Regulating Bank Equity Holdings in Japan

Yasuyuki Fuchita

1. Japan's Regulations on Bank Equity Holdings

1) Outline of proposed regulations

On 26 June, the Second Subcommittee of the Financial System Council's Sectional Committee on the Financial System published a report ("Bank Equity Holdings" [in Japanese]) recommending that Japanese banks be subject to restrictions on their equity holdings. The following are the report's main recommendations:

- Banks' equity holdings should not exceed their equity capital (i.e., Tier-1 capital or the value of their capital account).
- This maximum limit should come into force in 2004, and consideration should be given to extending this for a further 1-2 years for banks that would be particularly affected.
- The limit should apply to banks (including trust banks), long-term credit banks, Norinchukin Bank and Shinkin Central Bank, and consideration should be given to including bank subsidiaries. However, shares held in trust should not normally be included.
- The issue of whether shares in subsidiaries and affiliates, shares acquired as a result of debt-equity swaps, and shares in venture businesses should be subject to this maximum limit should be considered separately.
- The Basel Committee on Banking Supervision is considering whether the current rule (whereby all equity holdings have a risk weighting of 100%) is appropriate. However, Japan's banking supervisors need to reach an understanding with their opposite members in other countries on a framework that reflects (as accurately as possible) the various risks to which banks are exposed (and share price volatility, in particular).
- Japanese banks may not lend or invest more than a certain percentage of their equity capital (25% in the case of single companies and 40% in the case of groups of companies) in any one company, but more needs to be done to see whether these limits are sufficient to prevent banks from overexposing themselves to particular companies.
- Although the Banking Law and the Antimonopoly Law prevent Japanese banks from holding more than 5% of the shares of any company, this limit may also prevent them from fostering venture businesses to the extent that is needed.

As a result of the report, the Banking Law and a number of related laws will have to be revised. Similarly, work is under way to set up a body by January 2002 to purchase shares from banks, which are expected to step up their sales of their equity holdings when such a limit is imposed.

2) Background

Since the Second World War, Japanese banks have steadily built up their equity holdings to cement their corporate relationships. As these holdings have been valued at cost, they have generated considerable unrealized gains that have helped the banks' main operations. In addition, the fact that banks have been allowed to include up to 45% of these unrealized gains as Tier-2 capital has helped to bolster their capital adequacy ratios.

However, as banks have increasingly realized these gains as a means of writing off losses on non-performing loans, the book value of these holdings has risen. As a result, the book value of these holdings (and especially those of the country's leading banks) is now much greater than the banks' equity capital. In addition, when market value accounting is adopted in September of this year, such holdings will be classified as "other securities" and 60% of any decline in their value will have to be deducted from the banks' capital surplus.

In Japan, share price volatility has therefore come to be regarded as one of the biggest risks to which banks are exposed—a view reflected in the fact that this was one of the issues mentioned in the package of emergency economic measures announced on 6 April: "In order to reform Japan's financial system and raise public confidence in it, consideration needs to be given not only to encouraging banks to deal with their non-performing loans off their balance sheets but also to imposing some limit on banks' equity holdings so that their exposure to share price volatility can be made more manageable and their financial soundness improved. … For example, banks could be required to limit their equity holdings to the amount of their equity capital and to dispose of any holdings in excess of that amount over a period of time." Similarly, "The disposals that such a measure might trigger could, in the short term, affect the balance of demand and supply on the stock market and the market's pricing mechanism. Depending on the overall level of share prices, this could have a negative effect on the stability of the financial system and the economy in general. Some sort of government-backed body therefore needs to be set up to purchase any such shares for a limited period."

The above recommendations published by the Financial System Council in response to these emergency measures are the results of discussions by a working group set up by the Council's Second Subcommittee.[1]

2. The Debate on Regulating Banks' Equity Holdings

1) Criticism of the proposals for a maximum limit

The issue of whether bank equity holdings should be regulated involves not only the risk to which such holdings expose banks but also a number of other factors, including the negative effect cross-shareholdings have had on corporate governance in Japan, the distorting effect this can have on the stock market's pricing mechanism, and the amplifying (so-called "pro-cyclical") effect that the level of the stock market can have on banks' willingness to lend. However, the urgency with which the debate has been conducted is largely due to the risk to which banks are seen to be exposed (see above).

