Historical Changes in the Flow of Funds in Japan and the Future Direction of Japan's Financial Industry: The Need for the Discipline of Valuation

Yasuyuki Fuchita

1. Direct Finance: Hope and Reality

As the 21st century has begun, the consequences of the gap between the reality of direct finance[1] in Japan and the hopes that have been vested in it are becoming increasingly apparent.

The publication in February 2001 of the report by the Liberal Democratic Party's Committee for the Reinvigoration of the Securities Markets and in June 2001 of the government-backed Council on Economic and Fiscal Policy's policy document "Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management" showed that the need to extend the role of direct finance in Japan has been recognized at a national level. As a result, treasury stock and exchange-traded funds are now permitted, and the taxation of securities, while still in need of reform, has come a long way. With blanket guarantees for bank deposits about to disappear, local authority and corporate investors are reconsidering their overdependence on bank deposits and the need to invest more of their funds in securities. The long-awaited bill on the Japanese version of US 401(k) plans has also finally become law. As far as these developments are concerned, 2001 can be said to have given direct finance considerable institutional support.

In contrast, the banks' non-performing loans and the massive corporate debts that underlie them continued to mount as economic growth remained weak and deflationary pressure showed no signs of easing. As calls for prompt action to sort out the problems posed by the banks' non-performing loans and the massive corporate debts that underlie them (and, by implication, for the companies concerned to make an early exit from their industries) increased, a number of well-known companies (including Mycal and Aoki) collapsed. The share prices of the major banks fell

1 This report regards direct finance as financial transactions in general (including sales and purchases of investment trusts) that take place on markets and excludes privately arranged transactions.

sharply as investors, concerned about the fact that blanket guarantees on bank deposits were soon to disappear, considered the implications of action to deal with the collapse of a number of *shinkin* banks, credit cooperatives and second-tier regional banks as well as the use of prompt correction action and special inspections.

The September 11 attacks in the United States not only put further downward pressure on global economic growth—they also brought about the collapse of Taisei Fire & Marine Insurance. Directly and indirectly the Japanese market was affected by the end of the global information technology bubble, the collapse of Enron and Argentina's default.

Therefore, although 2001 can be said to have given direct finance considerable institutional support, investor expectations and confidence in Japan's securities markets were hit by weak stock markets, defaults by corporate bond issuers, steep declines in equity mutual fund prices, the loss of capital invested in money market funds and a dramatic widening of credit spreads.

While some of these trends are likely to continue in 2002, investors are hoping that 2002 will benefit from an economic recovery and the positive effects of increased institutional support (e.g., tax concessions for securities investors).

However, a solution to the problems of non-performing loans and excessive debt is unlikely to be found in a hurry, as indicated by the fact that very little progress was made during the 1990s in correcting the excessive growth of bank lending (from 50% to 100%) that occurred during the boom of the late 1980s.[2] Therefore, depending on what happens to the economy and the strength of deflationary pressures, concerns about the stability of the financial system and the possibility of a major bankruptcy could emerge at any time to put a damper on the market's animal spirits.

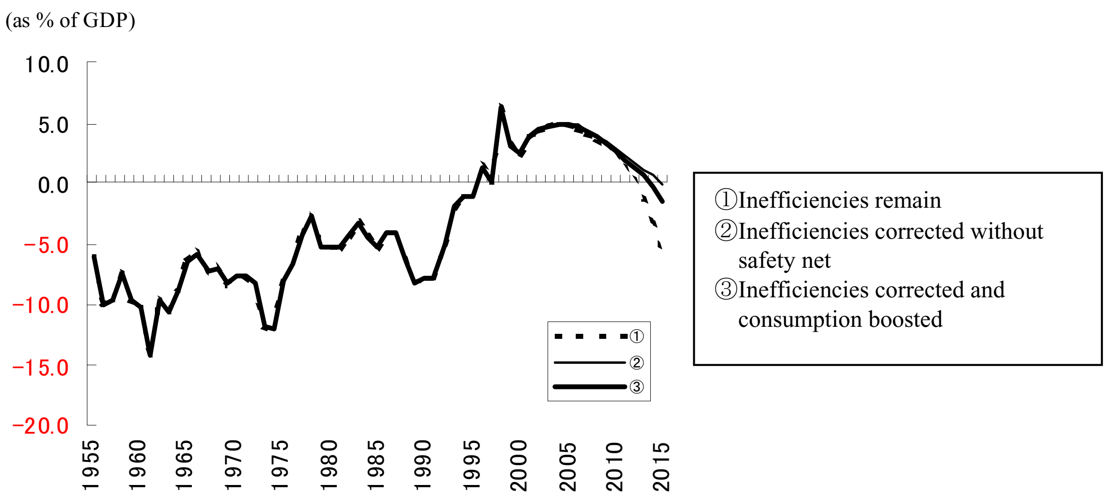
2. The Significance of the Corporate Sector's Structural Surplus of Funds

