Japan's Loans are Changing - Are its Banks?

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Problems with loans in Japan

The average outstanding loan balance for private-sector banks grew 1.5% YoY in FY2006, the first positive growth in 10 years (since 1996). The lending environment for the banking sector appears to have finally begun to improve after years of difficulties. We aim here to confirm whether this recovery is purely quantitative in nature or includes qualitative reforms, as well. This is relevant because the banking sector's nonperforming loan problem, the cause of a lost decade and a half, can probably be attributed to various problems inherent in Japan's loan market, as we explain below. If lending resumes a growth path while these problems are left to fester, that growth itself will be laden with risk.

In an economy like Japan's where the banks' role as financial intermediaries is so large, problems in the loan market affect the behavior of many different economic agents and also distort the capital markets, thereby making it necessary to examine the nature of loans from the standpoint of developing Japan's capital market.

The following have been identified as problems related to lending in Japan.

(1) The limited demand for funding from quality borrowers combined with a large number of financial institutions seeking to lend funds has resulted in excess competition, leading in turn to loan interest rates being set too low for the risk involved and to lending fees that are insufficient to cover costs. The existence of low-rate loans from government-affiliated financial institutions has exacerbated this tendency.

(2) Loans tend to overly rely on real estate collateral and personal guarantees, and often insufficient consideration is given to estimates of future cash flows from the borrower's business. This creates a problem in which companies heavy on intellectual property but lacking real estate assets are unable to access adequate financing. There are also cases where the fairness of collateral values is not properly monitored after the loan is made. Although in some cases personal guarantees can be an effective way to instill management discipline in loans to owner-managed corporations, it can also put excessive repayment burdens on the owner and the owners family, not only exacerbating the challenges but often also ending in tragedy. When these personal guarantees include third party guarantees, there are times when the tragedy winds up enveloping industry colleagues and even acquaintances who do not directly benefit from the loans and are not even in a position to monitor the business.

(3) There are problems with the "main bank" practice. The establishment of a main bank relationship has traditionally been looked at as an effective mode of corporate governance, since the bank is not only a major lender but also a shareholder and a source of seconded executives. In reality, however, it is the depth of the relationship that creates the conditions under which, when the corporation gets into trouble, the main bank winds up lending is compelled to lend additional funds and continue making unreasonable commitments. This also creates a situation in which banks that are not the main bank are asked to take on main bank responsibility and wind up being forced to shoulder the nonperforming loans.

(4) In the case of loans to small and medium enterprises (SMEs), there is a tendency to repeatedly rollover a portion of working capital loans, such that the loans effectively become perpetual, or their terms are reduced or exempted depending on the borrower's business conditions. This leads to a pseudo-equitization of the loan. Such corporate-bank relationships did not lead to any problems during the years of stable economic growth, but once the SMEs were confronted with the need to make structural changes, the presence of pseudo-equity led to a problem of insufficient capital and wound up exposing financial weaknesses in Japan's SMEs. From the financial institution's perspective, this treatment of the transaction as a loan despite it effectively being equity creates doubt over whether risks have been properly managed.

(5) The loan contract itself (i.e., the bank transaction agreement) was extremely simple compared with those in the US, and unfairly advantageous to the bank, allowing it, for example, to demand additional collateral when necessary.

The existence of the problems outlined above sowed the seeds for the bubble economy and nonperforming loan problem, and eliminating these problems is a critical step toward not only bettering Japan's financial and capital markets but also toward making its broader economy more sound. Accordingly, reform of Japan's financial and capital markets should not stop at simply lowering the non-performing loan (NPL) ratio and putting in place a comprehensive system for investor protection; equally important is an assessment of progress in reforming the loan business.

Administrative measures aimed at loan reform

When viewing the lending business in Japan based on an awareness of the problems noted above, it becomes possible to identify numerous important changes that have occurred in the process of overcoming the NPL problem. Let us start by looking back at the major milestones on the regulatory front.