The government's response in its package of emergency measures was to try to impose overall or maximum limits on these holdings (equivalent, for example, to banks' equity capital). From the outset, however, doubts about and objections to this approach have been voiced.

First of all, the Basel Committee is discussing a new capital accord (the "new Accord") which, instead of imposing one-size-fits-all rules on the assets that banks may own, seeks to allow banks to develop their own risk management systems as far as possible. The Committee also prefers banks to manage their own risks, with national supervisors checking their systems and procedures for doing this and encouraging the market to exercise its own discipline by requiring banks to disclose information. The Japanese government's approach (of trying to impose limits) has been criticized as being contrary to this spirit.

The second criticism of the government's proposed limit is that banks own many different assets besides shares. By owning government bonds, for example, they are exposed to interest rate risk. Also, the degree of risk is reduced by a diversification effect if there is a negative correlation between bond and share prices. Any attempt to single out and regulate shares can therefore be criticized as inconsistent.

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1 Working Group on Improving the Financial System. The group met nearly every week from the end of April to the end of June, and the author took part in the discussions as one of its members.

Third, banks do not manage the risk of owning shares in isolation but in combination with the risk of owning a range of assets, and this total risk exposure is tied to their Tier-1 capital. Asset disposals are also conducted as an integral part of this risk management process, and the government's proposal to force banks to dispose of their equity holdings has therefore been criticized as unnecessary.

2) National legislation on bank equity holdings

There has therefore been considerable disagreement in Japan about how the risk of share price volatility to which banks are exposed through their equity holdings should be managed. Legislation in this area appears to vary considerably from country to country and is not always relevant to the situation in Japan.

In the United States, for example, banks were for a long time not allowed to own shares in other companies on their own account (Glass-Steagall Act). Under the Gramm-Leach-Bliley (GLB) Act of 1999, however, a securities subsidiary of a financial holding company is allowed to do this, and it has been proposed that an amount equivalent to 8%-25% of the value of these holdings should be deducted from Tier-1 capital in such cases.

In Germany, a bank's shareholdings in companies of which it owns more than 10% of the voting shares must not exceed (1) 15% of its equity capital, in the case of any one company, and (2) 60% of its equity capital, in total.

In Japan, banks are not allowed to own more than 5% of the shares of any company—a less stringent limit than in the United States. In Germany, on the other hand, banks are allowed to own shares equivalent in value to up to 60% of their equity capital; but this applies only to companies in which they own at least 10% of the voting shares—a much more generous limit than the 5% limit that applies to all shareholdings in Japan. The German regulations are actually based on a European Union directive, and this relaxed attitude to bank equity holdings can be found in all member countries of the European Union.

Therefore, although national regulations vary, all the main international banks will have to comply with the new Accord. Although there is considerable interest in how it will deal with share price volatility, no conclusions had been reached when the Financial System Council's Working Group met in April-June.

3. The Basel Accord and the Treatment of Equity Holdings

1) Treatment under the existing Accord

How equity holdings are treated under the 1988 Basel Accord depends very much on whether they are held on a bank's banking account or its trading account. If a bank owns shares in a company for strategic reasons, it is required to hold them on its banking account and to assign them a risk weight of 100%—the same as a normal loan. In other words, no provision is made for price volatility in the case of such shares, which are simply treated as a kind of loan in accordance with the credit risk posed by the borrowing company. Eight percent of the value of such holdings has to be covered by equity capital.

Shares held for trading purposes must be held on a bank's trading account and are subject to the 1996 Market Risk Amendment. In such a case, a bank is allowed to calculate (and thereby reduce) the figure for the total risk of its trading portfolio (which may include bonds and foreign exchange as well as shares) by allowing for the correlations between the different asset classes rather than simply add up the figures for the risk of each.

