The Problems Raised by Measures to Guarantee Transaction Deposits

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I. The Problems Raised by Two Decisions Made in 2002 before the Ending of the Blanket Guarantee on Bank Deposits

Less than a year remains before the blanket guarantee on Japanese bank deposits is ended in April 2005. The guarantee on term deposits was ended in April 2002, and the guarantee on sight deposits was due to be ended in April 2003. However, following Prime Minister Koizumi's announcement that he wanted to step up the pace of structural reform and solve the country's bad debt problems by the end of fiscal 2004, the newly appointed Minister for Financial Services, Heizo Takenaka, announced on 7 October 2002 that he would prefer to postpone the ending of the guarantee by two years until April 2005 (i.e., until after the bad debt problem was solved) in order to avoid any disruption (especially to depositors) that might result from any accelerated action to deal with the bad debts.

The guarantee was introduced as part of the June 1996 amendments to the Deposit Insurance Law one year after the Ministry of Finance published its June 1995 "Proposals for Restoring the Functioning of the Financial System" following action to deal with the collapse of two Tokyo credit unions. The guarantee remained in force for five years until March 2001 as an exceptional measure taken to allay concern about the financial system. Although the Deposit Insurance Law was originally enacted in 1971, the Ministry felt that the measure was necessary because of the widespread belief in Japan that bank deposits were guaranteed in full and the need to improve disclosure by financial institutions.

Then, following an agreement among the three members of the ruling coalition on 29 December 1999 that action was needed to improve the way in which the country's small financial institutions were run in order to create a more robust financial system, amendments to the Law were enacted on 24 May 2000. As a result, the deadline for ending the guarantee was extended from the end of March 2001 to the end of March 2002 for time deposits and to the end of March 2003 for sight deposits. However, as a result of the Minister for Financial Services' October 2002 announcement, the deadline was extended yet again.

Normally, a creditor of a company that becomes insolvent can expect to lose all the money he has lent. The ending of the guarantee on deposits simply applies that basic economic principle to transactions between banks and their depositors.

Clearly, small depositors with neither the expertise nor the information to discriminate between safe and risky financial institutions would be shocked if they lost money when one of them collapsed. Also, the fact that deposits are used to settle transactions means that such a collapse would disrupt the entire payments system ("systemic risk").

It is because of concerns such as these that Japan has a depositor protection scheme to safeguard small depositors. Under the scheme, depositors are protected against the loss of ¥10 million of principle as well as any interest on their deposits. Also, financial institutions are required to have a license and are subject to inspection and supervision by the financial authorities. Furthermore, the financial authorities keep an eye on their equity ratios and would require them to take "prompt corrective action" to put their house in order long before they became insolvent. In addition, if there are grounds for believing that a financial crisis might occur, there are special provisions under Section 102 of the Deposit Insurance Law. However, by requiring a financial institution to take appropriate action long before it becomes insolvent, the authorities should be able to prevent a state of affairs where depositors have to be compensated—even after the blanket guarantee on deposits is ended.

To end the guarantee is therefore simply to confirm a perfectly obvious principle—and one that, in the normal course of events, would scarcely ever need to be applied. To make anything more of it than that is doubly odd.

However, the replacement of Hakuo Yanagisawa by Heizo Takenaka as Minister for Financial Services in the 30 September 2002 cabinet reshuffle probably reflected the view that Japan's bad debt problem and the true state of its financial institutions needed to be taken more seriously and recognition of the fact that the Japanese public had lost confidence in its financial authorities. Given the views and institutional arrangements on which the decision to end the blanket guarantee was based, the decision to postpone the ending of the guarantee was perhaps inevitable at a time when the government had decided that it wanted to signal an important change in its assessment of the state of the country's financial system, implement a program of financial reform and restructure the system of financial administration.

In the middle of last year, less than 12 months after the government's decision to postpone the ending of the guarantee, business confidence started to recover and the stock market rallied. The bad debt ratios of the main banks have also declined steadily and are on target to achieve the government's aim of halving them by the end of fiscal

2004 (i.e., March 2005). A bill to enable more taxpayers' money to be injected into the banking system is also proceeding smoothly. Once it becomes law, Japan's financial authorities will have even more means at their disposal to ensure the stability of the financial system.

