Speech by Mr. Hoshi, COO at FSA Conference on Financial Regulation and Growth in Asia

Topic: Financial Intermediation for Growth

Opening

Ladies and gentlemen, distinguished representatives of Asian financial authorities, I am Fumio Hoshi, Chief Operating Officer of the Japan Bank for International Cooperation. It is my great honor and pleasure to address such a distinguished group of leaders of the financial authorities of so many Asian countries today on the topic of Financial Intermediation for Growth.

It goes without saying that robust economic activity and healthy financial functioning form an important pair of engines to facilitate growth, and that smooth financial intermediation under an appropriate financial regulatory framework is indispensable for sustainable economic growth in Asia.

Today I would like to speak with you about my views on our business of financial intermediation to support projects in such fields as trade, energy, infrastructure and business investment through the supply of long-term financing.

1. Asian growth and financial needs

While the IMF's forecast of its World Economic Outlook October 2013 revised the economic growth rate of emerging countries down to 4.5% for 2013 and 5.1% for 2014 from the July forecasts, the economic growth rate of Asian countries is projected to reach 6.3% in 2013 and 6.5% in 2014, figures that are relatively higher than in other regions. Thus, it is safe to say that the Asian countries are supporting global economic growth.

Asian countries have used their advantages as exports bases to attract foreign direct investment in the manufacturing industry, and such foreign capital has played an important role in enhancing the region’s industrial structure. Well-developed industrial clusters in the region help to create more advanced supply chains and highly integrated networks. A number of Japanese companies — from major companies to small and medium-sized enterprises — have also entered the Asian region and contributed to industrial development, creation of employment opportunities and export promotion of the host country. JBIC has supported such Japanese companies by actively providing finance for the capital expenditure and long-term working capital that are required for such investment.

Furthermore, one cannot deny that domestic demand has been expanding in Asia owing to the development of a robust “middle class” in the region supported by the synergetic effects of the economic growth of the country and the improved income of its population. In recent years, attention is increasingly focused on Asia as a market for consumption, and there are many examples of JBIC’s efforts to support consumption activities, such as providing auto loans and guarantees and facilitating the businesses of Japanese affiliates and subsidiaries through supporting securitization of collateralized credit card receivables.

There continues to be huge demand for investment in infrastructure due in large part to the economic growth and urbanization of Asia, particularly in the sectors of electricity, railways, roads, ports, airports, water supply and sewage treatment. Efforts to enhancing ASEAN intra-regional connectivity in light of its economic integration as well as APEC's planning of infrastructure development will also contribute to increased infrastructure investment. To date, JBIC has provided loans to a large number of infrastructure projects in Asia, mainly in the power sector, in the form of export loans or investment loans by utilizing the project financing scheme where appropriate.

2. Importance of financial intermediation for growth

As the horizon for economic activities widens in the areas of production, consumption, and infrastructure investment, and as the interdependence of business transactions increases, it is imperative for the stability and growth of the economy that financial intermediation should flow smoothly through every aspect of such economic activities just as blood circulates through the body. I am certain that you can appreciate this fact after the adverse experiences we suffered when the collapse of the financial markets spilled over to impair the rest of the economy after the Lehman shock of 2008, causing turmoil in economic activities and a plunge in the growth rate of every country.

The feature of financial intermediation in Asia is said to be the conventional type of financial intermediation through loans based on bank deposits, where bank intermediation plays the central role of facilitating financing. The key element in such financial intermediation is the capability of risk assessment, and for finance involving bank intermediation, the competence of the lenders in assessing creditworthiness is considered critical to ensure the ongoing soundness of the banks and ultimately of the financial system. I believe that supervision and inspection by financial authorities plays an important role in maintaining and improving the health of financial institutions and the financial system.

Furthermore, from the trans-regional macro perspective, efforts have been made under the Chiang Mai Initiative as part of financial cooperation in the Asian region to learn from the lessons from the Asian currency crisis, and these efforts have contributed substantially to the stability of foreign exchange and financial markets in Asia.

3. Challenges for financial intermediation and directions for response

To further ensure Asian economic growth through financial intermediation, I would like to raise two issues that I see as challenges for the days ahead as well as the ideas for responding to them and JBIC's efforts to do so. These are my perspectives based upon my experiences of deep involvement in projects in the Asian region.

The first issue is that the private sector's capacity to supply the long-term financing required for business and infrastructure investment may be declining under the changing economic climate surrounding private financial institutions.

While it is true that the review of American monetary easing policy – the so-called "tapering" – may affect the financial outflows from emerging countries, I do not think in can be said that savings are insufficient in Asia, and it would appear that that funds for investment can be secured. The point, however, is that such funds, though available, are not easily transformed into the long-term financing that is necessary for investment in projects, and my belief is that private financial institutions may be suffering limited capacity to fulfill their intermediary function to facilitate long-term financing.

When we exchange views with private financial institutions, our co-financing partners, we find that the regulatory framework for supplying long-term funds has become more difficult than ever, as this trend has strengthened after Lehman shock though increased efforts to enhance financial regulations, particularly Basel III.

Under the reinforced regulatory framework, private financial institutions are naturally required to be very strict in selecting the projects to which they provide loans. In the case of projects that need long-term financial commitments, such as infrastructure projects, there will be more and more cases where private institutions have no choice but to give up opportunities despite their interest, given their limited management capital. In addition, even where financing is secured, there will be cases where the maturity of the loan must be shorter than requested or the lending rate must rise due to the higher requirements for return on capital.

From the perspective of the host country of a proposed project, decreasing the number of potential long-term funding suppliers may cause delay in the realization of the long-awaited infrastructure project and may hinder economic activities and growth. Further, if borrowing rates increase, this could lead to an increase in the overall cost of the infrastructure project and, in turn, to an increase in the financial burden of the infrastructure users.