Bonds held on a bank's banking account are also only subject to a credit risk weight. As a result, government bonds have a zero risk weight. Under the existing Accord this means that any risk that a bank's government bonds may decline in value because of rising interest rates is disregarded. Bonds held on a bank's trading account, however, are weighted for market risk—just like shares held for the same purpose.

2) Structure of the new Accord

The new Basel Accord, consultation on which began in 1998 and the final report on which is due to be published by the end of 2002, consists of three "pillars": the first pillar adopts an "internal rating-based" (IRB) approach to calculating a minimum capital adequacy requirement; the second pillar defines the responsibilities of national supervisors for managing risk in accordance with the situation faced by each bank rather than according to one-size-fits-all rules; and the third pillar deals with disclosure, which is essential if market discipline is to work effectively.

However, the revised Consultative Document published in January of this year does not envisage changing the way in which financial assets are treated according to the purpose for which they are held. There is a major difference in how securities are treated depending on whether they are held on a bank's banking account or its trading account. The new Accord does not envisage any major changes to this treatment, and securities held on a bank's trading account will continue to be weighted for market risk.

Similarly, securities held on a bank's banking account will continue to be weighted for credit risk when their capital adequacy is calculated.

3) Treatment of equity holdings under the new Accord

However, it would appear from the revised Consultative Document that the new Accord may adopt a new approach to shares held on a bank's banking account.

First, under the standardized approach (where risk weights for shares are normally 100%), risk weights for shares in venture businesses or unlisted companies could, at the discretion of national supervisors, be set at 150% or more.

Under the IRB approach, equity holdings can be treated in one of two ways. The first of these approaches disregards price volatility and takes only counterparty credit risk into account (i.e., it treats equity holdings just like loan assets). Under the 1988 Accord, strategic equity holdings are also assigned a risk weight of 100% (just like loans to private-sector borrowers). Under the new Accord, however, such holdings would be weighted according to counterparty credit risk, using "probability of default" (PD) and "loss given default" (LGD), rather than simply being assigned a 100% risk weight. This means that strategic holdings in blue chip companies might be weighted at, say, 20% (i.e., lower than at present).

The second of these approaches to equity holdings does take price volatility into account and seeks to determine an appropriate level of capital adequacy by measuring market risk (using Value at Risk (VaR)) and stress testing.[2] If VaR were to be used to measure share price volatility in Japan, banks might (depending on the assumptions that were made) have to assign their equity holdings risk weights of 400% or more.

4) The revised Consultative Document and the options available to Japan

In summary, therefore, according to the revised Consultative Document, banks would weight the shares they held on their trading accounts to reflect their price volatility; but it is unclear whether they would be required to do this for the shares they held on their banking accounts (in addition to assigning them a credit risk). Nor does the Accord suggest how Japanese banks should treat their cross-shareholdings.

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[2] This seeks to calculate the potential loss to a financial institution of an exceptional, but likely event.

Given that the Accord is designed to put banks on a sound financial footing, price volatility might seem an obvious criterion for determining capital adequacy ratios. However, shares are not the only volatile assets that banks own. Loans and bonds are also volatile. The Committee's basic stance (reflecting technical difficulties and the different circumstances in which banks operate) is to assign only a credit risk to loans and bonds (rather than require banks to allow for factors such as interest rate risk and liquidity risk when they calculate their capital adequacy ratios), and to rely on supervision (the second pillar). It is therefore possible to make a case for not including price volatility in the risk of equity holdings, either.

In Japan, the approach that disregards price volatility when calculating the risk posed to banks by their equity holdings is the one that has been advocated by both the authorities and the banks themselves—partly to maintain consistency with the way loans and bonds are treated and partly because of the sheer impact on the banks of their equity holdings. However, the Financial System Council's report signals a major change of policy in favor of the second IRB approach.

This suggests that the risks posed to Japanese banks by their equity holdings (as mentioned in the emergency measures announced in April) are now such a focus of public concern that it would have been difficult for the Council to continue to advocate any approach to capital adequacy that totally disregarded share price volatility.