The problem of excessive corporate debt is part and parcel not only of the excessive lending in which banks engaged but also of the financing binge in which Japan's capital markets indulged. Narrowing corporate profit margins mean that there is an excess not only of debt but also of equity.

2 See Yasuyuki Fuchita, Recent Developments Concerning Japan's Bad Loan Problem and the Outlook for Its Financial System, Capital Research Journal, Winter 2001.

If companies are to generate returns that suppliers of capital such as lenders, bondholders and shareholders will be happy with, they will have to streamline their assets and their liabilities as well as make them work harder. As an inevitable result of this process, the Japanese corporate sector as a whole will find itself with a net surplus of funds. Indeed, in its Medium-Term Economic Outlook for Japan, NRI sees this surplus continuing for the next 10-15 years (see Figure 1).

Figure 1 Savings-Investment Gap of Japan's Corporate Sector

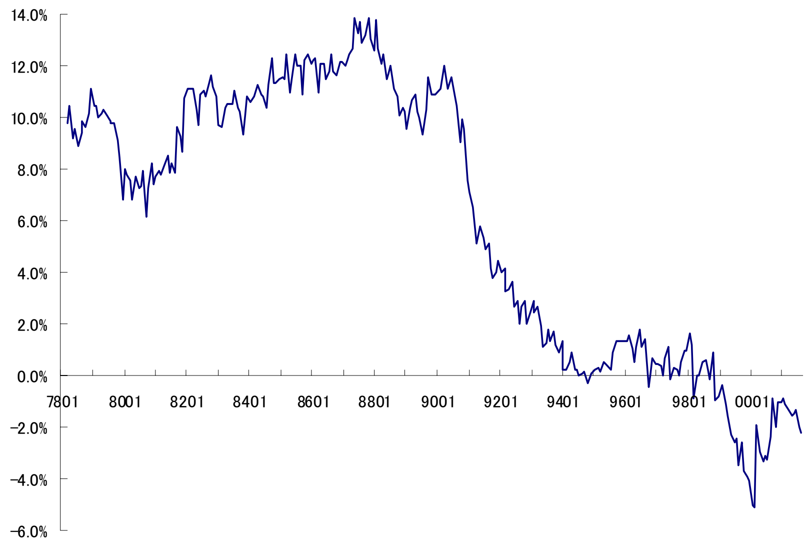


Source: NRI's Medium-Term Economic Outlook for Japan 2002.

Under normal economic conditions, personal savings supplement a shortage of corporate funds. In the medium term, however, there is no prospect of such a scenario in Japan. Both the personal and corporate sectors will be in surplus, and only the government sector with its massive budget deficit will be short of funds.

