

(Draft)

Japanese Financial Sector : Progress and Prospect

For

Symposium on Building the Financial System of the 21st Century:
An Agenda for Japan and the United States
Warrenton, Virginia

By

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

20 September 2002

It is my pleasure to take a part at your renowned forum. I wish to express my gratitude for your invitation extended to me again this year. I hope that my presentation would help obtain your accurate understanding of the current state of Japan's financial sector and its future prospect in the light of the relevant policy by our government.

1. I wish to begin with touching upon the issues of keen interest, that is, the latest situation of the banking sector, including non-performing loans and its disposal effort.

a) At Gotenba session of this forum in December last year, I elaborated our policy and measures for disposal of non-performing loans established and implemented during the previous one year. That occasion coincided with my first anniversary as the incumbent of Minister for Financial Services, which I accepted after a brief interval from my previous tenure as the Minister for Financial Reconstruction. I wish to revisit those points covering my first year, briefly as follows:

The first step we took was to take measures for more meticulous assessment of non-performing loans and strict provisioning. I conducted, for example, special inspection on major banks' loans to large enterprises that were faced with significant decline of market evaluations such as their stock prices and ratings.

The second measures were taken to accelerate further removal of non-performing loans from banks' balance sheets. These measures were intended to encourage major banks to remove the existing loans extended to borrowers who had been classified as "in danger of bankruptcy or below", within the subsequent two business years, and those newly classified as such within the following three business years.

The third point was about the expansion of the operational range of the Resolution and Collection Corporation (RCC). The original mandate of the RCC, unlike the Resolution Trust Corporation (RTC) of the United States, was assigned mainly for

the debt collection. The Diet, however, amended a law in active collaboration with the government to enhance the function of RCC and its capabilities.

b) The effect of these measures was clearly witnessed in the major banks' statement of accounts and the prospects of their financial conditions announced at the end of March this year.

First, as an initial result of more accurate assessment of non-performing loans and provisioning, the outstanding balance of non-performing loans totally increased by approximately 50 % over the previous year, with 76% increase in "Need Special Attention" category due to the application of more stringent criteria. These increased non-performing loans are properly covered by provisions, collateral and guarantee.

Second, non-performing loans of totally 6.2 trillion yen was already removed from the balance sheets in FY 2001. While size of disposal complied with the two-to-three-year time line that the government had set up for implementation, we further accelerated this time frame of the removal of non-performing loans from balance sheets, by guiding major banks to remove 50 % of them within a year, and over 80 % in total within two years. As adequate provisioning had been made available for these loans, we estimate that approximately ten trillion yen of non-performing loans will be disposed of by the end of FY 2002 without deteriorating financial soundness of Japanese banks.

In addition, as for selling off of loan assets to the RCC, the sales prices have considerably increased to the fair value. The amount of sales has also begun to demonstrate a sign of increase.

c) Due to the accelerated disposal of non-performing loans through FY 2001 as explained before, disposal cost of such loans incurred by the Japan's major banks amounted to 7.7 trillion yen. This amount is the magnitude second to 10.4 trillion yen of losses incurred in FY1998, when public capital injection was executed, while the average capital adequacy ratio is still 10.8 %, which is well above the standard of financial soundness.

Furthermore, I have committed myself to redouble our efforts to expeditiously dispose of non-performing loans as Prime Minister Koizumi mentioned when he met President Bush last week.

d) Judging from the present situation of non-performing loans and the progress of our policies, the Koizumi Cabinet made public the prospects for the accomplishment of non-performing loan normalization target in FY 2004. This normalization means that the reduction of the ratio of non-performing loans among total loans to below 4 % and the ratio of the losses to the total credit to around 0.3 %. Projecting the future amount of non-performing loans of major banks by using migration rates among loan classifications, which were based on the relevant Cabinet agency's official forecast of the Japanese economy as well as hearing with each bank, we expect that the targeted normalization can meet our target time line as mentioned before.

(e) In addition to non-performing loans, another element, which needs attention in the banking sector, is that banks hold a large amount of shares and therefore, are exposed to stock price fluctuation risk. This problem is illustrated by that fact that amid the depressed stock price environment, the major banks declared valuation losses such as impairment of 3.1 trillion yen in their financial statements as of the end of March 2002, as mark-to-market accounting was firstly applied for the FY2001. Fluctuation risk in stock prices has now become a more disturbing source than non-performing loans for stabilization of the Japanese financial system.

During the previous extraordinary Diet session, a law was enacted on restricting shareholding by each bank and therefore requiring it to reduce its shareholdings to the amount corresponding to the Tier1 capital by September 2004. This new regulation enables banks to substantially reduce market risk associated with stock price fluctuations.

In addition, the day before yesterday, the Bank of Japan decided that it would purchase the portion of banks' shareholdings in excess of the Tier 1. I believe that this decision will greatly contribute to the stabilization of the Japanese financial system, while the details of this initiative will be further examined by the BOJ.

2. Now, I would like to discuss the conditions of regional or local financial institutions.

a) The number of regional financial institutions is expected to decrease from 900 at the end of March 1998, to around 650 by the end of FY2002, largely due to mergers and consolidations among Shinkin banks and credit cooperatives. During FY2001, we resolved 2 regional banks, 13 Shinkin banks, and 41 credit cooperatives as failed financial institutions. In other words, the numbers of local banks, Shinkin banks and credit cooperatives decreased by 8.4 %, 7.5% and 18.4 % respectively during one year period of FY2001.

b) As a result of failures of a number of financial institutions, the existing regional financial institutions have started the new business year under a situation where their financial conditions satisfy the standard of financial soundness.

