Japan's "Revived" Financial System

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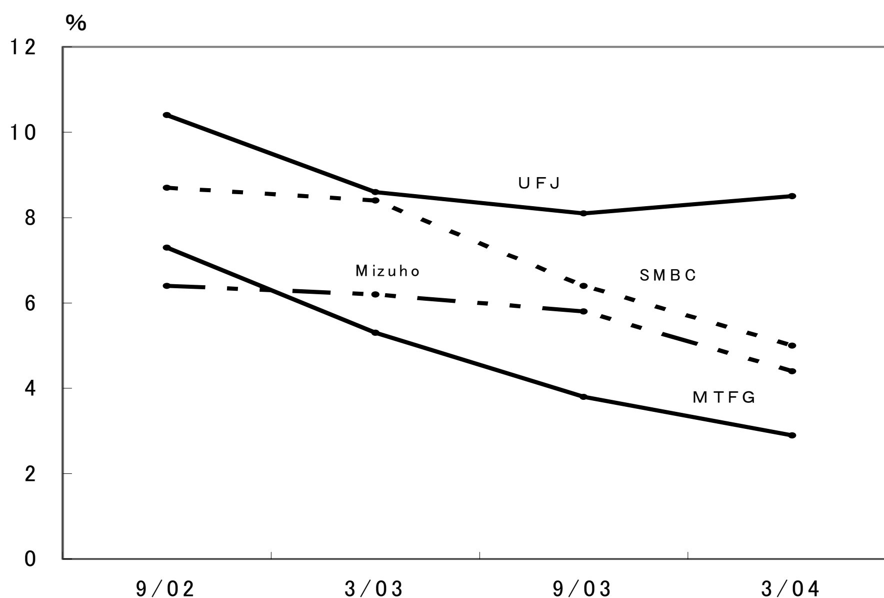
From "Intensive Adjustment" to "Concentrated Consolidation"

Japan's bad debt problem, which has been the biggest economic and political problem facing the country for over 10 years, now appears to be nearing resolution. The decline in the bad debt ratio of the country's major banking groups was confirmed when they reported their results for fiscal 2003 at the end of May 2004 (see Figure 1). And UFJ, whose bad debt ratio still stood at 8.5% at the end of March 2004 after having made little progress in reducing its debts, announced that it would reduce the ratio to 3.4% by the end of March 2005 by dealing with its main remaining debts in the first half of fiscal 2004. Since then, however, UFJ has opted for a more radical solution—merger with MTFG.

Figure 1 NPL Ratio of Four Major Banking Groups



Source: NICMR

This means that the objective of halving the bad debt ratio of the main banking groups by the end of March 2005 (set out in September 2002 in the government's Program for Financial Revival) is likely to be achieved as reconstruction gathers speed.

Nor is the bad debt problem the only area where progress has been achieved. While attention during the past few years has been focused on the bad debt problem, there has also been the problem of how to deal with mushrooming tax-deferred assets and deteriorating capital adequacy. However, many banks have made considerable progress during the past year in dealing with these two problems. Finally, the banks have also succeeded in trimming their equity holdings and are now less sensitive to share price movements than in January 2002, when restrictions on such holdings came into force.

The Japanese banking system is therefore slowly but surely returning to normal. In the light of this progress, the government announced in its third set of "Basic Policies for Managing and Reforming the Economy," published in June 2004, that fiscal 2005 and 2006 would mark a period of "concentrated consolidation" after the final stage of "intensive adjustment" to the legacy of the late 1980s was completed in fiscal 2004.

When the government published its first set of "Basic Policies for Managing and Reforming the Economy," in June 2001, it indicated that Japan would have to accept two or three years of low growth as a concomitant of the final stage of "intensive adjustment." In January 2003 the government announced that this final stage would take a year longer than expected; but this year the outlook has finally improved.

The question now is how Japan's financial regulators should respond to this improvement. In its third set of "Basic Policies for Managing and Reforming the Economy" the government announced that it would draw up an action plan for the financial system that would mark the end of the period of having to react to the bad debt problem and the beginning of a period of reforming and revitalizing the country's financial sector to enable it to provide a service on a par with the highest international standards in readiness for a new period of economic growth.

The goal of providing a service on a par with the highest international standards is reminiscent of Japan's Big Bang program of reforms announced in November 1996. Although the program did lead to a number of reforms, especially of the country's securities markets, its goal of putting Tokyo on an equal footing with London and New York failed as a result of the need to deal with asset deflation first.