This is not to say, of course, that everything is bright and rosy and that the threat of asset deflation will not rear its ugly head once more or that the financial system can be given a clean bill of health. However, hopes are high that the guarantee can finally be ended.

It should not be forgotten, however, that the ending of the guarantee will not apply to transaction deposits, which will continue to be guaranteed in full. The reason for this is that the decision to maintain the guarantee on such accounts was taken by Hakuo Yanagisawa in 2002 before his successor, Heizo Takenaka, decided to end the blanket guarantee. Even when he took over as Minister for Financial Services, Takenaka did not revoke his predecessor's decision, and it became law along with the other amendments to the Deposit Insurance Law on 21 December 2002.

To debate whether the guarantee on deposits should be ended or not without first debating the rights and wrongs of a blanket guarantee on transaction deposits is extremely one-sided. Indeed, to leave things as they are will actually increase the risk to the financial system of moral hazard (see below). After examining the circumstances in which it was decided to provide a blanket guarantee on transaction deposits, the rest of this report makes the case for re-assessing the blanket guarantee on transaction deposits regardless of whether the guarantee on other deposits is ended.[1]

II. The Circumstances Leading to the Decision to Guarantee Transaction Deposits

The debate about guaranteeing transaction deposits began in earnest on 30 July 2002 when Prime Minister Koizumi instructed the then Minister of Financial Affairs, Hakuo Yanagisawa, to continue with plans to otherwise end the guarantee on bank deposits but, at the same time, to invite proposals on how to ensure the integrity of the payments system.

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1 In its March 2004 report "Arubeki Kin'yu Shisutemu e no Kaikaku—Shorai e no Michisuji" [A Guide to Reforming Japan's Financial System] the Japan Committee for Economic Development recommends that the proposals for introducing transaction deposits should be re-assessed.

The Prime Minister's instructions came soon after the guarantee on term deposits was ended in April 2002 and in the midst of a heated debate in the Diet on whether the guarantee on other types of deposits should be ended the following spring. It was also at the time when the statistics confirmed a massive switch out of term deposits into sight deposits. Concern was rising that ending the guarantee on ordinary accounts and transaction deposits might trigger a huge migration of depositors from small financial institutions to large ones and that the conditions that would be needed to be able to end the guarantee might not yet exist. In the course of July 2002 ministers faced tough questioning, especially before the House of Representatives' Finance Committee, not only from opposition members but also members of their own parties concerned about what might happen if the guarantee was ended.

Acting formally under the instructions of the Prime Minister, a project team was set up by the Financial System Council's Sectional Committee on the Financial System to ensure the integrity of the payments system. In only four weeks the team discussed the issues in depth and published a report on this subject for the Council on 5 September 2002.

The report recommended that a system of fully guaranteed deposits (transaction deposits) be set up as a secure means of payment other than cash and that a system was needed to ensure that payments in progress could be completed smoothly.[2] This would ensure that, whether a payment was initiated by the payee (debit) or the payer (transfer), the same degree of security would be ensured.

The report defined "transaction deposits" as accounts that satisfied the following three conditions: (1) balances had to be payable at sight; (2) the accounts had to offer standard payment facilities; and (3) they could not pay interest. The full guarantee was to be funded by deposit insurance premiums levied at a different rate from those for other accounts. The report also recommended that the guarantee should be permanent in order to ensure the long-term integrity of the payments system. Finally, it expressed the view that it would not be appropriate for all financial institutions to be required to offer such accounts.

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2 The concept of a separate system of transaction deposits had already been proposed by the Financial System Council's Second Subcommittee in July 1999 when it examined what system of deposit insurance could best replace the full guarantee on bank deposits. The Subcommittee made two points: first, that, since transaction deposits would exist purely to provide security rather than a return on investment, they should be repaid as soon as possible by being guaranteed in full; and, second, that the problem to which transaction deposits were supposed to be a solution might better be solved by other means and that guaranteeing such accounts in full might create problems of its own, such as higher costs, a greater risk of moral hazard and the difficulty of distinguishing between these and existing types of deposit account.