Originally, the revised Consultative Document's recommendations on the treatment of equity holdings were to form part of the new Accord due to be published at the end of this year (along with some "think pieces" (i.e., additional recommendations) that were due to be published in summer). However, at a meeting on 25 June the Committee decided to publish a further revision to the Accord in the first quarter of 2002 and then to invite public comment before publishing the new Accord at the end of 2002. This means that the new Accord will not come into effect until 2005—instead of in 2004 as originally planned.

Although the discussion process has taken longer than expected, the fact that the Japanese authorities are now committed to a very different approach from their previous one is likely to have a big influence on the course of the debate on this issue.

4. Assessment of Financial System Council’s Report and Its Likely Impact

1) Need to include share price volatility in order to ensure adequate capitalization

Some of those involved in the discussions that led to the Financial System Council's report took the view that banks could manage share price volatility perfectly well as part of their overall risk management and that there was no need for the authorities to intervene.

At the same time, however, it cannot be ignored that, by building up large cross-shareholdings over many years and then taking profits on them until there were virtually no more profits left, Japanese banks now find themselves with equity holdings far in excess of their equity capital as well as the subject of nervous attention at the end of every fiscal year—not only from Japanese investors but also foreign financial authorities—because of the impact the year-end level of the Nikkei 225 may have on their results.

This is the background against which the Japanese government announced in April (as part of its package of emergency economic measures) that it had no choice but to intervene and against which the Financial System Council's Working Group met (at the government's behest) to discuss exactly what form this intervention should take.

The main difference between the package of emergency measures announced on 6 April and the Financial System Council's report is that, whereas the former proposes a maximum limit on bank equity holdings (equivalent to their equity capital), the latter focuses on the need to ensure that banks are adequately capitalized and to take account of share price volatility as a risk factor.

Preferable to simply comparing the level of a bank's equity holdings and its capitalization is to ensure that banks have enough capital to deal with the risks they face. This approach also seeks to comply with international rules such as those of the new Basel Accord. In normal circumstances, the Japanese authorities might have decided that there was no need for them to set their own limits if they were going to adopt the new Accord in any case.

Nor is it surprising, in the absence of any decision by the Basel Committee on whether banks should include share price volatility when calculating their capital adequacy requirement, that there should have been criticism of the Japanese authorities' change of tack.

Given the actual impact on Japanese banks of share price volatility, however, there is nothing untoward in the Japanese government adopting a clear stance over an issue of such regulatory importance rather than leaving the decision to an international body such as the Basel Committee.

The Committee might, of course, have decided to include share price volatility even if the Japanese authorities had taken a completely opposite view, and Japanese banks should have been thinking about how to deal with their equity holdings long before the current discussions began in case share price volatility was included as one of the factors used to calculate capital adequacy.

2) Impact

A rough calculation would suggest that, if the proposed limits are imposed, shares worth more than ¥10 trillion would have to be disposed of.[3]

The issue is how share price volatility would be treated under the new Accord. If VaR were to be recommended, Japanese banks could find themselves having to use a risk weight of more than 400% (see above). If share disposals were the only means used to prevent the decline in capital adequacy ratios that this would produce, Japan's leading banks would find themselves having to dispose of nearly ¥20 trillion in shares in addition to the ¥10 trillion already mentioned.

Much has been made of the fact that such disposals could send the stock market lower, and this is another reason why preparations are being made to set up a body to purchase such shares from the banks. Under normal circumstances, buyers would appear if share prices fell well below the levels justified by the fundamentals of the companies concerned; so it would seem unlikely that the unwinding of cross-shareholdings could continue indefinitely to depress share prices across the board. What is more likely is that such intervention will cause liquidity to dry up and impair the market's efficiency and impartiality.

The real impact of having levels of equity capital that reflect the risk presented by share price volatility is not so much the possibility of a stock market crash as the fact that banks will generally be more reluctant to lend and invest, and that returns on loans, bonds and shares will be affected in relative terms.

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3 According to the September 2000 figures, Japan's leading banks have ¥14 trillion more in equity holdings than capital. However, the current figure is likely to be lower as banks have since disposed of some of their equity holdings.