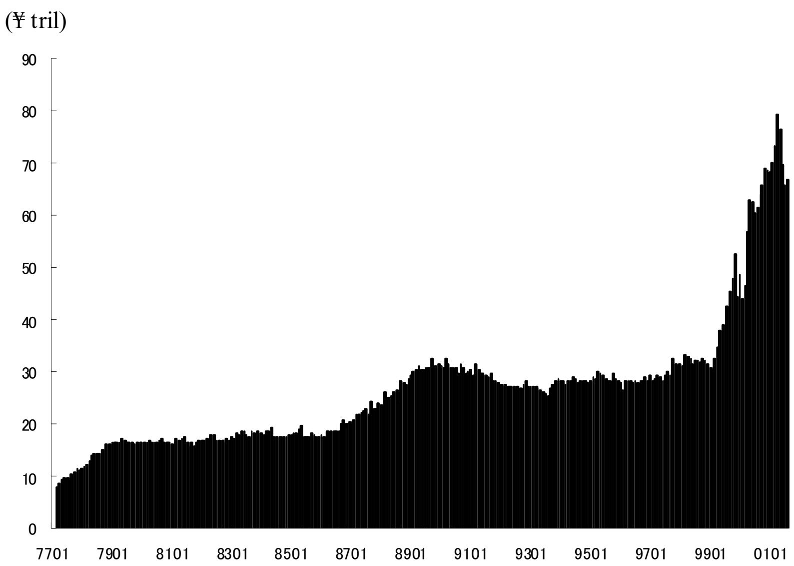
Financial intermediaries, whose role it has been to attract savings from the personal sector in order to support the corporate sector, will find themselves having to play a very different role. A breakdown of banks' assets shows that the banks' holdings of government bonds have risen from ¥30 trillion-plus in the mid-1990s to between ¥60 and ¥80 trillion in the early 2000s at the same time as their loan portfolios have continued to shrink from year to year (see Figures 2 and 3). Banking in the traditional sense is no longer viable. The banks' non-performing loans are only one aspect of a more fundamental problem.

Figure 2 Japanese Bank Loans Outstanding (annual % change)



Note: The data are from domestic banks' banking accounts.

Figure 3 Japanese Banks' Holdings of Japanese Government Bonds



Source: Kin'yu Keizai Tokei Geppo [Monthly Bulletin of Financial and Economic Statistics], Bank of Japan.

3. The Revival of Banking in the United States Does Not Hold the Key to Solving Japan's Problems

It has often been said that the 2% spread that Japanese banks are said to earn by lending the money deposited with them is only half of what US banks earn. In practice, however, Japanese banks' lending margins have been virtually zero in recent years once the costs of writing off their non-performing loans are taken into account. The reason for this state of affairs is the fact that the banks' lending conditions have not reflected their risks. Underlying this is the fact that demand for funds has been more than counterbalanced by an excess lending capacity often referred to as "overbanking." This overcompetition has made it extremely difficult for financial institutions to lend on reasonable terms.

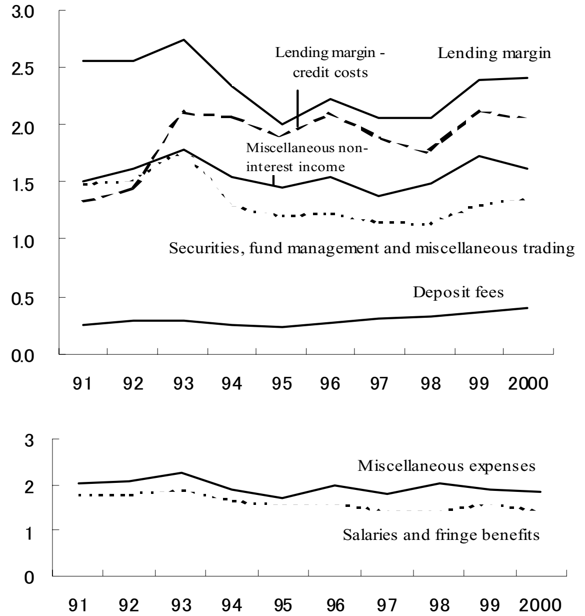
If we add to this the prospect (see above) that the corporate sector will find itself in surplus for the next 10 years or more, any attempt by the banks to normalize their lending conditions is likely to lead only to a contraction in bank lending. If Japanese banks are to rise from the ashes, they will have to drastically reduce their overdependence on traditional lending.