In regards to problems with the bank transaction agreement, the Japanese Bankers Association responded to findings by the Financial System Research Committee in 1997 by getting rid of its standardized form for the bank transaction agreement, and by making it obligatory for banks to provide the appropriate information to its customers.

Although the Financial Reconstruction Program announced by the Financial Services Agency (FSA) in October 2002 was primarily known for its measures forcing the major banks to cut their NPL ratios in half, it also included measures encouraging the reform of the nature of the loans themselves. Specifically, it provided guidelines for a new financial regulatory framework, starting with efforts to make the criteria used by financial institutions to appraise assets consistent with market valuations. The idea behind making the assessment of loans, which generally do not form a market price as efficiently as securities, consistent with market valuations is to force a change in the stance taken by Japan's banks. Japanese banks had a tendency at the time to underestimate a company's credit risk owing both to real estate collateral valuations that did not sufficiently reflect market prices and to an economically irrational emphasis on long-term corporate relations. These measures forced a major turnaround in the stance taken by Japan's financial institutions, toward a loan valuation approach that was at least somewhat similar to that used by investors to value corporate bonds, and that assessed the loan's economic value based on the borrower's ability to repay the loan, by taking a critical look at the actual value of collateral, analyzing the balance sheet, and estimating future cash flows. The program also proposed the establishment of a market for the trading of loan assets.

This program was limited to the major banks, and the guidelines making asset assessments more strict noted above were largely introduced as a way to deal with those major banks that were not proactively working to reveal their potential NPL problems. This was based on the thinking that such a framework was necessary to eliminate the concern, both in Japan and overseas, over the NPL problem of Japanese banks and to aggressively deal with that problem. The end result, however, seems to be that the measures wound up forcing a major shift in the thinking behind the nature of new loans and the entire loan business.

The measures dealing with NPL dispositions at the regional and smaller banks included an action program related to the nature of relationship banking. Announced in March 2003, the action program emphasized cash flow and encouraged companies to work with smaller financial institutions that did not overly rely on collateral and guarantees (especially third-party guarantees). In other words, it was not only the major banks that were expected to change course in the loan business, but the smaller and regional banks, as well.

The action program's loan-related measures also included establishing a research council to look at the use of debt-equity swaps, financial covenants, and securitization, the establishment, enhancement, and better use of credit risk databases, a clarification of how best to supervise the process in which critical terms of the loan and guarantee contract are explained to the borrower, and the establishment of a system aimed at ensuring that interest rates are set at a level commensurate with risk.

Based on this action program, each regional bank submitted to the FSA a plan for strengthening their relationship banking capabilities, and a mechanism was put in place for the FSA to follow up on the implementation of those plans. In response to the action plan, a research council on new legislation for small corporate financing was established in April 2003 to advise the chief of the FSA's Supervisory Bureau.

This council studied, from both the legal and accounting perspectives, such issues as using financial covenants for new loans to small- and mid-sized enterprises without overreliance on collateral and guarantees, as well as the conversion of this pseudo equity portion to preferred shares in the case of small- to mid-sized enterprises concentrated in competitive regions with advanced technology.

The action program was modified slightly in March 2005, as a response to subsequent changes in the economic and financial landscape and to reflect the results achieved thus far, and was then rolled into a new program. The new program, in addition to continuing to promote financing that is not overly dependent on collateral and guarantees, also identified new financing methods aimed at diversifying fund procurement options for SMEs. These included loans guaranteed by intellectual property, nonrecourse loans (where the lender's only remedy is foreclosure of the designated property), and project financing.

The Financial Reconstruction program was thus used as a lever for the FSA to start dealing with Japan's loan problem, but several important measures were implemented by a number of other related government agencies.

The Ministry of Justice's Legislative Council began examining in March 2004 a specific aspect of problems related to personal guarantees, that concerning the wording of guarantee contracts, and identified these contracts as particularly harmful because of the lack of any maximums or time limits on the guarantee. In response, legislation was passed in November 2004 amending a portion of the Civil Code so as to prohibit this type of guaranteed contract, with the law going into effect in April 2005.