If banks are obliged to take account of share price volatility, they could find themselves not only having to dispose of shares in order to maintain their capital adequacy ratios: they might also have to call in loans and sell some of their bond holdings. For example, a bank might prefer to forego a loan to a relatively unimportant corporate client rather than sell its equity holding in an important business partner.

In other words, the existence of a body to purchase such shares from banks would not prevent banks worried about the risk of holding shares from reducing their lending levels—with negative consequences for the economy and financial markets. In addition, the risk-return relationship between loans and bonds (where banks are not obliged to allow for price volatility when calculating their capital adequacy requirements), on the one hand, and shares (where they are required to do this), on the other, might be distorted.

As was mentioned above, the effect of including price volatility in any calculation of risk would be dramatic if VaR were used in an unmodified form, so careful consideration needs to be given to the particular method used. As the wording of the Financial System Council's report ("Best practice, i.e., the most sophisticated risk management technique available at any given time, should be used") indicates, the issue of which technique is most appropriate needs to be resolved.

3) Conclusion

I have examined the various rules on equity holdings referred to in the Financial System Council's report on stabilizing the banking system; but it is important to remember that these rules alone will not achieve that goal.

The main reason that banks' equity holdings now exceed their equity capital is not so much that the banks have followed irresponsible investment policies as that repeated profit-taking on these holdings in order to write off non-performing loans has raised the book value of the holdings.

This means that any restrictions on such holdings will fail to solve the problem unless the underlying problem of the banks' non-performing loans is also solved. Indeed, far from any solution to the problem of non-performing loans being found, the problem may actually grow as banks continue to make loans on terms that do not reflect the full risk involved.

The problem facing Japanese banks (i.e., the fact that the credit and market risks they are exposed to are not fully reflected in the terms of their loans) has actually been obscured by capital adequacy rules that also fail to reflect these risks and by cost-based accounting standards. As a result, the problem is growing.

Therefore, rather than being a new imposition, the new Basel Accord and the adoption of market value accounting are simply a means of making Japanese banks more aware of risks that have existed for a long time and of forcing them to decide (as they should have done already) what would be an adequate return for the risks they face and how much capital they need if they fail to achieve that return.

More work is likely to be done on making these means effective. Last December the Joint Working Group consisting of representatives from the International Accounting Standards Committee (IASC) and the organizations responsible for setting the accounting standards of the leading industrial nations proposed that all financial instruments should be valued at market.

As a result of their proposals it may be necessary to reconsider the distinction the new Accord makes between banking and trading accounts.[4]

However, provided all the institutions concerned do try to assess their risks properly and to achieve returns and capital levels that reflect those risks, there is no reason why the adoption of market value accounting and the new Basel Accord should have any material impact.

What Japan is now experiencing is a reversion to the kind of behavior Japanese banks should have displayed in the first place. The direction of change is the right one, and all that remains is to decide how long the process should take. Just as any delays in the process of change must not be allowed to lead to further problems, so the hasty adoption of changes must not be allowed to lead to unintended side effects that deter people from pursuing reforms.

The benefits (and not just the costs) of change need to be emphasized. Nor is the reduced risk that the problems of the banking sector could spread to the economy as a whole the only benefit. For example, as cross-shareholdings are unwound, the proceeds of the sales might be used for other, more profitable investments, while a reduction in the number of stable shareholders should make banks more vulnerable to

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[4] One of the basic rules proposed by the group is that banks should not be allowed to vary the way they treat their assets according to the purpose for which they are held.

takeover and more susceptible to pressure from investors to improve their performance. If this boosts shareholder value, the stock market and the economy are also more likely to recover.

Needless to say, these changes will proceed more smoothly if new investors can be found to fill the role traditionally played by banks. As well as a greater role for individual investors and mutual funds, there is a need for new institutions such as employee share ownership plans. Hopefully, efforts to encourage greater use of direct financing and to revive the stock market (including by some of the means suggested in this paper) will now gather momentum.[5]

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[5] See Y. Fuchita, "The Thorny Path to Direct Financing," Capital Research Journal, Summer 2001.