Japan's Financial Sector Reform: Progress and Challenges

for
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Hakuo Yanagisawa M.P.
Minister for Financial Services
Japan

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Sir Howard Davies, ladies and gentlemen, it is my great pleasure to have this opportunity, at your renowned agency in a world financial center, London, to exchange views on the issues of our mutual and vital interest.

I wish to address as the Minister for Financial Services on the recent transformation of Japan's financial system, its agenda and restructuring of financial institutions, in order to establish a strong and healthy financial structure in Japan. In this context, I would like to elaborate the process of establishment of the Financial Services Agency and discuss the issue of non-performing loans.

1. Reforms of Financial Regulatory Institutions

Japan's financial administration has undergone major change for the past few years. In June 1998, the financial supervisory functions were separated from the Ministry of Finance and entrusted to the independent Financial Supervisory Agency. Then in July 2000, the planning functions for financial sector policies were merged with the supervisory functions under the Agency, and the Financial Services Agency, FSA, was established. Through this re-organization, the jurisdiction over all aspects of financial administration including policy planning, supervision and inspections for banking, securities and insurance firms has now been completely separated from the Ministry of Finance.

These changes in Japan's administrative structure of financial policies are the direct reflection of the Finance Ministry's failure to efficiently cope with the bubble economy. The Ministry of Finance, which has led Japan successfully to her economic prosperity in the post World War II, and in fact even since Japan's modernization, was held responsible for the emergence of bubble economy in the latter 1980s, and its delays in containing the financial instability in the aftermath of the bubble's collapse in 1990s.

The Japanese financial system was severely shaken in 1997 and 1998. Amid this unrest, a few banks became insolvent and major banks needed to be recapitalized. To accomplish this process, two laws were enacted in October 1998; namely the Financial Reconstruction Law which stipulates the provisions to address failed institutions, and the Financial Function Early Strengthening Law which authorizes the public funds injection into banks.

The implementation of what these two laws envisaged, carefully designing the use of tax payer's money, was not mandated to the Financial Supervisory Agency, instead, entrusted to newly established five-member governmental body, the Financial Reconstruction Commission. In order to implement these two laws, I was appointed as the Minister of State for Financial Reconstruction in October, and as the Chairman of the Financial Reconstruction Commission in December of the same year.

2. Overcoming the Financial Crisis

The prerequisite to implement these two laws, the Financial Reconstruction Law and the Financial Function Strengthening Law, is to articulately grasp the financial conditions of the financial institutions, through complete inspections conducted by the relevant authorities. Fortunately, the Ministry of Finance, which was still in charge of this function in 1998, had taken the first step toward revising its inspection procedure, thus initiated comprehensive and strict examination of the appropriateness of loan classification and loan loss provisioning.

From July to October 1998, the Financial Supervisory Agency executed its first round of examinations of all 19 major banks simultaneously under the revised inspection procedure, in cooperation with the Bank of Japan.

Based on the results of these inspections, I recognized the failures of the Long-Term Credit Bank of Japan in October, and Nippon Credit Bank in December 1998. In March 1999 towards book closing of the business year 1998, I decided to inject public funds into all the other major banks except one.

At that stage, I established a substantially stringent provisioning standard: that is, 15% of the uncollateralized portions of loans which require special attention (which correspond to "sub-standard" loans by the U.S. classification standard), and 70% of the uncovered portion of loans whose debtors are in danger of bankruptcy (which correspond to "doubtful" loans by the U.S. criteria). Additional efforts were made to aim at bringing capital adequacy ratios to the order of 7% for Tier 1 capital and around 12% including Tier 2 capital, which is internationally competitive level.

At the end of fiscal year 1998, the Japanese financial institutions recovered from the near crisis in 1997 and 1998 and regained stability as a result of urgent and proper management of failures and capital increases through public funds infusions.

In July 1999, the revised inspection procedure, as I mentioned earlier, was evolved to "Financial Inspection Manual" and applied as official standards. The standards adopted in this Manual are fully compatible with the Basel Committee's "framework for internal control systems in banking organizations" which was adopted in September 1998, as well as with the U.S. Federal Reserve Board's bank examination standards.

The standards regulated by the "Financial Inspection Manual" were applied first to the inspection of regional banks. As a result of these inspections, six of them were injected with public funds in FY1999.

3. Appointment as Minister for Financial Services

In December 2000, 14 months after my previous tenure, I was called back again to serve for the financial reconstruction as the Minister for Financial Services. My mandate at this time is beyond implementation of the two financial reconstruction laws, and to cover all aspects of governmental policies relating to all financial industries.