The importance of securing long-term funds for investment is becoming a focus of increased attention in discussions among international financial communities. I was privileged to speak at the Meeting of the Heads of the G20 development institutions on the threshold of the meeting of G20 Finance Ministers and Central Bank Governors in Moscow this July on the topic of "Sustainable Growth through Long-Term Investments". Discussions in the meeting included the challenges for long-term investment and how to secure long-term financing, and the statement adopted after the meeting was expected to be used to prepare decisions for a G20 heads of state summit held in September in the city of Saint Petersburg. In the Communiqué of the G20 Meeting of Finance Ministers and Central Bank Governors held earlier this month in Washington D.C., the leaders re-affirmed the importance of long-term financing for investment to boost growth, create jobs and facilitate development.

In securing stable long-term financing by mobilizing private sector funds, I would like to place my focus on the need for collaboration between the private and the public sectors as well as on the role played by official financial institutions. For example, JBIC has a policy of collaboration with private financial institutions by complementing private financing. Since official financial institutions alone cannot meet all of the demand for long-term financing, our intention is to mobilize as much of private funding as possible to leverage up the impact of our official financing. For example, this year JBIC closed a syndicated loan for the development of the Nghi Son Refinery and Petrochemical Complex in Vietnam by committing financing jointly and sharing risk burdens with a number of private financial institutions as well as official export credit agencies, including The Export-Import Bank of Korea, bringing the overall co-financing amount to 5 billion U.S. dollars. This illustrates the way in which many private financial institutions wish to have the well-experienced JBIC as a co-financier in general, and how they rely on the risk mitigating functions of JBIC for projects in emerging countries in particular. Where private financial institutions alone may be reluctant to step up to provide long-term financing, JBIC can play a “catalytic role” to mobilize private financing. It is my view that public and private collaboration is the key to addressing the challenge we face in filling the long-term financing gap.

The scope of financial mobilization is not to be limited to private banks. Looking forward, expanding the horizon of potential funding suppliers will become an important task. Institutional investors, including insurance companies and pension funds, generally have a preference for long-term assets to match the long-term nature of their liabilities, which is highly compatible with the financing requirements of long-term projects such as infrastructure sector development. How best to encourage institutional investors to finance long-term projects is an important issue to be addressed.

In addition, it is worth paying attention to the counter-cyclical function performed by official financial institutions. A change in the economic environment can sometimes cause huge fluctuations in the financial markets, causing abrupt ups and downs in the amount of fund available from private financial institutions. On the other hand, given the backdrop of brisk economic activity, the demand for long term investments remains steady in the infrastructure and other sectors. In this context, it is important for official financial institutions with institutional and financial capabilities to play a role in balancing the fluctuations in the private financial markets. As an example of JBIC’s attempt to cooperate with official financial institutions, JBIC annually holds the Asian Exim Banks Forum with a number of Asian export-import banks, thereby making an effort to promote mutual collaboration and cooperation with them. This year’s Forum was held from the

16th to the 18th of this month, and I participated as JBIC's representative in fruitful discussions on the theme of reinforcing regional cooperation and connectivity.

The second issue that I would like to address is the challenge to effect smooth implementation of public private partnership projects. As I mentioned earlier, there is enormous demand for infrastructure development, and the public funds available to host governments cannot fully meet the needs. The Public Private Partnership (PPP) scheme has therefore become a crucial tool for the effective mobilization of long term private financial flows for infrastructure projects.

Since a country's infrastructure serves as a foundation to promote economic activity and improve people's livelihoods, it is inevitable that the policies of a host country will influence how prices of the services the infrastructure provides are to be set, how the project is to be operated and so on. Therefore, infrastructure business necessarily entails risks that private business operators alone cannot control, and a certain level of commitment by the host government is a critical factor in the success of such a project.

However I would have to say that a proper set of standards and structures has not yet been well established for the PPP scheme in Asia. We have seen some cases where problems have arisen such as setting tariffs that are lower than the project costs, lack of institutional consistency between central and regional governments, lack of adequate governmental support, and so on. Among PPP projects, some schemes may pay insufficient attention to the issue of "bankability", allocating excessive risks to the private sector and making it difficult for the private investors to see a clear path to project profitability. The definition of PPP, that is, the respective roles of the public and private sectors in the PPP projects, may be interpreted differently in each country, which can cause great confusion among private investors, with consequent disruptions and delays.

This is where JBIC can play a vital role. JBIC not only provides finance as a public financial institution, but also works with host governments to ensure that they work effectively to establish bankable PPP structures and to provide predictability and certainty which will help to enhance confidence in the private sector and attract long term investment from private funding sources in a timely fashion.

In this regard, JBIC strives to create a harmonization among what we call the "5Ps", that is, ①"Public entities" , ②"Private Investors", ③"People of the country", ④"Providers of finance", and ⑤"Partnership" among all the stakeholders over the long term. JBIC believes that this harmonization of the 5Ps helps to foster an environment where risks and responsibilities are adequately shared between the public and private sectors.

Here, I would like to also emphasize the importance of the effective partnership and sensible lending discipline among "Providers of Finance". The acceptance of an "unbankable" framework by a single financial provider with lack of financial disciplines would discourage the host government from developing an appropriate PPP structure to attract continued long term investment, which would eventually adversely affect the country's funding capacity in the future.

3. Conclusion

These are some of my personal views on the current situation of the role of financial intermediation and its challenges from the perspective of long-term financing in which JBIC engages. I hope that you find them to be worthy of consideration and that they may provide a basis for improved global financial intermediation. Thank you for your kind attention and it would be of my utmost pleasure if my remarks could serve as a foundation to further discussion among the leaders of the financial authorities of Asia.