Recent Developments Concerning Japan's Bad Loan Problem and the Outlook for Its Financial System

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In September 2001 Japan's Financial Services Agency (FSA) announced a series of measures to deal with the country's bad loan problem ("Reform Program") and put flesh on the policies which the government announced in April (as part of its emergency package) by means of new measures such as a system of ad hoc audits for banks.

Although this may mean that a number of banks may be found to be undercapitalized and that prompt corrective action may have to be taken in a number of cases, a distinction has to be made between the problems facing individual banks and those facing the financial system as a whole, and an effort must be made to rectify the country's "overbanking" and to allow direct finance to play a greater role.

1. Developments since April 2001

1) The emergency package announced in April

A heated debate has been going on since April about how the bad loan problem facing Japan's banks can be resolved as soon as possible. As well as considering the various views that have been voiced, this report considers possible future developments.

With the benefit of hindsight, it is clear that from the second half of 2000 to early 2001 the focus of attention was on reinvigorating Japan's securities markets rather than on finding a solution to the banks' bad loan problem. One of the reasons for this was that the Japanese stock market was in the midst of a correction following the sharp economic slowdown in the United States that became increasingly apparent in the autumn of 2000. Initially, a number of politicians proposed a scheme for setting up a body to support the stock market, but the ruling coalition's interim report ("Measures to Reinvigorate Japan's Securities Markets") published on 9 February, 2001, proposed a more comprehensive approach to reinvigorating the stock market (e.g., by permitting the use of treasury stock and the introduction of 401(k) plans; by considering whether to permit employee stock ownership plans (ESOPs); by introducing exchange-traded funds (ETFs); and by more favorable tax treatment for retail investors) in order to rectify the bias towards indirect finance—rather than simply trying to support share prices.

It was only later (when the problems facing Japan's financial sector were highlighted at the G7 meeting in Palermo) that the focus of the debate shifted from the securities markets to the banks' bad loan problems. By calling for an early resolution of these problems, the joint communiqué issued on 17 February focused attention on this issue to an unprecedented extent.

Following this, on 6 April, the Japanese government announced a package of proposed measures designed, in particular, to face the bad loan problem square on and deal with the problem of corporate debt at the same time. This would involve setting a two-year deadline for dealing with existing bad loans and a three-year deadline for new ones as well as a firm commitment to dealing with the bad loan problem off the balance sheet. Other proposals included measures to make it easier for companies to restructure, to encourage banks to forgive debtors, and to securitize loan assets by allowing the Resolution and Collection Corporation (RCC) to play a greater role.

At the same time, the proposal to set up a body to shore up the stock market, which appeared at one stage to have been dropped, reappeared in the form of a proposal to set up a body to purchase banks' cross-shareholdings—ostensibly to help banks restructure their operations.

2) The Reform Program and the debate on how to resolve the bad loan problem

When the Koizumi government was formed on 27 April, there were great expectations both at home and abroad that the new prime minister's high popularity ratings would enable his government to carry out the painful reforms needed to resolve the bad loan problem. These expectations were also reflected in the government-approved policy document of the Council on Economic and Fiscal Policy ("Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management") published on 26 June, which identifies "resolution of the non-performing loans problem" as "the first step toward economic reform."

One of the proposals—that the FSA adopt a much more rigorous audit regime for the country's major banks in order to induce them to carry out their internal risk assessments more carefully and thereby facilitate a resolution of the problem—has already been put into practice. As result, the Agency will not only carry out audits annually instead of every other year—it will also carry out detailed follow-up audits at the same time as banks carry out their internal risk assessments in order to ensure that they incorporate the recommendations that the Agency made at its last regular audit.

However, the statement in one of the explanatory documents which the Agency presented to the Council on Economic and Fiscal Policy on 28 August ("Japan's Financial Markets: Problems and Solutions")—namely, that Japan's outstanding bad loans could not be expected to return to normal levels until 2007—was taken to mean that the government was reneging on its commitment (declared in the April emergency package) to ensure that banks would deal with all their remaining bad loans off their balance sheets within 2-3 years.

