Japanese Banks – A Risk Factor for the Japanese Economy

The banking sector in Japan has been in deep crisis for more than ten years now and primary commercial banking functions are disrupted. Banking reform is making institutional progress now, but important performance indicators show that the situation in the banking sector is still difficult. The share of non-performing loans, for example, has fallen only slightly despite governmental interventions. Owing to write-offs on these loans the costs of banking business are also relatively high. Another difficulty is that the interest income realisable is low. Deflation has persisted for four years, and is still causing difficulties for the banks, as there is little incentive to borrow in such a situation. Hence, the volume of lending has been falling for more than three years. The commercial banking sector, which should actually help to diversify and transform risks, is thus itself a risk factor for macroeconomic development. One way out of the crisis would be greater international integration of the Japanese banking sector.

Non-performing loans – poor earnings prospects

At first sight the banking reform, which has been accelerated since 2001, appears to be partly successful.[1] At the end of the 2002/2003 financial year[2] the stock of non-performing loans[3] had fallen markedly compared with the previous year (cf. table 1), and its share in total lending had declined by almost 1 percentage point to 5%.[4] The drop would have been much greater if the extensive clearing of loans ('stocks') totalling 15.1 billion Yen out of the banks' balance sheets had not been counteracted by new non-performing loans ('flows') to the amount of about 7 billion Yen.

Despite the progress achieved in implementing institutional regulations the problems of lending have not yet been solved. Evidently, the banks have not succeeded in estimating the risks of the economic development in Japan correctly, and the *flow* problem is by no means solved. Consequently, the stock of non-performing loans shown marks the lower threshold of the actual burden of these loans on the banks' balance sheets.

Under the present regulations these new non-performing loans must be written off within three years, so that they are a considerable burden on the medium-term earnings prospects for the commercial banks holding them. To clear the balance sheets and thus ease the burden on the Japanese commercial banks basically two possible approaches could be adopted:

Firstly, the problem of the loans and advances can be tackled. State and private organisations specialising in this business can purchase loans and so ease the burden on the banks' balance sheets. Agencies of this kind have been set up in Japan as part of the banking reform. Their presence, and the admission that they can now also acquire non-performing loans from banks classified as 'sound', probably made a decisive contribution to the improvement in the banks' balance sheets with regard to old non-performing loans in the last financial year. Moreover, the framework conditions for debt/equity swaps were simplified. In these transactions borrowers with overdue payments transfer to the creditor rights of ownership (for instance in shares) in payment of the debt. A decisive advantage of clearing the balance sheet by tackling the problem of loans and advances is that these measures can be put through relatively quickly and at least some are market transactions. However,

Table 1
Non-performing Loans
In billion Yen

	March 2000	March 2001	March 2002	March 2003
Big banks	20.4	20.0	26.8	20.7
Regional banks	11.4	13.6	16.5	14.7
Other banks	10.4	9.4	10.9	9.1
Total	42.2	43.0	54.2	44.5
Memo item: Non-performing bank loans as % of commercial bank loans	4.5	4.6	5.9	5.0

Sources: IMF; OECD; FSA; DIW Berlin calculations

[1] Reform of the financial markets was to have been advanced with 'Big Bang' in 1997. According to the plans at the time the restructuring of the banking sector would have been completed in 2001. In fact, most of the necessary reforms were delayed and a change came in 2001 only when banking reform was declared a central factor in inducing recovery of the economy as a whole. Since then mainly institutional progress has been achieved. I.a. banking supervision has been strengthened and the risk classification of loans made more stringent. For details on current developments see *www.fsa.go.jp/indexe.html*.

[2] In Japan both the financial year and the fiscal year end on 31 March.

[3] Non-performing loans are loans with high risk of default. For details on Japanese regulations see *www.fsa.go.jp/indexe.html*

[4] When the classification criteria were made more stringent the number of loans classified as non-performing rose dramatically.

non-performing loans can only be sold on the secondary market at considerable discounts. In all actions that affect the commercial banks' outstanding claims directly a corresponding entry on the liabilities side is necessary, and as a result the stock of equity capital falls. A large number of Japanese commercial banks were affected by this last year.

