obligation" means an obligation to be borne as a result of loans or receiving a discount of a negotiable instrument, as defined in Article 465-3. Article 465-6 is not applicable if the guarantor is a corporation. Further, Article 465-6 is not applicable:

(a) if the principal obligor is a corporation and the guarantor is its managing administrator, director, executive officer, or any person equivalent thereto;
(b) if the principal obligor is a corporation and the guarantor is a person who controls the corporation; or
(c) if the principal obligor is not a corporation and the guarantor is a person that conducts business jointly with the principal obligor or the principal obligor's spouse who actually engages in the business conducted by the principal obligor.

It is important to note that a Japanese notary is a civil law notary – as opposed to a common law notary public – whose number are limited and not as easily accessible. Thus, this restriction makes it practically difficult for creditors in Japan to require a guarantee from an individual other than those to whom exceptions (a) to (c) above apply. The intention of the exceptions is to limit the guarantee by individuals to those with sufficient knowledge of risk of the business and where the provision of the guarantee by that person would be necessary and/or helpful in order for small- or mid-sized businesses to obtain debt financing.

A guarantor's right to rescind where inaccurate information is provided

Paragraph 1 of Article 465-10 sets forth that a principal obligor must provide a potential guarantor with the following information in relation to the principal obligor's business:

(a) the status of assets, and income and expenditure;
(b) whether the principal obligor has any obligations other than the principal obligation, and the amount and status of observance thereof; and
(c) if the principal obligor has provided or is seeking to provide any other security for the principal obligation, a statement to such effect and the details thereof.

Paragraph 2 of Article 465-10 further sets forth that if the principal obligor fails to provide information concerning the particulars set forth in the items (a) to (c) above or provides information concerning the particulars that is factually inaccurate, the guarantor may rescind the guarantee if the guarantor enters into the guarantee in reliance on the inaccurate information provided by the principal obligor. This Article 465-10 is not applicable if the guarantor is a corporation.

For creditors, this means that a guarantee could be rescinded because of a principal obligor's failure to provide information to the guarantor which is not under the creditor's control. In practice, a creditor should communicate with both the principal debtor and the guarantor to confirm that the necessary information has been provided accurately and appropriately, and further request that the principal obligor and guarantor provide representations and warranties as to the provision of information.

Provision of information regarding the guaranteed obligation
Article 458-2 sets forth that if a guarantor provides a guarantee upon request from the principal obligor, the creditor, upon request of the guarantor, must provide, without delay, the guarantor with information concerning:

(a) whether there has been a default in the terms of the principal of the guaranteed obligation or any interest, penalty or compensation for loss or damage incurred in connection with the guaranteed obligation or any other charges secondary to the guaranteed obligation; and
(b) the outstanding amounts of these items.

This Article 458-2 applies to corporations and natural persons alike.

In addition, Article 458-3 sets forth that a creditor must notify the guarantor within two months of the relevant date if a guaranteed obligation is accelerated. If a creditor fails to provide any such notice to the guarantor, the creditor is not permitted to demand that the guarantor pay any delay damages accrued after the acceleration date. This Article 458-3 does not apply to corporations.

Assignment of receivables
Two important changes have been made to the treatment of the assignment of receivables (*saiken*), such as assignment of a loan receivable and accounts receivables, under the amended Civil Code.

The effect of prohibition or restriction on the assignment of receivables
Prior to the amendment, if parties to a legal relationship (eg, a seller and a purchaser in a sales transaction) from which a receivable arose agreed to prohibit or restrict the assignment of the receivable, any assignment purportedly made in contravention of that prohibition or restriction would be considered invalid. Instead, paragraph 2 of the amended Article 466 sets forth that the validity of the assignment of a receivable shall not impaired even if a party to the receivable declares its intention to prohibit or restrict the assignment of the receivable. Therefore, under the amended Civil Code, even if the parties to the legal relationship agree to prohibit or restrict the assignment of a receivable arising thereunder, any assignment subsequently made, although in contravention of the agreed prohibition or restriction, shall be considered valid. This amendment has been made to facilitate financing that involves the assignment of receivables, such as factoring, as customarily in Japan contract forms used in such transactions contained language to prohibit or restrict such an assignment.