The Ministry of Economy, Trade and Industry (METI) also submitted a proposal related to the problem of personal guarantees, launched a study group on corporate law (and on the collateral system) to examine the collateral system from the perspective of diversifying funding sources, and issued a report in January 2003. METI's proposal identified the need to diversify funding sources, away from loans backed by real estate and toward loans collateralized by inventory and receivables, including through the use of packaged loan sales, securitization and project finance. An extraordinary Diet session held after that in November 2004 passed legislation partially amending the Law on Exceptions to the Civil Code Concerning Requirements for Opposition to Transfers of Claims, and this went into effect in October 2005. The amendment introduced a system to facilitate registration of inventory assets and other aggregated movable property as collateral, and also made it possible to set requirements for opposition to third parties, thereby increasing the likelihood of loans collateralized by goods or receivables.

To encourage the use of this new way to procure funding, known as asset-based lending (ABL, explained in detail below), METI established in September 2005 an ABL study council , which issued a report in March 2006.

Meanwhile, the Basic Law on the Administrative Reform of the Central Government, which was implemented in June 1998 with the aim of achieving smaller government, contained basic guidelines for revising government-affiliated financial

institutions, which had been under fire for competing with their private-sector counterparts. Serious debate of these proposals began with the cabinet decision in December 2000 that provided broad outlines for administrative reform, although implementation of reform was temporary delayed by the reluctance of private-sector banks to lend funds. Reform finally gained momentum when the Koizumi administration took power and the Cabinet passed a resolution in December 2001: its Reorganization and Rationalization Plan for Special Public Corporations. Debate then took on new urgency within the Council on Economic and Fiscal Policy, which eventually published the Basic Policies for Reform of Government-Affiliated Financial Institutions in November 2005. The Diet responded in May 2006 by passing the Regulatory Reform Law, which included an outline for restructuring government-affiliated financial institutions. The new law consolidated the policy finance function into a new government financial institution, reduced the GDP share of government-financed loans outstanding, and mandated the privatization of the Japan Development Bank and the Shoko Chukin Bank. These moves are expected to eliminate problem of competition between government-affiliated financial institutions and their private-sector counterparts.

The first of these moves occurred in the home loan sector, where the Government Home Loan Corporation (GHLC) was abolished and replaced by the Japan Housing Finance Agency (JHFA) effective 1 April 2007. This ended the GHLC's previous focus on the direct lending business, and the primary business of its successor, the JHFA, became securitization support, through the purchase and guarantee of home loans written by private-sector banks. Private-sector financial institutions have consequently become the primary providers of home loans, further contributing to the recent growth in bank lending.

Progress in loan innovation

In the wake of these administrative changes, the financial institutions themselves began developing new loan methods to overcome the problems noted above. As shown in the Figure, one of the innovations that has already been implemented and taken root in many financial institutions is the use of a scoring system for loans and syndicated loans. For loans, rather than rely on collateral and guarantees, lenders objectively and statistically analyze various data on the borrower, and then set the terms of the loan based on an accurate assessment of credit risk. In the case of syndicated loans, just as with the underwriting of bonds, multiple parties participate in closely assessing whether the financing terms are appropriate in light of publicly available information as well as information on the borrower provided by the arranger. Since the end of 2004, some syndicated loans have been devised so as to promote their active trading on the secondary market.

More recently, there has also been interest in large-scale syndicated loans connected to buyouts, owing to the growing number of large-scale mergers, acquisitions, and management buyouts in Japan. When Softbank acquired Vodafone in

2006, the deal was financed by Japan's largest ever LBO loan, worth ¥1.28 trillion. In addition, it was reported that Citigroup's acquisition of Nikko Cordial in 2007 was financed by Japan's largest ever syndicated loan, worth up to ¥1.7 trillion.