Now that Japan has nearly finished dealing with its bad debt problem, the question facing the government is what sort of action plan it should draw up to enable the financial sector to resume its development like that of other advanced economies. In the rest of this report I shall give my own views on three different aspects of this question: (1) the need to redirect the flow of money in the economy, (2) a comprehensive approach covering banking, investment services and insurance, and (3) the creation of a standard for advanced economies.

The Need to Redirect the Flow of Money

There is no question that one of the main achievements of the "intensive adjustment period" was coming to grips with the bad debt problem. However, a lasting solution to the problem will involve not only writing off existing debts but also reforming the financial system in order to prevent a recurrence of the problem. Therefore, during the "concentrated consolidation period" the fundamental causes of the problem need to be addressed.

One of the factors that exacerbated the bad debt problem was the way in which money flows in the Japanese economy, and it is a well known fact that banks play a dominant role in the way money flows in Japan, bearing more than their fair share of economic risk as a result.

In its July 2002 report ("Blueprint for Reforming Japan's Financial System and Financial Administration") a panel of advisors to the former Minister for Financial Services, Hakuo Yanagisawa, described the direction reform should take. Although banks would retain their role as intermediaries between depositors and borrowers, a market-based financial model (with markets acting as intermediaries and pricing mechanisms) would become increasingly important as a means of identifying, managing and allocating risk, and serve as the main line of a new, "two-track" financial system. The government's action plan will need to take account of the recommendations of both the July 2002 report and the September 2002 report by the Financial System Council ("A Medium-Term Blueprint for Reforming Japan's Financial System"), based on the earlier report, and come up with proposals for redirecting the flow of money in the economy.

Such a two-track financial system would address the need to prevent too much risk being concentrated in the banking system in the following way.

First, the fact that the role of the banks as financial intermediaries would still be important would mean that they would have to manage the risk of their traditional

bilateral lending better. To do this, they would need to ensure that any deals were priced in accordance with the risk and cost involved. Given the bilateral nature of such transactions, however, there is no reason why their terms should have to accord with market principles. In fact, it would be better if the terms reflected factors inherent in such a relationship, such as access to qualitative information. However, the fact that bilateral lending in Japan has been a long-term relationship has tended to lead to mutual overdependence, where banks have incurred more than their fair share of the risk and costs involved and corporate borrowers have found themselves having to pay a cost in the form of financial instability. Hopefully, therefore, both banks and their corporate customers will take a fresh look at their relationship, so that, instead of constraining and burdening the banks, it becomes a source of income in the proper sense of "relationship banking."

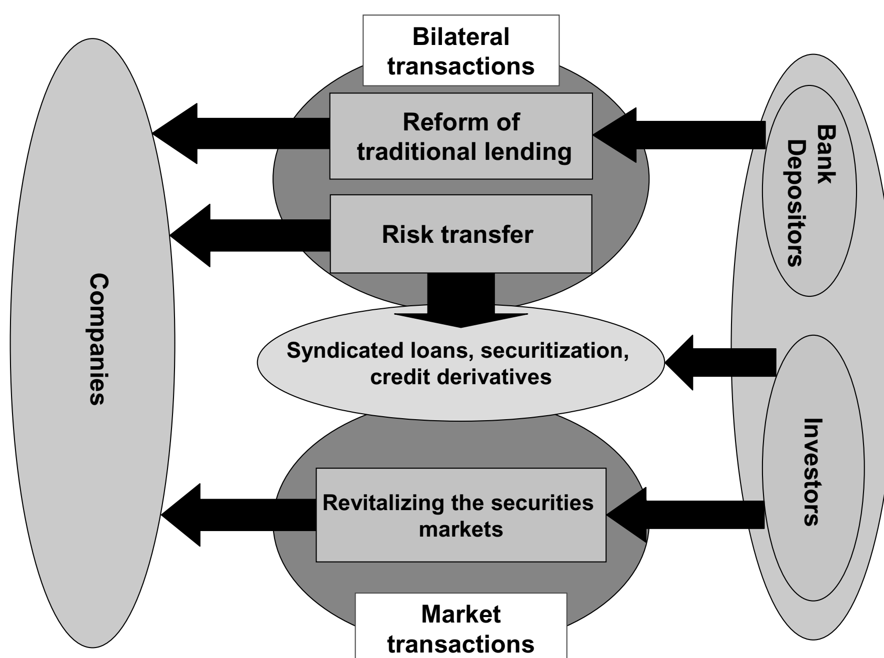
Following a report by the Financial System Council in March 2003, the Financial Services Agency called on the country's regional banks to take concrete action to put such precepts into practice. However, even the country's major banks will have to review their banking relationships to ensure that the terms of their bilateral loans reflect the risks and costs involved, and do not entail a loss. Such loans will have to be made on the basis of their true economic value and only if the bank concerned is adequately capitalized for the risk it would incur.