That is why the recovery enjoyed by US banks in the mid-1990s (when they made good the losses they had suffered as a result of non-performing loans) is not a blueprint for Japanese banks.

Figures 4-6 show US banks' changing profit margins. Return on equity and return on assets recovered rapidly from the extremely low levels they reached in the early 1990s. The main contributor was the fact that lending margins (after allowing for the cost of dealing with their non-performing loans) improved significantly regardless of the size of the bank.

In other words, the recovery in the US banking industry was a recovery in traditional banking. In Japan, on the other hand, lending is in structural decline, so Japanese banks will have to seek their salvation by very different means.

Figure 4 Margins and Expense Ratios of US Banks (ranking: 1-10, %)

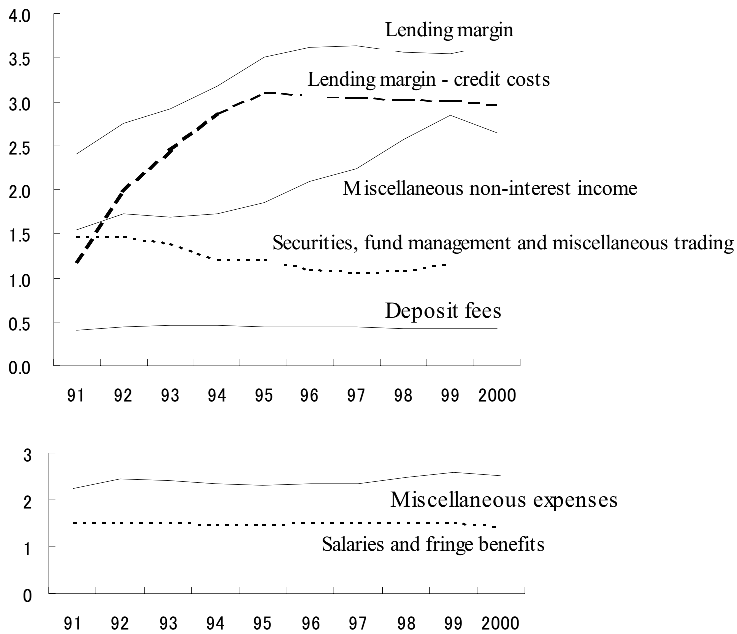


	91	92	93	94	95	96	97	98	99	2000
ROA	0.21	0.61	1.13	0.91	0.88	0.92	0.98	0.78	1.05	1.00
ROE	4.23	10.91	16.75	13.86	13.78	13.21	13.22	10.53	13.58	13.07

Note: The data are a percentage of assets. "Miscellaneous non-interest income" includes fees from credit card transactions, mortgage servicing, ATMs and the securitization of loan assets.

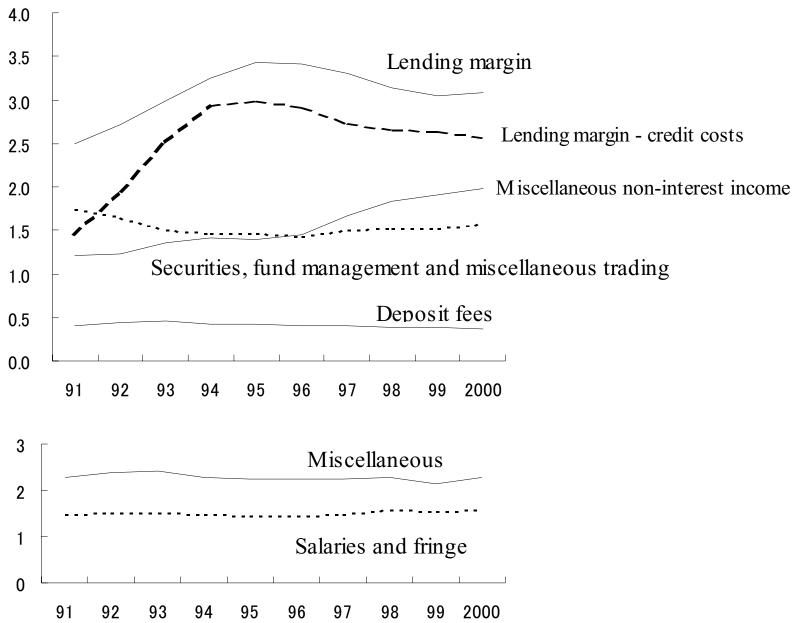
Source: Federal Financial Institutions Examination Council.