The frequent use of nonrecourse loans, the principal and interest payments of which are funded by the earnings from a specific business rather than a corporation's overall credit, should also help solve the problems created by the focus of loans having traditionally been on real estate collateral and a corporation's overall credit. The LBO loan for the Vodafone acquisition noted above was also a nonrecourse loan, and particularly noteworthy is the rapid increase that has occurred recently in nonrecourse loans to real estate funds. According to the FSA, nonrecourse loans made to real estate funds by the major banks grew by 30%, from ¥5 trillion in H1 FY2005 to ¥6.6 trillion in H1 FY2006.

In addition to the trends noted above, we expect to see growth in the following new loan segments.

Figure: Availability of new fund procurement methods at financial institutions

(%)

	Have track record and established product	Offer product, but not yet established	Considering offering product	No plans to offer product	Do not know
Loans backed by receivables	49.9	25.1	7.4	13.7	3.9
CLO	7.9	6.0	20.8	53.9	11.5
Loans based on credit scoring models	34.1	3.6	23.6	29.8	8.8
Privately placed bonds	28.9	10.7	13.3	41.2	5.9
Loans backed by inventory	0.2	1.7	20.0	61.3	16.7
Loans backed by movable property	3.3	5.7	26.4	49.5	15.0
Loans backed by liquid assets as a whole (ABL)	1.4	0.7	17.3	60.5	20.0
Syndicated loans	34.7	13.4	13.0	32.5	6.4
Commitment lines	17.1	5.8	16.9	48.0	12.3

Note: Results of the Survey on the Financing Environment for Small and Medium Enterprises, taken by the Research Institute of Economy, Trade, and Industry (RIETI). The financial institutions surveyed include the major banks, trust banks, the former long-term credit banks, regional banks, second-tier regional banks, Shinkin banks, credit cooperatives, and business moneylenders.

Source: Small and Medium Enterprise Agency, 2006 White Paper on Small and Medium Enterprises in Japan

- **ABL (asset-based lending)**

The bulk of the collateral on loans in the past has been comprised of real estate, with securities only used as collateral sparingly. There was a rapid increase in loans backed by real estate as a result of the increase in collateral values caused by rising land prices during the bubble, which in turn fueled further land purchases and accelerated the creation of a land price bubble. When the bubble began to collapse, declining land prices put credit into a downward spiral.

As noted earlier, overreliance on real estate collateral was identified as a problem that had to be dealt with. In addition, because the decline in land prices made it practically difficult for companies, especially SMEs, to obtain sufficient funding, there were also demands from regulators for greater use of liquid assets, including movable property and receivables, as collateral.

Such liquid assets have been used as collateral in the past, but mostly in a supplementary role. In contrast, the ABL developed in US is not defined purely by its use of movable property as collateral. What makes ABL unique is that the loan relies purely on the value of the collateral itself, unlike financial statements lending (FSL), which relies upon a company's credit worthiness and ability to pay, as determined by its financial position, profitability, and cash flow.

Nonbank finance companies began using ABL in the US in the 1970s, but it was not until the banks started to acquire the nonbanks in the 1990s based on their profitability and lack of uncertainty, and then began issuing asset-backed loans themselves, that ABL really took off. In the beginning, generally the only companies that relied on ABL were those that were unable to take out loans based on a profitability analysis of their financial statements, but recently even the large blue-chip companies have begun to use ABL to procure day-to-day working capital in some cases. Total outstanding ABL exceeded USD400 billion in the US at the end of 2005, which was equal to 20% of all outstanding loans of nonfinancial companies in the US.

As noted in the previous figure, although loans backed by accounts receivable have become fairly widespread in Japan, they are still not used to the same extent as loans backed by inventory, real estate, or current assets as a whole. It is important to note, however, the continued experimentation as described below.

Specifically, in April 2004, the Development Bank of Japan (DBJ) provided DIP (debtor in possession) financing for a children's uniform retailer undergoing a restructuring of its business, and used the company's in-store product inventory as collateral. For this deal, the bank hired Kiacon to take care of the appraisal and monitoring of the movable property and to run the store closing sale. Kiacon has an alliance with SB Capital Group, a US company with expertise in asset appraisals and dispositions. Since then, the DBJ has issued ABL collateralized by such assets as frozen meat and soy sauce. In addition, the Shoko Chukin broke ground in establishing an aggressive lending framework for a menswear manufacturer using as collateral a combined package of inventory, receivables, and current deposits, and has since developed loans using a wide variety of liquid assets as collateral, including kelp, pigs, steer, wine, *shochu* (Japanese liquor), sake, vegetables, crab, and machinery. Other financial institutions have also been competing over the past year in experimentally introducing ABL.