Second, even if a loan is originally made by a particular bank, banks will increasingly need to be able to transfer some of that risk to other lenders instead of keeping it all on their own balance sheets. Examples of such risk transfer (also known as market-type intermediation) are loan sales and securitization, syndicated loans and credit derivatives. Although such techniques are being increasingly used in Japan, they are still much less common than in the United States and Europe, and more needs to be done to encourage their use.

Third, the use of securities markets needs to be encouraged so that companies raise the capital they need from individual and institutional investors directly without having to approach a bank. This would avoid the concentration of too much corporate risk in the books of one bank.

These three changes are necessary if the flow of money in the Japanese economy is to be redirected (see Figure 2). Of these three, radical reform aimed at revitalizing Japan's securities markets—in the shape of the August 2001 "Program for Structural Reform of Japan's Securities Markets," the August 2002 "Program for Expediting Reform of Japan's Securities Markets," the December 2002 securities taxation reforms and the amendments to the Securities and Exchange Law in response to the December 2003 report by the Financial System Council ("Towards a Market-Oriented Financial System")—has already been carried out.

Figure 2 The Three Channels to Redirect the Flow of Money



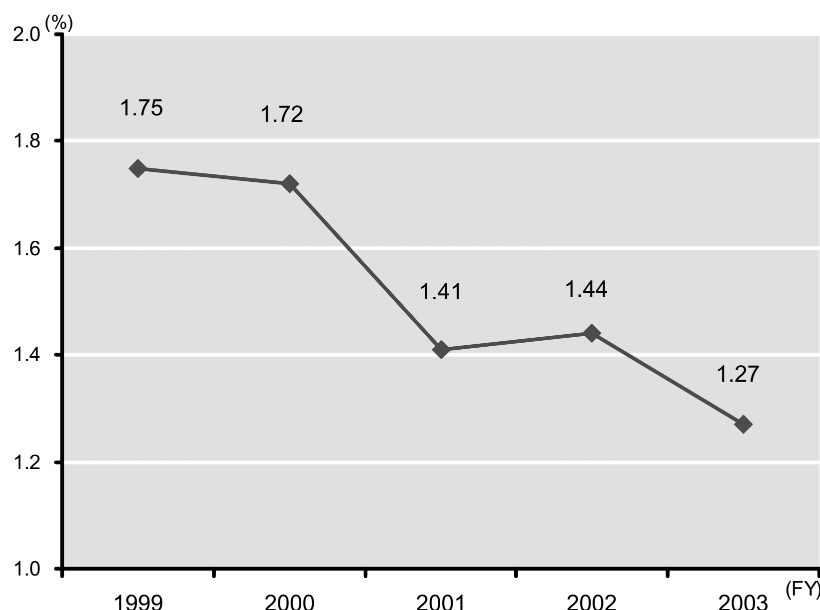
Source: NICMR.

From the outset (the Big Bang program of November 1996), more of an effort was made to reform Japan's securities markets than its banking and insurance industries in view of the need to redirect the flow of money in the economy. Internet trading, for example, would probably not have become as popular as it has if brokerage commissions had not been deregulated as a result of Big Bang. Similarly, fewer individual investors would have bought investment trusts if they had not been able to buy them at their local bank.

Reform of bilateral lending, on the other hand, has only just begun. Here what matters more than regulatory reform is whether banks are willing to change their behavior. So far, many appear to have been more concerned with sorting out their bad debts. Nevertheless, there are some positive signs. For example, some of the major banks have begun to reflect counterparty risk in the terms of their unsecured loans to small businesses, and some local banks have begun to develop their relationship banking.

However, fierce competition among lenders has meant that they have been unable to increase their lending margins (see Figure 3). Unable to make a satisfactory return from their corporate and mortgage lending businesses, the major banks have begun to show a serious interest in consumer finance, and some have taken stakes in consumer finance companies. Although there is nothing wrong with this, the risk remains that, so long as a significant proportion of bank lending continues to be made at rates that do not reflect the risk incurred, a bad debt problem may reoccur.

Figure 3 Major Banks' Lending Margins



Source: NICMR

Encouraged by the Financial Services Agency and the Bank of Japan, the banks are becoming more involved in risk transfer, whether in the form of loan securitization or loan syndication. Although many problems (such as the issue of disclosure and the need to obtain the permission of the original debtor before being able to transfer a loan) have still to be ironed out by the private sector, the initiative shown by the regulators (e.g., the Financial Services Agency's decision to allow all the participants in a syndicated loan to use the results of one inspection) will help the syndicated loan business to develop.[1]

However, no matter what efforts are made to encourage borrowers to use securities markets, they will have only limited success unless banks change their approach to traditional lending, which still accounts for a significant proportion of the flow of money in the economy. So long as banks are prepared to accept an unacceptably low return for the risk they incur, there will be no incentive for borrowers to use the securities markets. It will also be very difficult to securitize loans that have not been properly priced for risk.