Figure 5 Margins and Expense Ratios of US Banks (ranking 11-100, %)



	91	92	93	94	95	96	97	98	99	2000
ROA	0.47	1.04	1.25	1.22	1.31	1.34	1.42	1.46	1.54	1.34
ROE	7.71	15.16	16.86	16.27	16.84	16.78	17.36	17.38	18.48	15.85

Figure 6 Margins and Expense Ratios of US Banks (ranking 101-1,000, %)



	91	92	93	94	95	96	97	98	99	2000
ROA	0.49	0.90	1.21	1.29	1.28	1.29	1.37	1.47	1.47	1.29
ROE	6.91	12.01	14.91	15.40	14.82	14.47	14.90	15.53	16.16	14.19

Note: Sources for Figures 5 and 6 are the same as for Figure 4.

4. Need to Sell More Investment Products and Improve Fund Management Capability

Not surprisingly, most Japanese banks have already set about trying to match their lending conditions to the risk involved. A growing number of banks have also introduced a scoring model in an effort to boost their lending to small and medium-sized companies—a high-risk, high-return business. In macroeconomic terms, however, the fact that the corporate sector will remain in surplus for years to come means that such lending activity is likely to have a limited future.

A growing number of banks are also becoming more active in the consumer loan business (e.g., through tie-ups with consumer loan companies). Unlike in the United States, where the savings rate is zero, in Japan the high savings rate means that the borrowing needs of the personal sector as a whole are basically quite limited. It is questionable whether in a country where interest rates start at zero banks can expect to have people who are prepared to borrow at 15%-18% a year as core customers. Such customers should be seen as highly marginal, and it would be foolhardy to overestimate the prospects for such a market.

All this suggests that, even if banks are prepared to go to considerable lengths to streamline their operations and widen their lending margins, those that are unable to increase their profitability in areas other than lending will find it difficult to survive.

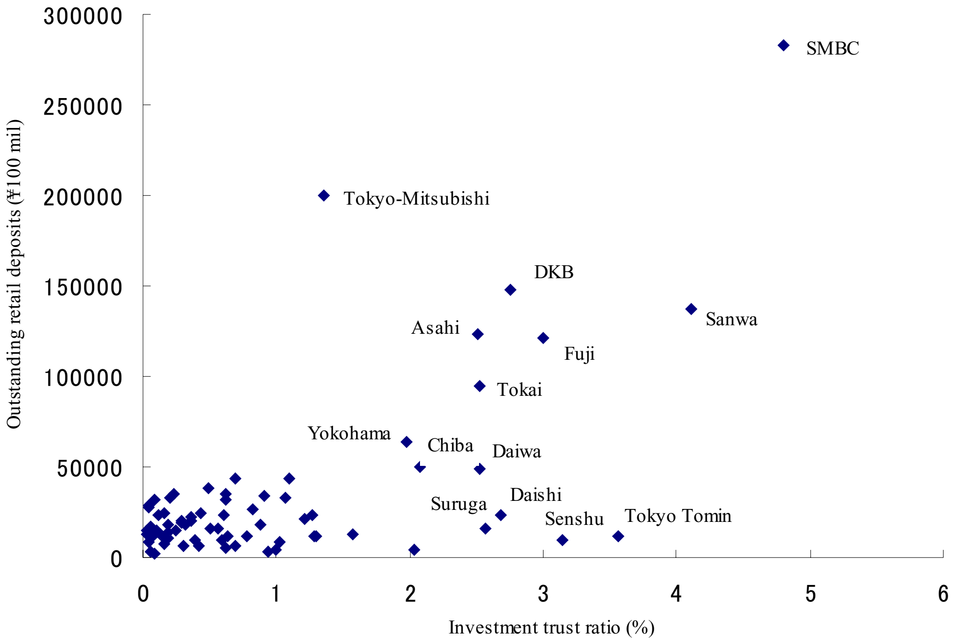
Assuming, therefore, that Japanese banks cannot find their salvation in the lending business, they will have no choice but to expand their fund management activities if their deposits continue to grow. Japan's banks are already active in this area and are increasing their exposure to bonds issued by the public sector (and especially the government—the one sector of the economy with a massive deficit). Nevertheless, lending is still their main activity and the area to which they continue to allocate the bulk of their resources. What they need to do is take a fresh look at their activities (in terms of their risks and rewards) and radically reallocate their capital.