On 30 September 2002, less than a month after the report was published, Hakuo Yanagisawa was replaced as Minister of Financial Affairs by Heizo Takenaka, and, as we saw in the introduction, the ending of the guarantee was postponed by two years.

These two important policies (i.e., Yanagisawa's decision to provide a permanent and full guarantee on transaction deposits and Takenaka's decision to postpone the ending of the blanket guarantee on accounts by two years), which were adopted in considerable haste in the space of just over two months, were presented to the Diet on 25 October 2002 as part of a bill to amend the Exceptions to the Deposit Insurance Law and the Reorganization Procedure for Financial Institutions. The bill became law on 11 December and came into force on 1 April 2003.

III. Some of the Problems Associated with the Guarantee on Transaction Deposits

This report focuses on some of the problems associated with the guarantee on transaction deposits rather than on the rights and wrongs of ending the blanket guarantee on bank deposits since the latter cannot be discussed sensibly without discussing the former.

When the report on transaction deposits was debated at a plenary session of the Financial System Council on 5 September 2002, some of the Council's members voiced their concern that the proposal to guarantee transaction deposits in full amounted to postponing or emasculating the ending of the blanket guarantee on bank deposits. Similar criticism was voiced repeatedly when the proposal was later debated in the Diet.

Supporters of the proposal advanced the following counterarguments in its defense.

First, they argued that, since transaction deposits do not pay any interest, any switch out of other accounts that might occur in anticipation of the ending of the guarantee would probably be limited.

Second, they argued that, unlike the United States, where checks were the main method of payment, in Japan the main methods were bank transfers and debits. Given the need for a secure noncash method of payment, action was needed to ensure the integrity of the payments system regardless of whether the guarantee on bank deposits was ended.

Third, they argued that, whereas in the United States creditors had a first claim on deposits, in Japan this was not the case. They also pointed out that, whereas in the United States banks are subject to a separate bankruptcy law and creditors can continue to exercise their claims even after bankruptcy proceedings have begun, in Japan banks are subject to the same bankruptcy law as other companies in this respect.

These counterarguments are not very convincing. As far as the first argument is concerned, to say that, just because transaction deposits do not pay any interest, any switch out of other accounts would probably be limited ignores the fact that under the current regime of zero interest rates the opportunity costs of not having one's money in an interest-paying account are minimal and the fact that there was a massive switch by risk-averse depositors out of term deposits into ordinary accounts paying virtually no interest. It is therefore easy to imagine that, when the guarantee on ordinary accounts ends, a similar shift into transaction deposits might occur. Also, if interest rates begin to rise, this money could be withdrawn overnight and reinvested in other financial products. One side-effect might be to destabilize banks' liabilities.

Naturally, if transaction deposits are made subject to a fee, such a sudden switch would not occur. The fact that transaction deposits will be subject to a higher deposit insurance premium than other accounts means that depositors can expect to have to pay some fee.[3] However, in its report the Financial System Council's Sectional Committee's project team recommended that, "in view of the current economic situation, general expectations and the need for the public and private sectors to be on an equal footing," any decision to make fees for transaction deposits compulsory should be made only after due consideration. Given the competition among financial institutions, it is perfectly possible that some banks could decide to charge hardly any fee and that depositors could continue to enjoy the benefits of a safety net without having to pay the full costs.

As far as the second argument (i.e., that the Japanese payments system is different from the US system inasmuch as it relies on bank accounts) is concerned, the two systems are no different inasmuch as payment by check also involves debiting someone's bank account and relies on public confidence in the banking system. Creating a secure noncash method of payment would involve according a portion of private-sector banks' liabilities the same credit status as the liabilities of a central bank—an extreme measure to which no industrialized economy has yet resorted.

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[3] Since fiscal 2003, current, ordinary and special accounts have been regarded as "transaction deposits" and guaranteed in full. The charge for this has been 0.090%—higher than the 0.080% levied on other types of deposit account. It has not yet been decided whether the difference between the two deposit insurance premium rates will be increased in fiscal 2005, when the present arrangement ends.