This triggered criticism of the Agency's approach from many sides. The following were the main criticisms:

(1) At the heart of the problem is no longer those loans that are classified as "non-performing" but those to 20-30 major companies that are still classified as "performing" or "doubtful" but have actually become non-performing. According to such critics, the Agency needs to tighten up its audits and require the banks to make the necessary provisions.

(2) Instead of regarding direct write-offs as the only proper way to deal with bad loans, banks should also be allowed to use provisioning.

(3) Pressurizing banks to make direct write-offs of those loans that are currently classified as "non-performing" runs the risk of forcing a large number of smaller companies into liquidation while ignoring the more serious problem presented by 20-30 major companies.

(4) The banks cannot be left to deal with their bad loans on their own. A committee needs to be set up with the task of drawing up a plan to reinvigorate Japanese industry and with the powers to force companies to comply with its directives. The RCC should then be responsible for purchasing the banks' bad loans and implementing the committee's directives.

(5) The RCC should purchase the banks' bad loans at book price.

(6) The banks should be given additional injections of public funds.

Following a heated debate in which views such as these were voiced, a "Reform Timetable," which included the Reform Program, was finally announced on 21 September. This incorporated measures such as "ad hoc audits" for debtors whose market rating has undergone a significant change and a requirement that major banks adopt internal ratings that reflect market signals in good time to ensure that they make adequate provisions for doubtful loans to listed companies. It was also proposed that the RCC should be more flexible about how it calculated purchase prices so that it could carry out most of its purchases of bad loans by the end of fiscal 2003 and that a fund should be set up to help companies restructure.

When the Diet reassembled on 27 September, Mr. Koizumi stated that the RCC would purchase bad loans at their market value rather than cost. Detailed discussions about how the powers of the RCC would be strengthened are going on among the three parties that make up the ruling coalition. Similarly, the FSA has indicated its determination to resolve the bad loan problem by such action as carrying out the first ad hoc audits as early as October and by making it clear that it will exercise its right to vote if any banks that have been given injections of public funds fail to pay a dividend on any preference shares they have issued.

2. Clarification of Immediate Objectives

1) FSA's position

Although the Reform Program proposed that audits be held more frequently and that banks' internal risk assessment procedures be more rigorous, it does not involve changing the overall framework for managing the financial system inasmuch as it relies on the banks to carry out their own risk assessment and on cooperation between them and their corporate debtors to try to resolve the bad loan problem. It must therefore have disappointed those who have called for decisive action to deal with the performing and doubtful loans to major companies that are such a concern to the market as well as those who have called for what would, to all intents and purposes, involve the RCC in using public funds to purchase the banks' bad loans at book value and those who want a committee to be set up with the task of drawing up a plan to reinvigorate Japanese industry and to have the powers to force a comprehensive solution of the bad loan problem on the parties involved.

The FSA's response to such criticisms is as follows:

(1) It has been said that loans to 20-30 major companies classified as "performing" or "doubtful" loans are at the heart of the bad loan problem; but who should decide who these companies are? Any company singled out as a "problem borrower" would immediately find itself at the center of all kinds of rumors. Nor would it be in accordance with proper accounting practice for a company to make loan-loss provisions purely on the basis of speculation and without any concrete evidence. If a bank that had made such provisions made any further loans to such a company, it would risk being accused of breach of trust and find it very difficult to continue lending to that company.

(2) Simply provisioning against loan losses will not change the way the debtor company is managed or bring about structural reforms. As a result of such experience in the United States, US banks prefer to write down such losses

directly.

(3) There has been criticism that it is small businesses that have had to suffer most as a result of banks' reluctance to lend. In fact, however, banks have been encouraged to ensure that small companies are able to obtain stable sources of funds. Indeed, those banks that have received injections of public money have been required to lend to small companies.

(4) The very concept of a committee charged with the task of reinvigorating Japanese industry begs the question whether it is appropriate for the state to interfere in the affairs of private companies as well as the question whether it is even capable of making the right decision about such matters.

(5) If the RCC were to purchase banks' bad loans at prices favorable to the banks and suffer losses as a result, it would be accused of bailing out the banks at taxpayers' expense. Sharing losses would absolve banks from their ultimate responsibility for dealing with the problem, while selling the bad loans to the RCC would simply postpone any solution.