However, paragraph 2 of the amended Article 466 has an important exception. An assignment of a receivable over bank accounts which is made in contradiction of any such prohibition or restriction shall be considered invalid (Article 466-5). Thus, an assignment of receivables over bank accounts will not be valid without the bank's permission, as banks in Japan universally prohibit any such assignment in their form of account agreement.

Further, this type of provision prohibiting or restricting the assignment of receivables, other than those over bank accounts, is not completely invalid under the amended Civil Code. Paragraph 3 of Article 466 sets forth that this type of provision works as an obligor's right to refuse to perform the obligation to the assignee. If such a prohibition or restriction exists, the obligor may refuse to perform the obligation for the assignee of the assignment and instead may perform the obligation for the assignor (ie, the original obligee). However, this right is not applicable if the obligor does not perform its obligation for the assignor within a reasonable period of time after the assignee's demand (paragraph 4 of Article 466). Thus, if the prohibition or restriction exists and the obligor refuses to make payment to the assignee, the assignee will demand payment from the assignor instead, as the assignor will be entitled to collect that payment from the obligor.

As above, the amended Civil Code provides rules on the effectiveness of prohibitions and restrictions on the assignment of receivables. One question remains unclear, however: whether such rules make the assignment prohibition or restriction invalid as a covenant of the parties. If not, an assignment made in

contravention of the prohibition or restriction would constitute a contractual breach by the assigner and would potentially give rise to a termination right and/or recourse to compensation under the contract. Ultimately, it means that this amendment to the Civil Code could not have the effect of facilitating financing involving the assignment of receivables. Government officials involved in the drafting of the amendment seem to believe that such an assignment would not constitute a contractual breach as an abuse of rights, by virtue of the amendment to the Civil Code. However, it is unclear whether this argument is persuasive enough, as the theory of abuse of rights is usually interpreted by the courts restrictively.

Effect of consent to an assignment without reservation of objection

Prior to the amendment, if an event occurred prior to an assignment that an obligor could assert against an obligee (such as payment), the obligor would not be entitled to assert that event against the assignee if the obligor consented to the assignment without reserving an objection to that event. Thus, if an obligor gave that consent without due consideration, it might bear an unexpected burden, such as the restoration of an otherwise discharged debt. The amendment has abolished this rule.

In practice, purchasers of receivables have relied heavily on this rule. If an obligor consents to an assignment of a receivable without a reservation of objection, the purchaser could assume that the receivable validly exists in its full amount. After the amendment, the purchaser will need to have an obligor's consent to waive each event that the obligor may assert against the assignee in order to enjoy the same effect.

Loan agreement termination

Paragraph 2 of amended Article 587-2 gives a borrower the statutory right to terminate a written loan agreement at any point until the loan is actually made. Therefore, in the case of a revolving credit agreement, even if the borrower thereto makes an utilisation request, the borrower may terminate the promise to borrow until the loan is advanced. Thus, it will be important for banks to insert sufficient language into credit agreements whereby the lender may demand compensation (eg, breakage costs) from a borrower in such cases of termination.

Expected further amendment

Further amendments to the Civil Code are expected. The Ministry of Justice is currently considering amendments to the laws of ownership (*bukken-hou*) under the Civil Code. Furthermore, the Ministry is said to have also begun discussing possible amendments to the laws of security (*tanpo-bukken-hou*) under the Civil Code. It is advisable for participants in the banking and finance sectors to keep a close watch on future amendments to the Civil Code.