However, regional financial institutions need to further innovate their new business approach and strengthen risk management capabilities. Under such a situation, the necessities and possibilities of mergers and consolidations among a number of financial institutions are compelling. I consider that the Japanese government needs to support their effort to promote management improvement in this direction.

From these perspectives, we have decided to take various legislative actions to facilitate merger and consolidation procedures. I expect that these legislative measures will be expeditiously approved by the Diet, thus accepted and applied by the regional financial institutions to promote their strength further.

3. It is my belief that only the market force is capable of accomplishing disposal of non-performing loans and enhancing effective risk management of Japanese financial institutions. As a result, sound management and profitability will be ensured.

a) From last autumn to early this year and onward, there has been one strong argument that the government should inject additional capital into major banks.

However, Japan is a major economy of market mechanism, and a nation ruled under the law. I firmly believe, therefore, it is not right to justify the necessity of capital injection in the light of macroeconomic policy and that banking supervision must be appropriately and legitimately conducted according to relevant laws and accounting rules.

Moreover, we have to be reminded that the capital injection is just like pouring cold water over the burning efforts by the management at the midst of their process to improve the sound financial status and promote profitability of each financial institution. We should understand that such an action would interrupt their devotion and spoil the sense of their duty towards active steps of structural reform of their own.

Having said so, however, I do not mean in any sense that I am indifferent to the serious situations of the Japanese financial system. I believe that we must not allow a Japanese financial crisis to happen. In order to avoid any financial crisis, I will not

hesitate to inject public capital into financial institutions when and if necessary.

b) I firmly believe that lifting of the blanket deposit protection scheme is another measures to mobilize the market pressure to work effectively towards the structural reform of Japanese financial institutions.

Full protection as exceptional measures is no longer applicable to time deposits over 10 million yen since April 2002, and liquid deposits in next April.

As scheduled, I implemented this transition to a partial protection of time deposits this April. I also intend to lift the full protection of liquid deposits.

However, we need to cope with the issue involving the payment and settlement function. The legal framework and practices in Japan are different from those in the United States. For example, in the United States, checks are used as a principal means of payment and settlement. Instead in Japan, almost all important payments and settlements are made through banking accounts such as direct debits from accounts at financial institutions and account transfers between financial institutions. Thus, payment and settlement deposits should be fully protected in Japan.

In general, "the principle of a least costly deposit insurance system" should be applied. Therefore, I consider it appropriate to limit the coverage of full protection to "payment and settlement deposit account" as a safety net for payments and settlements involving financial institutions, while the soundness of financial institutions should be closely attended with the high priority. I am confident that this new protection scheme is the best effective approach to ensure the stability of payment and settlement function, and at the same time to impose continuous and pressing incentives on managers of financial institutions towards structural reform.

4. Another weakness of Japanese financial market is a shortage of risk-money supply. It is an urgent agenda to establish a system to supply risk-money.

a) The Japanese business management has been mainly dependent upon indirect financing until now. Individuals as providers of funds have had strong risk aversion tendency and preferred to keep financial assets in the safer form of deposits. Enterprises as receivers of funds also considered indirect financing beneficial for their stakeholder-oriented management. In this process their relationship with banks worked smoothly and effectively.

However, this harmonized approach has become out of date because risks associated with the Japanese economy have now changed in quality and quantity.

In the mean time, financial institutions are criticized of ineffectiveness of the intermediary function entrusted to them, with their legs drawn in the muddle of non-performing problems. As the Minister in charge, I am making every effort to recover this particular function for them. However, looking from a different viewpoint, one may regard the present process as the phase that the Japanese economy is transforming from indirect financing system to a new financial system where direct financing plays a more important and major role.

b) In order to accelerate this transition, we announced last month a program consisting of a wide-range of measures in the future.

The first major point of the program is the diversification of intermediaries of securities transactions. For example, we plan to issue guidelines to banks to operate as security agencies and to share stores with securities companies.

The second major point is the reform in order to promote broader individual participation in the stock market. We consider, for instance, tax reduction on capital gains and dividends.

The third major point is ensuring fairness and transparency of the markets. It includes strengthening the organization and function of the Securities and Exchanges Surveillance Commission(SESC).

5. In view of the recent events in the United States, I think the most fundamental problem in the capital market is how to ensure corporate governance which can secure investors' confidence.

a) At present, corporate governance is under public scrutiny also in Japan.

I think that banks, especially main banks, have been playing the major role in sustaining the corporate governance. Banks have deeply committed themselves to the fate of companies as a large shareholder, as well as being well informed of financial condition in detail as major lenders. When borrowers had the management and /or financial difficulties, the banks have intervened to reshuffle the management, sent in their board members, and tackled such problems.

b) However, this system can be no longer sustained in the future. Banks tend to provide funds in the form of market oriented financing, instead of continuously holding enormous amount of outstanding loans. Furthermore, it becomes difficult for major banks to hold large share of stocks, and they are making big efforts to squeeze their shareholdings out. Under these circumstances, it is impossible to expect banks to play the same role in corporate governance as they used to do.

c) In order to cope with always changing economic dynamism, we have to renovate a new financial system expeditiously. It is an essential agenda to enhance and strengthen the business accounting procedure, auditing system, corporate governance and disclosure system, in order to promote open, transparent and responsible management by companies themselves, which helps them to facilitate financing from the market.

In this context, learning from the recent experiences and policy developments in the United States, I intend to take necessary policies and measures actively and extensively.

Thank you very much.