(6) There have been calls for more public funds to be injected into the banking system, but the problem is not so much a lack of equity capital as poor profitability. Capital injections would oblige banks to pay out more in dividends, thereby squeezing their margins even further. It would also make sellers of existing shareholders and risk putting further downward pressure on bank shares. If the banking system did find itself threatened because of a shortage of capital, however, ¥15 trillion could be injected into the system under the Deposit Insurance Law.

2) Some basic facts about any solution to the bad debt problem

If we consider the following, the FSA's response would seem both highly rational and realistic.

First, those best qualified to form an accurate view of the mass of information on all the loans extended by Japanese banks are the banks themselves. The FSA does not have more credit analysts at its disposal than the banks. The main aim of the FSA's audits is not to assess each and every loan but to ensure that the banks' own credit and risk analysis departments are up to the job. Nor does it seem likely that any committee-type organization could do a better job of auditing the banks than the FSA's own auditors, who have a wealth of practical experience.

Nor is it simply a matter of assessing the banks' bad loans: once identified, the loans have to be dealt with. Inasmuch as this involves thousands of contracts between the banks and their corporate clients, both sides should be expected to fulfil their obligations, and it should be the job of the authorities to ensure that the right rules and conditions are in place to encourage them to do this.

Second, although underlying the entire debate there is probably anxiety that the bad loan problem will lead to a financial crisis in Japan, a distinction has to be made between the problems facing individual institutions and those facing the system itself. There is already provision (in the form of the rules for prompt corrective action) to deal with the problems facing individual institutions, and action can be taken where necessary if any banks should find themselves short of capital to prevent the problem spreading. In spite of the fact that this is the established procedure, some people have tended to argue that the risk that certain banks may run out of capital represents a crisis of the entire Japanese financial system and that it is wrong to delay further injections of public funds.

However, if the financial system (as distinct from particular banks) should face a crisis, the prime minister (in consultation with the Financial Crisis Action Committee) is authorized to initiate appropriate emergency action—in this case, the injection of ¥15 trillion into the banking system (see above)—if the Committee feels that there is a major risk that the system may cease to function in either the country as a whole or in areas where particular financial institutions are operating.

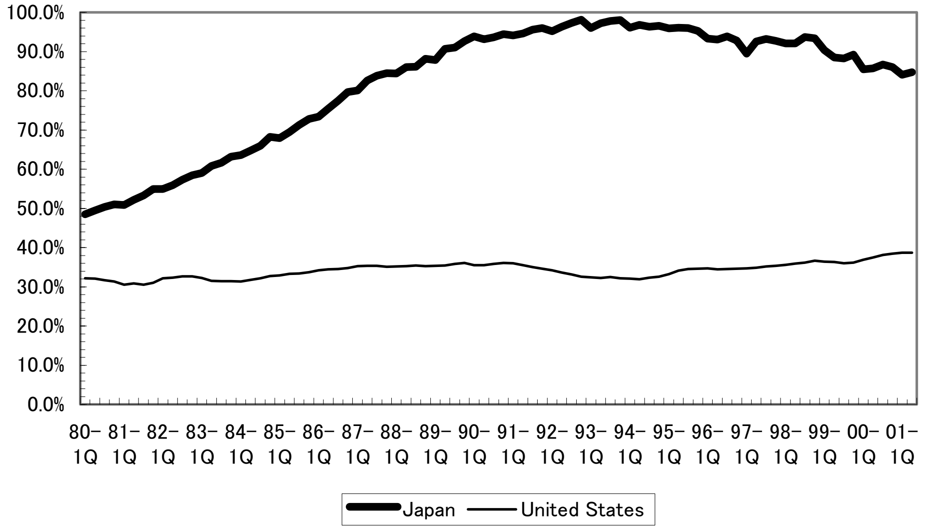
In other words, it is not so much the case that the authorities are reluctant to inject more public funds as that they do not perceive any need for such action at present and have the means to respond should they ever feel that such action is required.

3) Japan's financial crisis and the need to correct the state of overbanking

It is particularly important to distinguish between a crisis facing individual institutions and one facing the financial system as a whole, and this is probably an area where more needs to be done to correct all sorts of misunderstandings. For many years observers have pointed out the overbanked state of Japan's financial system.[1] This became critical during the asset boom of the late 1980s. Figure 1 shows how (as a percentage of GDP) bank lending in Japan has long exceeded that in the United States and how it has still to return to past levels since it ballooned in the late 1980s. Japanese banks are still lending on wafer-thin margins that cannot be sustained in the long run.