JPY-LIBOR

Historically, the majority of the domestic loan transactions that refer to a base interest rate have used TIBOR, the Tokyo Interbank Offered Rate, which is currently provided by the JBA TIBOR Administration (JBTA), rather than JPY-LIBOR. The JBTA is controlled by the Japan Bankers Association, which is comprised of banks in Japan. Since TIBOR is convenient for domestic transactions as it is published in Japan Standard Time on a business day in Japan and (probably more importantly) tends to be higher than JPY-LIBOR, Japanese banks prefer TIBOR. There is no plan to abolish TIBOR. Nevertheless, JPY-LIBOR is important, as derivatives involving JPY interest rates have often used JPY-LIBOR as a reference rate and a significant number of debt finance transactions (such as cross-border loan transactions and bond transactions) use JPY-LIBOR.

While the discontinuation of LIBOR, expected to occur on or before 31 December 2021, is getting closer, no clear replacement has emerged. The BOJ established a cross-industry committee of banks, securities companies, institutional investors and non-financial corporations, known as the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks (Committee) in August 2018, which released its final report on 29 November 2019 (please refer to "Final Report on the Results of the Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks" published on the BOJ's website) after conducting a public consultation with a wide range of market participants. In the final report, feedback from respondents was somewhat divided. In relation to loan transactions, the majority of the banks supported TIBOR as the replacement of JPY-LIBOR, while many of the other respondents, such as non-financial corporations, securities companies and institutional investors, preferred (a) term reference rates (swap), the underlying rates of which are JPY overnight index swap, and (b) term reference rates (futures), the underlying rate of which are overnight call-rate futures. Both of these would be calculated based on the uncollateralised overnight call rates, called the Tokyo OverNight Average rates (TONA), which are announced daily by the BOJ on its website.

However, in relation to bond transactions, the majority of the respondents preferred term reference rates (swap) and term reference rates (futures), while a relatively large number of the respondents supported compounded overnight rates (fixed in arrears), the underlying rates of which are TONA. The final report concluded, probably as the result of certain compromises, that most respondents supported term reference rates (swap/futures) and that there was a consensus among respondents on the need to establish robust and reliable term reference rates, since such rates do not exist presently, while the Committee also concluded that lenders and borrowers still need to reach a

mutual agreement on the appropriate treatment of loan transactions through further communication.

In February 2020, in order to develop the term reference rates (swap), the BOJ conducted a public solicitation process and selected Quick Corporation, a subsidiary of Nikkei, as the entity to calculate and publish term reference rates (swap) for Phase I. In Phase I, the selected provider will calculate and publish prototype rates of the term reference rates (swap) for evaluation. On 26 May 2020, Quick Corporation began publishing the prototype rates (please refer to "Statement regarding Calculation and Publication of Prototype Rates for Term Reference Rates (Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks)" published on the BOJ's website). By the end of the second quarter of 2021, the trial is expected to enter into Phase II, where a selected provider will calculate and publish term reference rates (swap) to be used in actual transactions.

Because of the ongoing uncertainty surrounding the replacement of JPY LIBOR, it is difficult to specify what will be the replacement in the fall-back provisions. Market participants will be well served to monitor continuously how discussions on the replacement of JPY LIBOR proceed, particularly in relation to the presumptive leading candidate, the term reference rate (swap) published by Quick Corporation.

Financing for Hostile Takeover Bids

Recently, hostile takeover bids appear to be increasing in the market in Japan, despite successful hostile takeover bids remaining relatively uncommon. Arguably, the most important recent change regarding hostile takeover bids in Japan has been that some of Japanese banks have started to show their willingness to provide debt finance to fund a hostile takeover bid. Until recently, the provision of debt finance by a Japanese bank to fund a hostile takeover bid was almost unthinkable. Japanese banks tended to be relationship-oriented and unwilling to risk damaging their relationship with clients by providing assistance to a hostile takeover bid. Strongly negative attitudes towards hostile takeover bids in Japanese society are also a factor. However, the recent hostile takeover bid activity, such as a successful takeover bid in 2019 for Descent Ltd by Itochu Corp, a leading trading firm in Japan, and some securities companies in Japan starting to engage openly in hostile takeover bids, seems to have affected Japanese banks' attitudes. If this trend continues, the hostile takeover bid, which was once considered contrary to social norms in Japan, could become more common in Japan.

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