One recent cause of concern is the fact that those banks whose risk tolerance has increased as a result of rising share prices and the progress that they have made in writing off their bad debts appear to be less motivated to charge interest rates that

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1 Yasuyuki Fuchita, "Regulatory Initiatives for Expanding Japan's Syndicated Loan Market," Capital Research Journal, Autumn 2004.

reflect the risk they are incurring or to use techniques such as securitization to transfer that risk. It is difficult not to conclude that they are reverting to their habit of accumulating deposits and loans.

If this is to be avoided, appropriate measures will have to be incorporated in the government's action plan.

A Comprehensive Approach to Banking, Investment Services and Insurance

The second point that the government's action plan will have to address is the need for a comprehensive approach to banking, investment services and insurance. One of the aims of Japan's Big Bang program was to stimulate competition in the country's financial services industry by allowing banks, securities companies and insurance companies to enter into each other's business by establishing a financial holding company. Although some progress has been made as banks have, for example, moved into stockbroking, there is no denying the fact that some banks have acted contrary to the spirit of the program (e.g., by merging or forming holding companies in order to generate an amalgamation surplus that could be used to write off some of their bad debts).

Furthermore, banks and insurance companies, whose priority was to survive a crisis, had a different attitude to reform from securities companies, which had to face a series of radical reforms while competing with rivals old and new.

Hopefully, the "concentrated consolidation period" will be characterized by balanced reforms that will enable all three sectors of the financial services industry to compete in the international arena.

Although it is not uncommon to hear calls for the financial regulators to turn their attention to the insurance and stockbroking industries after spending so much time dealing with the banks' bad debt problems, the fact of the matter is, as was mentioned above, that radical reform of the securities industry aimed at redirecting the flow of money in the economy has been taking place ever since Big Bang. In fact, the banking and insurance industries need some of the same momentum for reform. As this report has already pointed out, it will not be possible to redirect the flow of money in the economy unless the banks are able to find a way of making a profit from their core operations. Similarly, the slow pace of reform in the insurance industry is illustrated by the delays in allowing banks to sell insurance over the counter—in striking

contrast to the ease with which they were allowed to act as intermediaries for securities companies.

This is not, of course, to say that there will be no need for further reform of the securities industry. However, the term "securities industry" is itself becoming obsolescent and needs to be replaced by a more accurate one such as "investment services industry." Similarly, urgent action is needed to deal with some of the sharp practices in currency futures trading that have affected so many individual investors. The failure of the regulators to act sooner is a disgrace in a country that is supposed to be an advanced economy. Although action was taken to deal with this particular problem (by amending the Financial Futures Law) after the publication of a report by a subcommittee of the Financial System Council in June 2004, an investment services law covering all investment services rather than just the securities industry is needed if the regulators are not to find themselves having to play Whack-a-Mole every time a new problem occurs.

Any attempt to replace the Securities and Exchange Law with an investment services law will need to address the issue of where exactly to draw the boundaries between securities companies (hitherto engaged mainly in stockbroking), banks and insurance companies. In particular, now that banks are not only allowed to sell investment trusts over the counter as part of the effort to revitalize Japan's securities markets but can act as intermediaries for securities companies and engage in other market-based activities, the raison d'être of a securities company in the traditional sense is disappearing rapidly.

There will have to be a debate about which rules should be retained for specific sectors of the financial industry and whether any new rules will be needed. However, instead of trying to defend the vested interests of each sector, such a debate should aim to raise the standards of Japan's financial services industry to an international level, taking account of both developments overseas and realities at home.

The Development of an International Standard

The third point that the government's action plan will have to address is the need for an international standard. The fact that Japan's financial regulators were worried that the introduction of international standards on the country's financial markets might actually make the situation facing the country's financial institutions even worse partly explains why they were less than wholehearted in introducing them during the "intensive adjustment period."

The "concentrated consolidation period" should therefore be a time to reconsider issues such as these. One such issue is capital adequacy rules and whether a ratio of 4% is adequate for banks that are not seeking to meet the international standard. At some point in the future Japan will probably want to follow the example of most other countries and adopt a single ratio. The same is true of the New Basel Accord: Japan would not want to be in a position where its banks found themselves unable to adopt the most advanced approach.