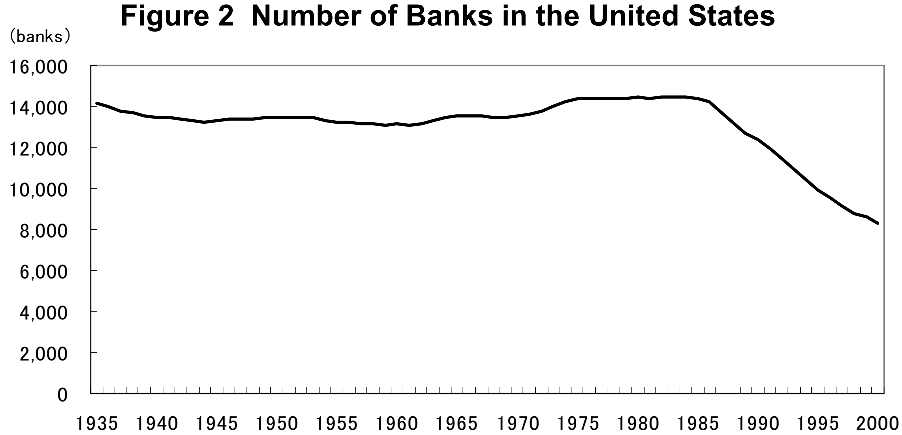
1 Takeo Hoshi and Anil Kashyap, "The Japanese Banking Crisis: Where Did it Come from and How Will it End?," Macroeconomics Annual 1999, NBER.

Figure 1 Bank Lending as a Percentage of GDP in the United States and Japan (1980-2000, quarterly basis)



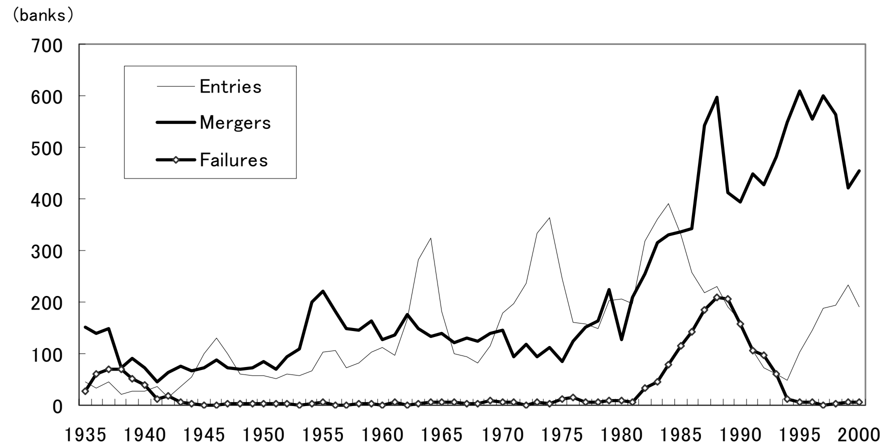
Source: NRI.

Figure 2 Number of Banks in the United States



Source: NRI.

Figure 3 Number of Entries, Mergers and Failures in US Banking Industry



Source: NRI.

More than two thirds of the International Monetary Fund's 180 member nations have faced a financial crisis at one time or other during the past 20 years; so financial crises are not something peculiar to Japan. However, one of the lessons that can be drawn from their experience is that, the more an economy depends on its banking system, the more difficult it is to deal with a financial crisis and the greater is the need for alternative sources of finance (to a government-guaranteed banking system).[2] This means that Japan needs to reduce its dependence on its banking system drastically—and not simply to the level that existed before the asset boom of the late 1980s.

Figure 2 shows the number of banks in the United States since the 1930s. There was a sharp fall in the number during the financial crisis of the late 1980s and early 1990s. However, it is significant that the decline was not confined to this period and continued throughout the economic recovery that followed. Furthermore, as can be seen in Figure 3, it is not simply a case that banks have been merged or have exited the industry: many new banks have also been established and the process of rejuvenation in the US banking industry is clearly very much at work. In contrast, in Japan the process of restructuring and rejuvenation has only just begun.