ABL from the DBJ depends on the cash value of liquid assets, while the ABL developed by the Shoko Chukin is based on a different concept of using as collateral the entire business flow, from the purchase of the materials that are combined with intermediate products to produce the final goods, to their sale and transformation into

receivables, and finally to their transformation into cash when payment is collected. Another aspect that differentiates ABL from regular loans is that the former does not simply use liquid assets as collateral, but also incorporates other mechanisms as described below, such as covenants and warranties with conditions precedent.

As noted above, as a result of implementation of the Law on Exceptions to the Civil Code Concerning Requirements for Opposition to Transfers of Claims in October 2005 and the introduction of a system facilitating the registration of collateral for transferring inventory goods and other aggregated movable property, it became possible to add in requirements for opposition to third parties, thereby promoting the use of loans collateralized by such movable property. This law also made it possible to use an overall package of receivables as collateral without specifying each third party, resulting in an increase in loans collateralized by receivables. Another factor contributing to growth in ABL has been the huge improvements over the past few years, made possible by the use of IC tags and other technical advancements, in the efficiency of specifying and managing inventory goods used as collateral.

- **The use of covenants**

As in the case of real estate collateral, loans issued in Japan have typically entailed insufficient monitoring after the loan is written. This gave rise to calls for the increased use of loans with covenants as part of a more thorough monitoring process following issuance of the loan. These covenants include corporate disclosure obligations, financial covenants, and restrictions on the disposal of assets and certain other actions. When these covenants are not met, following consultation with the corporate borrower the loans in some cases are recalled.

Covenants are now being used on syndicated loans and other types of loans as a way to avoid lending that is overly dependent on collateral and guarantees.

- **Personal guarantees with conditions precedent**

As noted above, the use of personal guarantees can be a problem if it is excessive, but it can be an effective way to instill management discipline if used only as a credit enhancement tool, particularly when lending to SMEs. ABL and lending with covenants were developed in which management is not held personally responsible, and the triggering of incidental guarantee obligations is limited only to cases in which certain covenants are violated, as long as management is performing its business in good faith and making an effort to repay the loan, even in cases where the borrower's business or financial condition winds up worsening.

The introduction of policy measures does not mean that policy objectives have been achieved

We expect ABL to keep growing based on continued progress on the regulatory front.

Draft legislation on book-entry receivables submitted to the current session of the Diet should ensure that information related to the creation, transfer, and elimination of receivables is managed on a consolidated basis by an electronic management institution, that collateral is set, and that it is administered consistently, and we expect the passage and promulgation of that legislation to encourage wider use of ABL.

ABL is gradually gaining momentum amid moves toward lending that is less dependent upon collateral and guarantees, although the value of these new loans remains minute relative to the aggregate total of bank loans outstanding. The action program for relationship banking has come to require the innovation of new types of loans, but their actual usage has been marginal, and few financial institutions appear to be truly changing their lending behavior. Accordingly, we think it realistic to expect traditional loans dependent upon real estate collateral to remain the mainstream form of lending.

In fact, at regional roundtables held in Osaka and Kumamoto in February 2007 by the FSA's working group on the nature of relationship banking, corporations repeatedly noted that there was an insufficient access to loans without collateral or guarantees.

Although the action program for relationship banking has to date sought to eliminate the lending environment's excessive reliance on real estate collateral and personal guarantees, the specific items reported on by financial institutions in this regard have been the amount of ABL and score-based lending.

Nevertheless, the use of these new loan methods should be viewed as merely a tool rather than an objective. Given that the policy objective is to reduce the overreliance on collateral and guarantees, prior to requesting reports related to the creation of new types of loans we think it first necessary to understand the current level of dependence on personal guarantees, the extent to which dependence on collateral and guarantees has declined, and whether it in fact has declined at all.