Also, although the importance of the payments system means that private-sector financial institutions are required to display a greater degree of discipline than companies in other sectors, the suggestion that they should be accorded the same credit status as the central bank for the sake of the public good is incompatible with the very notion of discipline.

As far as the third argument (i.e., the issue of whether bank deposits should be guaranteed and how best to regulate the way in which financial institutions are wound up) is concerned, it might be more appropriate to ask why Japan has to choose whether to adopt a system of guaranteeing transaction deposits—and a permanent one at that.

Although the above arguments are concerned with whether transaction deposits would make nonsense of removing the guarantee on bank deposits, the issue is not simply one of whether or not to protect deposits in their traditional economic role: it is also concerned with the possibility that this could be a new financial product or service with a full guarantee as its selling point.

For example, customers (not just of banks but of any company) could be required to deposit money that they intend to use in payment of some goods or services. One example is the deposit that users of prepaid cards are required to pay (normally at least half of the unused balance of the card). In the case of banks, however, the possibility cannot be ruled out that such a deposit might be fully guaranteed by the Deposit Insurance Corporation by virtue of its being a transaction deposit and therefore enjoy an unfair advantage over other companies offering a similar service. The whole notion of transaction deposits is therefore fraught with problems such as what exactly the scope of the guarantee should be and how unfair advantages over other types of business can be avoided.

IV. The Problem Raised by the Extension of Deposit Insurance to Cover the Actual Payment Process

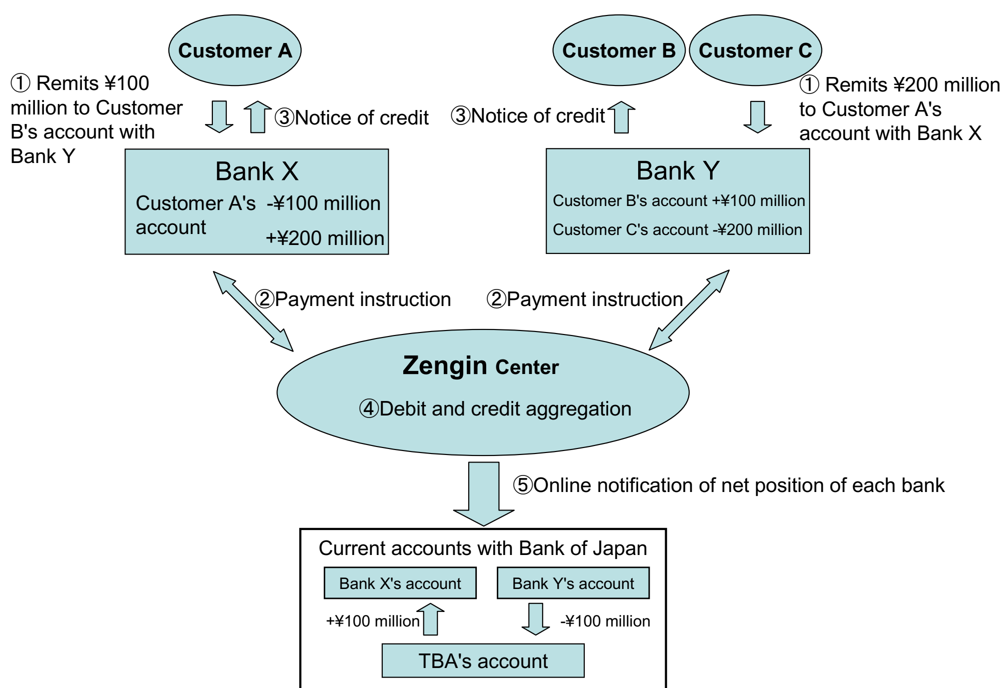
So far we have focused on the problems presented by offering depositors a product with special features ("transaction deposits"). However, there is the additional problem that the protection provided by deposit insurance would extend to the payment process itself.

In Japan's domestic funds transfer system (the "Zengin System") banks act as intermediaries between payers and payees in numerous transactions, and net payments

to the payee's bank or receipts from the payer's bank are debited or credited to each bank's current account with the Bank of Japan at 16:15 each working day.