This means that action to induce problem banks to exit the industry should actually be encouraged in Japan, and there is a risk that those who seek to present such problems as a threat to the financial system as a whole could actually impede the structural reforms that Japan needs to carry out.

As for the question when problems with individual institutions become a threat to the financial system as a whole, this is defined by the Deposit Protection Scheme Law and is a highly political matter to be decided ultimately by the prime minister—not something for which the authorities can have hard and fast guidelines.

3. The Relation between the Bad Loan Problem and Corporate "Excesses"

1) Excess debt, excess capacity and excess labor

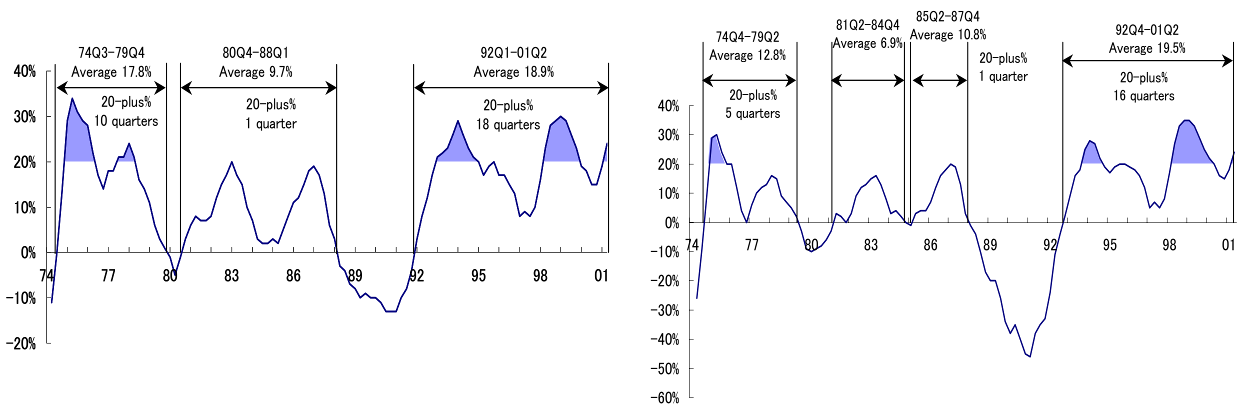
Although there have been loud calls both at home and abroad for prompt and comprehensive action to deal with Japan's bad loan problem, the view that what is needed is top-down compulsory measures to deal with the problem at one fell swoop may not be a very realistic one. This is partly because, as we explained above, much will inevitably depend on the individual banks and companies involved and partly because the problem is not simply the quality of the loan assets held by the banks.

2 James Barth et al., "Choosing the Right Financial System for Growth," Journal of Applied Corporate Finance, Winter 2001.

The banks' bad loan problem is, of course, only one side of the coin: the other is excess corporate debt. This, in turn, gave rise to excess capacity and excess labor. As can be seen from Figure 4, the excess capacity and labor that has existed since the early 1990s is even now more serious than that which followed the First Oil Crisis. Although stimulus packages and the business cycle have produced intermittent improvements, these have not proved sustainable.

Figure 4 Perceived Excesses of Capacity and Labor

Production and sales capacity ("too much" − "too little")　　Labor ("too much" − "too little")



Note: The data are for all industries.
Source: "Tankan" Survey, Bank of Japan.

Any attempt to deal with the bad loan problem at one fell swoop would necessarily involve similar treatment for the corporate sector's excess capacity and labor. In practice, however, this would obviously be very difficult. While any move by the RCC to step up its purchases of bad loans would help to put a more exact figure on the banks' losses and reduce some of the uncertainty facing the financial system, it would also saddle the RCC with most of the responsibility for dealing with the corporate sector's excess capacity and labor. In order to minimize the risk of secondary losses, the RCC would have to set about trying to reinvigorate Japanese industry. In terms of both staff (the RCC has far fewer staff than all the specialists employed by the banks) and expertise (until now the RCC has specialized in trying to recover bad loans and has little experience in turning companies around), it would be a mistake to overestimate its capabilities, and there is no guarantee that this would alleviate the problem.