In that sense, the Financial System Council's working group on relationship banking, which held its third round of meetings starting in February 2007, following the first two rounds in 2003 and 2005, issued a report in April 2007 arguing that instead of requesting disclosure of the number of loans issued under the new method, it would be more appropriate to request disclosure of figures indicative of the effort being made to promote loans that were not overly reliant on personal guarantees or real estate collateral. An example of this would be the value of loans issued without requirement for third-party guarantees or real estate collateral.

Taking this a bit further, however, even the reduction of dependence on collateral and guarantees is no more than a means toward achieving a higher-order objective.

The ultimate problem with loans in the past has been that neither the creditworthiness of the borrower evident from financial statements nor the value of collateral and guarantees were properly assessed, and loan risk was not kept at a suitable level relative to return. That is, the problem that needs to be fixed is the failure of collateral and guarantees to adequately protect against deterioration in the value of loan assets, at the root of which is that loan terms are not being initially set in a way that compensates for risk. Of course, irresponsibly focusing purely on reducing reliance on collateral and guarantees could actually wind up actually making loans even riskier, which is the opposite of what is desired.

Problems with Japan's version of FSL and ABL

An adequate reflection of the past suggests that to change the nature of bank lending in Japan, there is a need, in the case of FSL, for the bulk of loans to be of the type for which suitable loan terms are set after a very close look at the borrower's cash flow and other factors affecting credit worthiness, and which also remains subject to a strict review process after the loan is written. In the case of ABL, there is a need to put mechanisms in place to ensure that loan terms are set after gaining an objective understanding of the disposal value of assets serving as collateral, and that collateral values continue to be monitored, and reassessed, after the loan is written. Despite the loan reforms and innovations described in this report that have already been achieved, however, in some respects there does not seem to be much progress in attaining the policy objectives in either the FSL or ABL segments.

For example, in the syndicated loan arena there appears to be excessive competition to lower lending fees and interest rates. For nonrecourse real estate loans, as well, even when the decision to lend is based on valuations calculated using cap rates, there appears to be a number of cases that warrant concern as to whether (1) there was an accurate appraisal of the land or building in the context of its regulatory suitability, terms of use, and presence of defects, (2) the estimate of future cash flows had a proper basis that included the property's usage plan and forecast demand, and (3) the cap rate and discount rate used were suitable.

There are even still some concerns over ABL, a segment where new techniques continue to be implemented. The circumstances under which ABL were introduced in Japan differ from those under which ABL was introduced in the US. In Japan, there was a need to respond to two issues, 1) the overreliance on real estate collateral and inadequate assessment of a borrower's creditworthiness based on an analysis of cash flow and other factors, and 2) the emergence, under this regime of reliance on real estate collateral, of companies that were unable to get sufficient financing as a result of declining real estate prices. Consequently, the introduction of ABL in Japan was led by the regulatory authorities and government-affiliated financial institutions.

ABL by the Shoko Chukin is based on the concept of using as collateral the entire business process, ranging from the initial purchase of inputs to the sale of product and collection of receivables, whereas ABL in the US is based on the value of the

collateral rather than the cash flow from the business. Because of this, in the US the covenants on ABL are less complex than those on FSL, a feature that makes ABL relatively more attractive, whereas the Shoko Chukin introduced the use of covenants on its ABL to differentiate it from traditional-type loans. Furthermore, because the Shoko Chukin's schemes did not always require an objective appraisal of collateral by a third party, when a problem surfaced in the borrower's business, there remained doubt over whether the value of the loan asset could be fully protected through the use of covenants and the disposition of collateral. Another problem that has been identified is the administrative costs and efforts required for the inventory checks and other means used by the financial institution to understand the status of the borrower's business.