When I took up my current post, I believed that the time has finally come to take a step forward for re-establishment of Japan's financial structure. However, the reality was different. The weak Japanese economy only allows me to devote most of my time again to initiate and implement policies to ensure the financial soundness of the nation's financial institutions.

4. Non-performing Loans

The first priority of my work has been to reduce the outstanding balance of non-performing loans. As of 31 March 2001, which marked the end of the most recent business year, the aggregate amount of outstanding non-performing loans held by major Japanese banks was approximately 17.4 trillion yen, which amounts to 5.7% of some 304 trillion yen in their total outstanding loans. During the business year 2000, these banks spent 4.3 trillion yen to dispose of these loans, and this figure is equivalent to 1.4% of their total loan exposures.

Given these conditions, I have taken a new approach in order to remove non-performing loans from the banks' balance sheets. Under this scheme, the banks are expected to finally dispose loans classified as "in danger of bankruptcy" or worse within two to three years. Meanwhile, banks are urged to help debtors in "need attention" and "special attention" categories to recover their financial soundness by providing business know-how and information on restructuring.

Moreover, the functions of the Resolution and Collection Corporation or RCC will be expanded and enhanced, such as by allowing the RCC to engage in the trust business on banks' behalf. This will provide supplementary measures to dispose of non-performing loans, which private financial institutions cannot handle. This approach is expected to expedite an intensive reduction of non-performing loans still remaining on banks' balance sheets.

Holding non-performing loans at the high ratio of nearly 6% over a long period could undermine the confidence of investors and depositors, and foment unnecessary anxieties and confusion both in Japan and abroad. Thus, we have to get rid of this situation as soon as possible. At the same time, 1.4% ratio of the cost of disposal of non-performing loans to all loan exposures is at significantly high level in Japan's finance history and in the light of the present loan spreads. Permitting this to continue unabated would damage the long-term soundness of the banking management, so these expenses must be promptly curtailed for the banks to recover their profitability. Importantly, it is obvious that banks' active approach towards their debtors will help manage the revival of the firms that can still be viable, thus contribute to the recovery of the real macro economy. These are the reasons why I am now taking active initiative to finalize the disposal of non-performing loans.

The government policy of urging Japanese banks to implement final disposal of their non-performing loans is directly targeted at the nation's major banks. However, Japan's regional banks will have to actively work with their debtors in precisely the same manner as the major banks, while paying due regard to their client base which is primarily comprised of small and medium enterprises. If the regional banks give due consideration to their competition with the major banks in view of the partial deposit insurance coverage policy which will start in April 2002, the quality of their loan portfolios should improve.

The Financial Services Agency model projections indicate that through intensive efforts to reduce the outstanding balance of non-performing loans over the three years from business year 2001, it should become possible to reduce the ratio of non-performing loans to total loans outstanding at the nation's major banks to below 4% by business year 2004. It should also be possible to reduce the ratio of the cost of disposal of non-performing loans to total credit to less than 0.3 percent, and final profit is expected to increase each year.

I should mention that there are some views regarding the non-performing loans of Japanese banks that are different from the government's position.

Some argue that the majority of the so-called "need attention" loans must be incorporated into the NPL calculations, or that the aggregate total of the non-performing loans is actually much higher than that indicated by the banks' own disclosures. Others argue that even if "need attention" loans are not categorized as non-performing loans, present provisioning is still insufficient. Certain analysts say that allocating sufficient provisioning for all the potential bad debts would lower the banks' capital adequacy ratios, and thus would require an additional injection of public funds.

Some analysts have indicated that the size of the non-performing loans calculated by their macroeconomic analyses is quite different from banks' disclosure. Even if we disregard the boldness of the methodologies adopted in some of these analyses, arbitral application of such methodologies could still be highly questionable. For example, these analysts often ignore the fact that Japanese finance is based on the corporate finance system rather than the project finance system, and this difference significantly affects their conclusions. Under the corporate finance framework, losses can be covered by the debtors' retained earnings and their current profits from other profitable businesses.

While the present levels of provisioning for "need attention" loans are decided based on the recent data of loan losses, some advocate that provisioning should also incorporate the forward-looking approach in light of overall economic outlook in the future. However, future expenses and losses, such as provisioning, must be calculated on an objective ground, that is an internationally accepted practice.

Nevertheless, I recently instructed the Financial Services Agency to have banks to consider developing and introducing a formula that incorporates market signals, such as stock prices and external ratings and to use them in the process of more detailed in-house loan classification and calculation of the provisions.