Basically, the problem of excess corporate capacity and labor varies from one company to the next and does not lend itself to a centralized solution imposed from on high. It would be more realistic to assume that companies will have to find their own solutions by a process of trial and error.

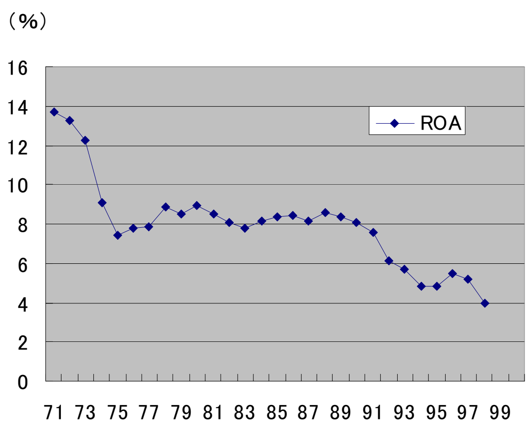
2) Problems facing the corporate sector and the financial sector are two sides of the same coin

We have used the terms "excess capacity," "excess labor," "excess debt" and "bad loans" without defining them. In the following we shall try to define them and the relations between them in simple terms.

To say that a resource is "in excess" means that its productivity has declined. Production capacity (or, more generally, the problem of excess corporate assets) can be shown as a decline in ROA—as in Figure 5, which shows ROA in Japan in macroeconomic terms. It is clear that ROA is still declining. Figure 6 breaks this down into capital productivity and the share of capital. It is clear that not only capital productivity but also the share of capital is declining. In other words, the share of the labor sector is rising. Although there is an oversupply of labor, the fact that Japanese companies find it difficult to cut payrolls and wages means that their share of the added value generated by their assets has declined in relative terms.

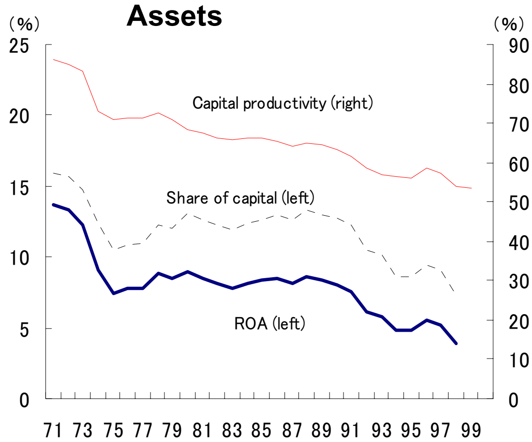
This share is the return to lenders and investors on the capital they have provided. The fact that this return is declining means that lenders will be unable to earn the return they expect—in other words, that their loan assets are impaired. For investors it means that the expected rate of return on their securities investments is also declining.

Figure 5 Return on Assets (SNA basis)



Note: ROA = Corporate operating surpluses/private capital stock
Source: NRI, from Standard National Accounts data.