Nor should they focus solely on improving their in-house fund management capability—they also have the option of outsourcing more of such business. If so, they will need to improve their fund management administration in areas such as performance analysis and risk management.

Banks will have to radically rethink their reasons for taking deposits. So long as their liabilities consist of deposits whose principal and interest are guaranteed, their ability to take risks will remain limited even if they improve their fund management capability. Rather than take deposits that they are unable to invest, they should try to reduce these as much as possible and concentrate on marketing other financial products such as investment trusts.

Most of the banks now market investment trusts, and their share of total outstanding investment trusts is steadily rising. Nevertheless, total outstanding investment trusts sold by the banks account for an average of only 1.9% of their outstanding retail deposits (total for city and the main regional banks as of end-March 2001). However, as can be seen from Figure 7, the figure for individual banks varies from 0% to more than 3%, reflecting a wide difference between those which have made a significant commitment to the investment trust business and those which have made none. The banks will also have to seriously consider marketing life insurance products. In both cases, the key for the banks will be to focus more resources on marketing financial products to retail customers without having to use their own balance sheets.

Figure 7 Banks' Outstanding Retail Deposits and Investment Trust Ratios



Note: Investment trust ratio = banks' total outstanding investment trusts sold/outstanding retail deposits (%) as of end-March 2001.
Source: NRI.

Another key area where the banks will not have to use their own balance sheets will be asset securitization. Although the banks have already removed many of their non-performing loans from their balance sheets in response to calls from the government to deal with the problem, their ultimate aim should be to raise their capital adequacy ratios by reducing not only their non-performing loans but also both their doubtful and performing loans. It is also obvious that this in itself will not be enough and that they need to increase their fee income (e.g., by making more of their credit control and servicing capabilities) and thereby establish a profit structure that is no longer overdependent on loan-deposit margins. Moreover, if the banking system as a whole is to improve its capital adequacy ratios and profit structures, the banks will have to sell their loan assets not just to other banks but also to other institutional investors.

By securitizing their loan assets so that they meet the valuation criteria of the market, the banks will help to establish lending conditions that reflect the risks involved and encourage new lending practices that place a higher priority on cash flow than the value of collateral. In turn, a market in securitized loan assets should act as a catalyst in encouraging arbitrage between the loan market and the corporate bond market and help to establish a proper functional balance between indirect and direct finance.

The recovery scenario of the US banking industry in the 1990s (where lending margins recovered rapidly and the US economy enjoyed an unprecedented boom) is not a model for Japan. However, banks in Japan have even closer ties with their retail and corporate customers than banks in the United States, and traditionally enjoy considerable confidence. What they now need to do is to make the most of their competitive advantages and make a major commitment to shifting resources from their traditional business to new business areas.

5. From Financial Intermediation to Valuation

Banks will therefore have to seek their salvation by taking a fresh look at both sides of their balance sheets. The future flow of money in the economy will mean that there is no future for banks' traditional role as financial intermediaries, taking deposits from households and lending the money to companies in need of finance. However, there is a new role for banks if they are prepared to radically reallocate their existing assets and liabilities.

Nor are banks the only financial institutions that need to take a fresh look at their balance sheets. Other financial institutions, companies, individuals and various organizations including local authorities, universities and foundations etc. also need to do this in an appropriate way.