Meanwhile, the focus of ABL issued by the DBJ is on appraising the collateral, similar to the US, but Japan's network of appraisers and liquidators is considerably less developed than that of the US, and its market for used merchandise much more limited. This creates more uncertainty in Japan over whether property can be properly assessed and disposed of at the assessed price. It has also been noted that although the DBJ sets its loan terms based on market price appraisals of inventory from third parties, there are only a few companies in Japan that supply such appraisal services, and thus the fees charged are fairly high.

Because of these drawbacks, when the priority is placed on generating ABL volume, often either collateral is improperly valued or financial institutions wind up trying to avoid the expense of effort and funds associated with the process. This results in financial institutions taking on unexpected risks, which not only inhibits the sound development of the ABL market, but also risks having a negative impact on the soundness of the financial institutions.

Not that these concerns are not being addressed, however. Through its subsidiary Asuka DBJ Investment, in July 2006 the DBJ established Gordon Brothers Japan as a joint venture with the Gordon Brothers Group, a major US-based liquidator, in order to encourage the development of the appraiser and liquidator businesses in the ABL segment. In the report by its ABL research committee, METI proposed the creation of a market to trade in properties disposed of by financial institutions and the establishment of a system for movable property appraisers.

Three paths toward the reform of financial institution behavior

It did not take the involvement of the government and government-affiliated financial institutions to support the development of such service providers and markets in the US, however. These businesses and markets developed spontaneously as financial institutions became serious about offering ABL. This shift in the focus of US financial institutions toward ABL, scoring, and syndicated loans was sparked by a desire to change business models, based on the assessment that traditional corporate lending had become a commodity business that was no longer profitable.

In a recent development in the US, although financial institutions are still the originators of loans, ownership of the loan assets is being transferred to hedge funds and other investors. Development of the market for credit derivatives has also stepped up activity in transferring only the credit risk portion of loans to investors. As a result of the rapid development of information and financial technologies, along with increasing demands for economic rationality, the role and function of financial institutions within the US economy is being transformed into something different than it was before.

If Japan's financial institutions do not undergo a real change in their behavior, no matter how many new types of loans that they develop and regardless of how well those loans are received, the problems associated with setting loan terms that are not commensurate with risk, with improperly valuing collateral, and with charging fees that do not cover costs will continue to resurface, even if in a different form. This will make it impossible to achieve the ultimate objective of building a sound financial system. Borrowers obviously have no real incentive to participate in this reform, since it is to their benefit when financial institutions lend money for cheap fees and at terms that are insufficient to cover their risks.

What is needed to get the banks to change? We see three possible paths. The first is to introduce a package of investment incentives to encourage individual investors to shift their funds from savings to investments and eliminate the problem of excess deposits. The idea is that such a shift may ameliorate the excessive competition to make loans that has resulted from the overconcentration of funds into bank deposits.

Second would be to encourage financial institution shareholders to orient their business models more toward raising enterprise value. Shareholders need to become much less tolerant of the banks continuing to write unprofitable loans.

Third would be to strengthen inspections and monitoring by financial regulators and demand strict compliance by financial institutions in those aspects of their risk management that are lacking. With the Financial Reconstruction program having proposed a new financial regulatory framework built on asset appraisals consistent with market valuations, it is important that the accompanying measures aimed at making asset appraisals more rigorous not be only transitory. It is also important not to simply rescue financial institutions that are in major trouble, but to instead force them out of the market. It is also essential that, in addition to taking such a hard-line

stance toward private-sector financial institutions, the government not pull any punches in its pursuit of reform of government-affiliated financial institutions.

It is too early to tell at this stage whether the pressures applied from any of these paths can be effective, but the implementation of the three basic pillars of Basel II, which began at end-March 2007, should provide added momentum to the second and third paths noted above. I think it important to emphasize that the first path would be all the more essential if it were to go beyond bank reform and actually aim at making Japan's financial and capital markets more competitive.

What is certain is that unless the banks change and innovate their lending programs in a way that accommodates these changes, Japan will continue to be at a high risk of the NPL problem re-occurring. It is important to focus on solving the real problems that remain, without taking too much comfort in the recent growth in lending and ostensible loan innovations.