Figure 6 Factor Analysis of Return on Assets

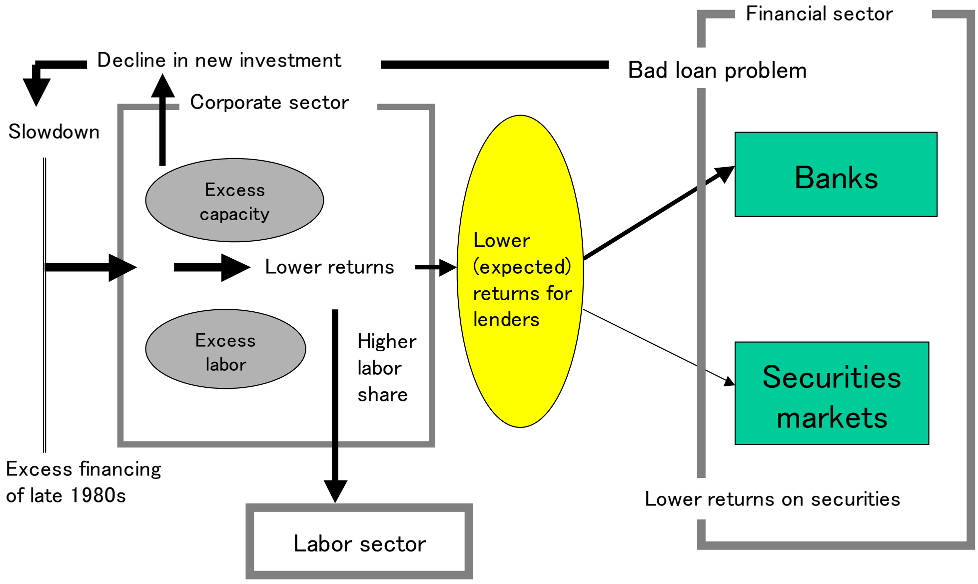


Notes: 1. ROA = Corporate operating surpluses/private capital stock
2. The data for private capital stock have been adjusted using the capital investment deflator.
Source: NRI, from Standard National Accounts data.

Return on assets = (GDP × capital share) ÷ A(capital stock) = capital productivity(GDP/A) × capital share

Source: NRI, from "NRI Medium-Term Economic Outlook 2001-2005."

Figure 7 Links between Bad Loan Problem and Weakness of Securities Markets



Source: NRI.

Excess corporate capacity, labor and debt; the banks' bad loan problem; and the slump in Japan's securities markets are all part of the same problem. Simply tackling the bad loan problem or trying to reinvigorate Japan's securities markets will obviously not produce a solution unless companies also deal with their excess capacity and labor. Figure 7 shows how these are all linked.

4. Outlook

1) Need for banks to change their attitude

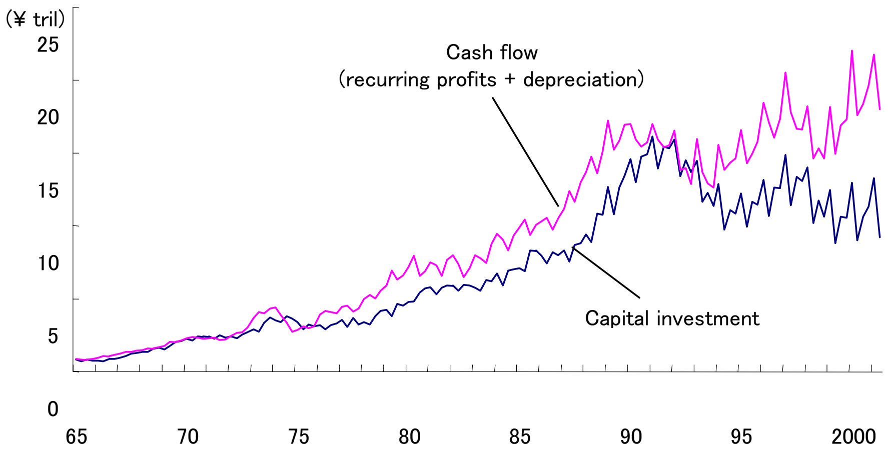
As the bad loan problem is also a problem of excess corporate debt, forcing only the banks to do something about it will not solve the problem. However, this does not mean, as some have advocated, that fiscal and monetary policy should be expected to provide a solution.

With Japan's fiscal deficit already at a high level, an ill-considered expansionary policy would risk triggering a rise in long-term interest rates because of the effect on both demand and supply as well as on credit ratings. With interest rates already at zero, there would be numerous problems attached to targeting inflation or adopting an unorthodox approach to monetary policy, as some have pointed out. And even if such measures did succeed in boosting the economy in the short term, the risk would be that the effect would be only temporary—as happened in the 1990s.

The fact that bad loans are already at a high level also means that they are dampening any boost to the economy. Figure 8 shows the relationship between corporate cash flow and capital investment. Whereas in past years capital investment tended to be at nearly the same level as cash flow, since the mid-1990s cash flow has not fed through to capital investment—probably because the corporate sector's priority has been to repay its excess borrowing.

This also indicates why macroeconomic policies alone will not be enough to solve the problem unless companies and banks are also involved at a microeconomic level. As the experience of the 1990s shows, an overdependence on macroeconomic policies can not only lead to a reluctance to deal with problems at the microeconomic level but also weaken public finances and reduce the effectiveness of monetary policy. While it is true that deflation exacerbates bad loans, Japanese banks need to take a fresh look at the way in which corporate finance has dominated their lending policies and led to them acquiring a mountain of corporate loan assets that would inevitably be highly vulnerable to deflation.