Companies will have to rethink their attitude to the capital markets—partly because the banks will have to revise their lending practices, which have been based on the value of collateral and on corporate relations. In other words, companies will have to increase their enterprise value, scrap unneeded plant and equipment, review their business activities and make greater use of options such as divestiture and mergers and acquisitions. Share buybacks and disposals of cross-shareholdings will continue as part of this process.

With the end to blanket guarantees on bank deposits in sight, individuals and various organizations will have to rethink their overdependence on bank deposits.

The economy's various agents will therefore have to take a fresh look at their financial assets and liabilities (rather than their flows of income and expenditure), but how this process is carried out will depend largely on financial markets. Japan is about to begin what could be described as a massive "portfolio reshuffle."

More important in this process of taking a fresh look at assets and liabilities (i.e., of radically restructuring balance sheets) than the quantitative adjustments traditionally involved in channeling money to sectors of the economy that are in deficit will be how to value financial products and transactions.

Japanese banks are already reconsidering their traditional lending practices, which emphasize the role of property as collateral and corporate relations. The banks' need to remove loan assets from their balance sheets will also encourage them to "revalue" these assets in terms of their market value.

As lending comes to reflect market valuations, companies will reassess the cost of each of their liabilities—bank borrowings, bonds and equity. At the same time, they will come under increasing pressure from their suppliers of capital to increase their enterprise value in market terms. As a result, they will dispose of more of their cross-shareholdings and strategic investments, and regard equities more as what they really are.

The end of the blanket guarantee on bank deposits will force depositors to put a valuation on each bank they deposit money with, thereby leading to greater selectivity. Also, the fact that bank deposits will no longer be risk-free assets will mean that demand for securities products should increase. However, this assumes that such products are valued properly. There is always a risk that a sudden fall in the value of corporate bonds or money market funds could lead retail investors to abandon valuation and take refuge in the security of risk-free products.

One theory that has been gaining increasing acceptance among financial theorists recently is that the role of financial institutions is not so much to channel funds from left to right but to help individuals and institutional investors to rebalance their portfolios by valuing companies and businesses properly.

In Japan, an emphasis on financial intermediation has meant that the financial system has traditionally focused on developing a system of indirect finance that could apportion funds strategically to sectors where they were needed. During the asset boom of the late 1980s the banking industry and the securities markets both lost sight of proper valuations and pursued expansion for its own sake. Now that the corporate sector looks like remaining in a permanent financial surplus, however, proper valuations are increasingly being seen as the key to a healthy financial industry. Hopefully, this will usher in an age when indirect and direct finance can each play its proper role.

Having said this, the general direction should be to move from the current overdependence on indirect finance (which exposes the banking sector to more than its fair share of risk) to a situation more like the (admittedly extreme) US model, where direct finance can play a greater role.

6. Need for the Discipline of Valuation

However, we need to remember that in the United States itself—following the bursting of the IT bubble and the collapse of Enron—a debate is now under way on some of the structural problems facing the country's capital markets. These include issues such as disclosure, external auditing, initial public offerings, the role of analysts, fund managers, rating agencies, corporate governance, 401(k) plans and stock options.

Although Japan modeled its Big Bang program of financial reform on US capital markets, these very markets are still trying to find the right framework and code of professional conduct for ensuring proper valuations. In other countries, too, the debate about how financial products should be valued has the proponents of market value (or "fair value") accounting demanding its thoroughgoing adoption, on one hand, and its vehement opponents, on the other. It is probably fair to say that there is as yet no consensus on what constitutes a "fair valuation."

This year Japan's financial markets—with one eye on developments overseas—will have to take a fresh look at their approach to valuation—whether it be in indirect or direct finance. Banks, securities companies and institutional investors all have a key role to play both in ensuring that these markets provide a return that matches the risks involved and in restructuring their balance sheets so that they reflect proper valuations.

Loan officers, investment bankers, financial advisers, fund managers, analysts, accountants and those who work for rating agencies (to name just a few) each have a role to play as valuation professionals in maintaining a high level of discipline.