In other words, if Customer A wants to remit money via Bank X to Customer B's account with Bank Y, the transaction, instead of being processed separately, is included with all the other transactions between the customers of Banks X and Y on the same day and the net balance is debited or credited to each bank's current account with the Bank of Japan as well as to the current account of the Tokyo Bankers Association, which acts as central counterparty, with the Bank of Japan (see figure).

Figure Japan's Domestic Funds Transfer System ("Zengin System")



Note: "TBA" stands for "Tokyo Bankers Association."
Source: NICMR.

If the bank which is the net payer (Bank Y in the figure) defaults before 16:15, the system as a whole will be unable to clear. What then happens in order to reduce the settlement risk is that the commercial banks themselves resort to one of a number of devices. First, there is a maximum limit on the net amount each participating bank can remit each day (the "sender net debit cap"). The net amount to be remitted by the problem bank can then be computed instantaneously using the payment notifications sent and received by each member bank. If the size of a transaction exceeds 70%, 80% or 90% of the limit, the banks send the problem bank a payment notification to warn it of the situation. If the problem bank then exceeds its limit, the payment notification is returned with an error message.

Even if the two banks with the largest sender net debit cap default, the Tokyo Bankers Association has an arrangement with certain banks whereby they will provide the liquidity needed to ensure that the system clears for that day. The banks that have provided the liquidity will later be repaid by selling in the market the collateral deposited by the bank or banks that have defaulted or from the guarantees provided to them by member banks. If the banks that provided liquidity have still not been repaid in full, the remaining banks share the cost of making good the shortfall.[4]

In January 2001 the Committee on Payment and Settlement Systems (CPSS), which reports to the central banks of the G10, published its "Core Principles for Systematically Important Payment Systems," setting out the best practice for reducing the risks posed by systems such as the Zengin System. As was mentioned above, the Japanese system, which is designed to enable payments to be settled even if the two banks with the largest sender net debit cap default, is based on Core Principle 5.

In spite of the fact that, as we have seen, Japan has a properly functioning payments system designed to reduce settlement risk and based on international standards, the amendments to the Deposit Insurance Law mean that both transaction deposits and any payment in progress will be fully guaranteed. This, in turn, means that, even if a bank should default, the Deposit Insurance Corporation will provide the necessary liquidity and make good any loss. In other words, the Corporation will discharge any obligation entered into by a bank at a customer's request. Therefore even if Banks X and Y in the figure default, the remittances of Customers' A and C will be guaranteed in full on a gross basis. As transfers between current accounts of net amounts of the order of ¥100 million will clearly occur as a result of this guarantee, a private-sector system for reducing risk that was originally designed to deal with bank defaults will inevitably become redundant.

In the case of a private-sector system designed to reduce risk, the failure of one bank will have a knock-on effect on the remaining banks, so each bank has an incentive to keep an eye on the others. However, if the Deposit Insurance Corporation is going to look after the banks, they will no longer have any incentive to do this.

By fully guaranteeing transaction deposits and payments in progress, there will be a much greater risk of moral hazard than in the past, and the whole point of ending the guarantee on bank deposits will have been nullified.

The reason for doing this was presumably the concern that, if a participating bank defaulted on a payment, it would automatically be excluded from the system as the

[4] See Makoto Saito, "Yokin Hoken ni Yoru Kessai Hogo wa Minkan no Jishuteki Risuku Kanri o Kotai Saseru" [Deposit Insurance Protection Will Act as a Disincentive to the Private Sector to Keep Its Own House in Order], Kin'yu Zaisei Jijo [Financial and Fiscal Affairs], 16 February 2004, and the Center for Financial Industry Information Systems (FISC), "Financial Information Systems in Japan (2004)."

risk reduction mechanism was triggered, thus making it more difficult for the bank to continue to operate on the basis that its business would be transferred to another bank.

However, there is no evidence that any serious effort has been made to reconcile the mechanism that automatically excludes a defaulting bank from the interbank payments system and the procedure for dealing with a defaulting bank by transferring its business to another bank.