5. The Bank Stockholding Issue

The second main issue for securing the financial soundness of Japanese banks is on the massive amount of bank stockholdings. This exposes Japanese banks to the risk of price fluctuation.

Through cross-shareholding with industrial firms, Japanese banks are said to serve as the core of corporate groupings replacing the zaibatsu conglomerates. The banks also appeared to play an important role as so-called "stable shareholders" in the course of capital liberalization.

It turned out that the banks' stockholdings could have weakened corporate governance of individual firms. At the same time, after the introduction of the mark-to-market accounting system, these stock holdings have directly exposed the banks to stock price volatility.

The Financial Services Agency now intends to restrict bank's stock holdings to within the range of their Tier 1 capital. The necessary laws to implement this policy, in principle, by 2004, are being drafted for submission to the Diet.

To ensure compliance with these laws, Japanese banks have to strive to sell their holding stocks on the open market, at their own discretion. Yet given the massive scale of their stock holdings, it may be difficult for the banks to ensure compliance with the law via voluntary market sales alone within the specific time frame. In order to assure that banks can always sell the excess stocks at the timing of their preference, we have decided to establish an entity in January 2002 as a kind of safety net to buy the stocks held by banks. In principle, the shares purchased by this new agency will be sold through ETF, exchange-traded fund or expected to be repurchased by issuing companies. This process is designed to be consistent with the market mechanism. However, stocks which cannot be disposed of via ETF sales or buybacks despite a certain level of marketability would be exceptionally placed in a special account at the new agency, and sold on the open market after a certain period at appropriate timing.

When the Basel Committee reaches a conclusion on its ongoing review of the Capital Accord relating to this aspect, banks will fully comply with the terms of the domestic restrictions on stock holdings as well as the new international rules of the Basel Committee.

6. Sufficient Level of Capital Adequacy

The last main issue for upholding the financial soundness of Japanese banks is how to maintain their capital adequacy ratios. Questions are asked as to whether it is possible for banks to generate net operating profits for the write-offs and provisioning to cover newly emerging non-performing loans, and whether it is possible to maintain the capital adequacy ratio, which currently stands at 11.7 percent, even if share prices declined further, to avert an additional infusion of public funds

The FSA model projections I mentioned earlier was conducted on an uncompromising assumption that the deterioration of bank loan portfolios in the coming three years will be even worse than that recorded during the past years of the low economic growth. Despite of this, the projections indicate no decline in capital adequacy ratios from write-offs and provisioning alone, and in business year 2004 and beyond, these ratios will be improved steadily.

Regarding the impact of stock price fluctuations, the correlation ratio between the prices of the shares presently held by Japanese banks and the Nikkei 225 Stock Average, which is Japan's representative stock index, is only about 50%, so even if the Nikkei declines by 20% from the levels posted at the end of March, the resulting decline in bank self-capitalization ratios will be relatively minor, on the order of 0.5%.

7. System to Respond to Financial Crisis

Given all these factors, I firmly believe that while the environment surrounding the Japanese banking industry will remain rather harsh for some time to come, there is absolutely no reason for concern on overall situation.

For those who still can not dispel the fears or "risk-phobics", I would like to clarify one essential fact. In Japan, we have established the Financial Crisis Response Council, chaired by the Prime Minister, to address any systemic risks in the finance field, and the government is free to resort to necessary actions, including additional injections of public funds, based on the Council's deliberations. Currently, up to 15 trillion yen has been allocated for such measures at any time.

Prime Minister Junichiro Koizumi recently made public pledges to G7 and other national leaders that the Japanese government will not permit global financial instability to emerge from Japan. I would like to reiterate that the Prime Minister's statement was well grounded.

8. Future of the Financial System

In closing, I would like to briefly touch upon two forward-looking reforms in implementation towards strengthening Japan's financial system.

One significant improvement is the revitalization of our securities market. The government of Japan has long encouraged individual savings as a national policy. We are now departing from this traditional line and pursuing the policy of attracting individual investors to securities market. We have decided to provide certain tax advantage and other incentives to foster individual investors as a source of risk capital.

The second development is relating to the role of public financial institutions. The public institutions have come to undermine the initiatives of private financial institutions. The ongoing review to restrict the role of public financial institutions, thus enlarging the opportunities of private institutions, is one of the main pillars of Prime Minister Koizumi's structural reform initiative, and will be vigorously promoted by the government of Japan.

Thank you very much.