Figure 8 Cash Flow and Capital Investment



Note: The data are for all industries. Capital investment = miscellaneous fixed tangible assets (new) + construction in progress (new).
Source: NRI, from "Financial Statements of Corporations (Quarterly Survey)," Ministry of Finance.

One of the things the authorities could do to encourage companies and banks to deal with the problem at the microeconomic level would be to put all sorts of pressure on the banks (which are, after all, licensed by the authorities). The decision to subject the banks to more rigorous audits of their bad loans must therefore be considered a realistic step in the right direction. Hopefully, these measures will encourage the banks to undertake their own reforms and to redouble their efforts to help their corporate debtors back on their feet.

The New Basel Accord is due to come into effect in 2005. As this will require banks to assign an appropriate risk weighting to their loans, they will be forced to review their current policy of lending at rates that fail to reflect the real credit risk. Likewise, the requirement that banks' capitalization reflect the risk of their shareholdings more accurately may force Japan's leading banks to reduce these holdings even more than the recent rules require.[3] As a result, Japanese companies, in turn, will be forced to rethink their approach to financing (which relies on the banks as both lenders and loyal shareholders). By playing their part in dealing with the banks' bad loans, they can help to bring about a new era in corporate finance.

2) Prerequisites for a move away from an overdependence on indirect finance

Japan's financial system clearly needs to become less dependent on indirect finance and make greater use of direct finance. For this to happen, however, the banks will have to mend their ways and, in particular, face up to their bad loan problem.

First, as can be seen from Figure 7, the problems in the corporate sector have led to lower expected returns for the financial sector as well as lower returns on securities. Tackling the bad loan problem should help the reforms taking place in the corporate sector and boost expected rates of return.

Second, the bad loan problem is a byproduct of the fact that the banks are lending at rates that fail to reflect the true risks they face, and, so long as this continues on a large scale, the price mechanism of Japan's securities markets will continue to malfunction and neither companies nor investors will have sufficient incentive to use these markets. Nor is this failure to reflect the true risks confined to investment and lending: it is becoming increasingly common in the banks' attitude to their commercial paper and equity portfolios.

Similarly, the attitude of the authorities—as reflected, for example, in the fact that public funds have been injected into the banks because of their bad loan problem; in the fact that the introduction of a payoff system for bank depositors has been postponed; and in the way the Bank of Japan conducts its commercial paper operations—has tended to put the securities markets at a disadvantage and maintain a status quo that favors indirect finance.

3 Yasuyuki Fuchita, "Regulating Bank Equity Holdings in Japan," Capital Research Journal, Autumn 2001.

Unless these problems are solved, it will be very difficult for direct finance to play a greater role. Although it may seem paradoxical, a sounder banking system will benefit Japan's securities markets.[4]

3) The pace of reform

As we have seen, the bad loan problem is, by its very nature, not something that lends itself to a quick solution. The process will take some time. However, this is because a solution will involve structural reform of the corporate and labor sectors. Postponing deadlines is not the way to do this. Indeed, the fact that there is very little scope for fiscal and monetary policy and that very little is likely to achieved by them means that there is just as little scope for postponing action and that the time is approaching when all those concerned will have to bite the bullet, allowing, where necessary, enough time for the action to take effect.

When this happens, more companies can be expected to fail—as well as some banks. However, a dispassionate distinction should be made between what is a crisis for a particular bank and a crisis for the financial system as a whole. Indeed, weeding out and winding up particular banks should be seen as an integral part of the process of ensuring that the problem, which has been created by a financial system biased in favor of indirect finance, does not recur.

Having said that the process of dealing with the bad loan problem will take some time, we need to remember that there is not that much time left. During the next five years, Japan will face mounting international pressure in the form of the New Basel Accord and more market value accounting rules—regardless of its particular circumstances.

Hopefully, the markets will speed up this process by valuing those banks and companies that face up to the problem more favorably than those that remain in denial.

[4] Yasuyuki Fuchita, "Some Reflections on Proposals for Reinvigorating Japan's Securities Markets," Capital Research Journal, Spring 2001.