Similarly, a situation where a bank's regulated capital only clears 8% (or 4%) because it has been grossly inflated by tax-deferred assets and injections of taxpayers' money is one that needs to be re-examined. A recent proposal by a working group of the Financial System Council that there should be a limit on the amount of tax-deferred assets that can be capitalized is a big step in the right direction. So long as such a limit would have threatened the survival of many banks, its adoption was out of the question no matter how desirable it might have been in theory. However, now that many banks are on the road to recovery, adopting the right regulations will enable those regulations to prevent a crisis at some time in the future. It will also be important to emphasize that the adoption of these regulations has not been postponed (as has been reported in the media) but simply delayed until a window of opportunity presents itself.

So long as banks were short of regulated capital and such capital as they had was inflated, it is hardly surprising that prompt corrective action was unable to fulfill its intended role (i.e., oblige banks to act immediately with no room for discretion) and that the regulatory authorities were obliged on a number of occasions to exercise such discretion. However, if the banks succeed in improving both the quality and the quantity of their capital during the "concentrated consolidation period," prompt corrective action should be able to fulfill its proper role of preventing a future crisis. Whereas, in the past, the regulatory authorities had to decide whether a situation was critical or merely required monitoring, now they will only have to decide whether a situation requires monitoring or not. In other words, Japan's financial emergency has ended.

In addition, anomalies such as permanent protection for transaction deposits,[2] fixed (rather than variable) premium rates for deposit insurance, and the practice of demanding personal guarantees from the owners of small businesses and their friends need to be rectified if Japan's financial system is to match those of other advanced economies.

[2] Yasuyuki Fuchita, "The Problems Raised by Measures to Guarantee Transaction Deposits," Capital Research Journal, Summer 2004.

With regard to the adoption of variable premium rates for deposit insurance, an advisory panel to the Deposit Insurance Corporation reported in June 2004 that the number of countries that have adopted variable rates has gradually increased since the United States adopted such a scheme in 1993. In its interim report the panel pointed out that, although there have been concerns that adopting such a scheme while Japan's financial system was still recovering might threaten some of the weaker institutions, the majority of its members favored the adoption of a scheme incorporating some element of variability. Now that Japan's financial system is recovering, the "concentrated consolidation period" will surely be the best time to consider adopting such a scheme.

With regard to the practice of demanding personal guarantees from the owners of small businesses and their friends, the Legislative Council of the Ministry of Justice has drawn up a draft proposal for abolishing comprehensive revolving guarantees, and a report on this is due to be published in September 2004. In view of the fact that the amendments to the Bankruptcy Law are due to come into effect early next year, it is important that entrepreneurs whose businesses have failed should be given a second chance. Furthermore, as the Financial System Council's report on relationship banking pointed out, this should encourage banks to re-examine their excessive reliance on personal guarantees and adopt a more normal attitude when dealing with small businesses.

A new issue that is likely to come up is that of how to deal with "large complex banking (financial) organizations" (LCBOs or LCFOs).

Although Japan's financial regulators have welcomed mergers and the creation of megabanks in view of the situation the country finds itself in, the growing number of bank mergers and the growth of megabanks in other advanced economies means that for their financial regulators how to regulate such large and complex institutions and what to do if a problem occurs is one of the biggest challenges they face. For them, too, the current period of relative calm is an opportunity to dispel the view that such institutions are too big to fail and to consider how best to deal with systemic risk.[3]

Conclusion

As this report has contended, the "concentrated consolidation period" is an opportunity for Japan's financial regulators to adopt the kind of standards an advanced economy should have anyway. It would have been difficult for them to do this when the country's financial system was in the midst of a crisis. A period of relative calm is

[3] Gary H. Stern and Ron J. Feldman, "Too Big to Fail—The Hazards of Bank Bailouts," The Brookings Institution, 2004.

the best time to adopt systems for crisis management. The government's action plan should therefore seek to create a regulatory framework for such a period.

However, this should be not only the time when Japan emerges from crisis to a period of relative calm but also the time to deal with issues such as redirecting the flow of money in the economy, passing an investment services law and taking a fresh look at the country's banking, securities and insurance industries. In other words, this is the time to radically reform Japan's financial markets and financial services industry.

The full range of reforms envisaged in the government's third set of "Basic Policies for Managing and Reforming the Economy" includes many important issues that have not been mentioned in this report: for example, privatization of Japan Post and the need for better public debt management, thoroughgoing reform of the taxation system, and comprehensive reform of the social security system. Hopefully, these reforms will be carried out in a way that does not conflict with the need to make Japan's financial markets and financial services industry more competitive.