The report of the Financial System Council's Sectional Committee on the Financial System takes the view that the measures for reducing the risk to a private-sector payments system such as the one we have described, while fine in normal circumstances, would not work in an emergency. Moreover, it points out that the present measures were not designed to cope with the simultaneous default of several banks.

However, a system that is designed to cope even if two banks reach their sender net debit cap might better be thought of as "for emergency use" rather than "for normal use." Furthermore, if the situation looks like developing into a more serious systemic risk, the Bank of Japan can always supply extra liquidity, or Section 102 of the Deposit Insurance Law can be invoked. Since this framework already exists, it is questionable whether there is any need for a permanent guarantee on transaction deposits and payments in progress—emergency or no emergency.

V. The Need to Reassess the Proposed Measures and to Suggest Alternatives

We have highlighted the problems raised by using the Deposit Insurance Corporation to continue to guarantee in full one type of bank deposit and to guarantee in full the private-sector payments process.

As far as the use of deposit insurance is concerned, it will be difficult to disagree with those who say it will make nonsense of removing the guarantee on bank deposits if transaction deposits are introduced on a large scale with only nominal charges.

Let us hope, in the first instance, that such accounts will be subject to proper charges and that any attempt to extend the scope of the guarantee will be discouraged. Ultimately, however, the full guarantee itself will surely have to be reassessed.

It goes without saying that holders of such accounts should be expected to pay appropriate charges—not least in view of the Financial System Council's September 2002 report "A Medium-Term Blueprint for Japan's Financial System," which says that one of the basic points that financial intermediaries need to consider is the need to earn a return that reflects their costs and risks.

As far as guaranteeing in full the private-sector payments process is concerned, the main aim for the time being should be to establish a clear risk-sharing framework that relies on the private sector's ability and efforts to reduce the risks to the system and only resorts to deposit insurance when all else fails.

All these points need to be considered, but ultimately the only proper course of action would appear to be to reject the proposals to guarantee in full transaction deposits and payments in progress.

As we saw above, the decision to make the proposed full guarantee on transaction deposits a permanent measure was taken after the project team set up by the Financial System Council's Sectional Committee on the Financial System to ensure the integrity of the payments system expressed the view in its September 2002 report that the need to ensure the integrity of the system meant that it would not be appropriate for the proposed measures to be temporary. However, the minutes of the Financial System Council's discussions on the report indicate that the team felt that, although the cost of postponing the ending of the full guarantee on all bank deposits would be unacceptably high, it was questionable whether the Japanese banking industry had returned to a normal state. Therefore, although the team recommended ending the guarantee on all bank deposits, it felt that action was needed to ensure that the payments system functioned properly. This suggests that the decision to introduce transaction deposits was made in haste to enable the guarantee on all existing deposits to be ended, as originally intended, in April 2003 in spite of the difficulties the banking industry still faced.

Soon after the report was published, the government decided to postpone the ending of the guarantee to April 2005. More than a year and a half has passed since then. The report mentions the fact (see above) that, in Japan creditors do not have a first claim on deposits as they do in the United States as well as the fact that, unlike the situation in the United States, where banks are subject to a different bankruptcy law from normal companies, in Japan the same law applies to both. Another option proposed in the report was the introduction of narrow banking accounts. Even if there may not have been enough time to consider this option in the summer of 2002, there has surely been more than enough time since then.

During this time the situation facing the Japanese financial system has also changed. Perhaps the banking industry has still not returned to a normal state. However, if this is an important condition, it follows that the need for a full guarantee on transaction deposits should be reviewed as soon it is fulfilled. At any rate, the kind of concerns we have described cannot justify continuing to provide a full and permanent guarantee.

Japan's economic system, just like that of other industrialized nations, is best safeguarded by measures such as proper financial regulation (which should include the flexible use of prompt corrective action), monitoring by the central bank, and the development of a better risk reduction mechanism by the body responsible for operating the private-sector payments system. If, however, such measures are not enough and a situation arises that could pose a systemic risk, the existence of measures such as the provision of liquidity by the Bank of Japan and Section 102 of the Deposit Insurance Law should not be forgotten.