Secondly, the state can inject capital to increase the equity capital. This was practised most recently for the Resona Group, that had only lately been formed through the merger of two big commercial banks, the Daiwa Bank and the Asahi Bank. Owing to non-performing loans the Resona Group's equity capital cover had fallen markedly (by just under 60% in the 2002/2003 financial year), so the Group was far below the equity capital requirement of the Bank for International Settlements.[5] The advantage of this kind of state bail-out is often seen as preventing a run on the commercial banks that could spread to the banking sector as a whole. Moreover, a high share of state-held equity gives the government more influence on commercial practices. A greater quantity of state intervention can compensate to some extent for the low quality of the public commodity of 'financial sector regulation' provided by the state. Depending on the extent of the financial injections by the state the increase in the equity capital cover can come close to nationalisation. The costs of taking on these risks are borne by the taxpayer, whereas the remaining shareholders benefit directly.

The range of measures to clear the banks' balance sheets so far extends from market purchases of non-performing loans at appropriate discounts to direct state intervention in the financial system. Considerable costs are incurred for any measure. The non-performing loans written off from 1992 to 2002 alone amount to almost 20% of the gross domestic product of 2002.

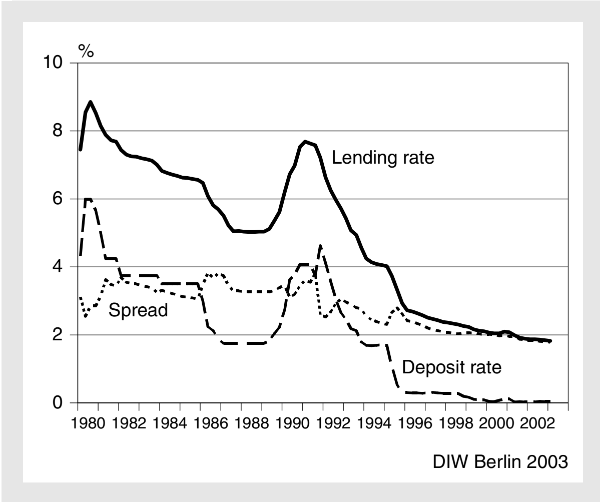
Financial intermediation is difficult in times of deflation

The necessary restructuring of the commercial banking sector that has now been started takes place in a difficult general economic environment. For several years the Japanese economy has been confronted with the phenomenon of deflation. To counter this the Japanese Central Bank switched to a combination of a zero interest rate policy with generous provision of liquidity for the commercial banking sector (an 'easy money' policy) a

Figure 1

Nominal Interest Rates in Japan

First quarter 1980 to first quarter 2003



Sources: IMF; International Financial Statistics CD-ROM, July 2003; DIW Berlin calculations.

long time ago.[6] Consequently the direct refinancing costs for the commercial banks are now extremely low; nominally they are about zero. It is the aim of the current monetary policy to supply the domestic economy with liquidity at favourable cost. In fact, the commercial banks have also handed on the central bank's gradual reductions in interest rates to borrowers. Parallel to the reduction in the interbank rates the average interest payable on loans has fallen by 25 base points since January 2001; in the first quarter of 2003 the nominal rate was about 1.8%, which was a historical low (cf. figure 1).

Theoretically, the market lending rate calculated by a bank should be the sum of its direct refinancing costs, the risk premium and a bank's profit. If – as is the case in Japan – the framework conditions change, the effect on the financial intermediary's costs will certainly not be neutral, as the state influences transaction costs through the legal framework it sets and through the exercise of its process policy instruments (monetary, foreign exchange and fiscal policy instruments). With regard to the Japanese banking sector there are good reasons why the change in the general conditions effected by the acceleration of the banking reform should have led to higher risk premiums.

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[5] In Japan only commercial banks operating internationally have to show a risk-weighted equity capital ratio of 8%; for banks operating solely in the Japanese market the benchmark risk-weighted equity capital ratio is 4%. The Resona Group failed to meet even that threshold.

[6] The declared aim of the zero interest rate policy is to keep the interest rates calculated in the interbank market around zero. The easy money policy relies on providing the commercial banks with plenty of liquid funds. The target set by the central bank aimes at the 'surplus reserves' maintained by the commercial banks at the central bank. In the past the target figure was raised several times.

At the same time a continued high level of liquidity in the banking sector is furthering the reduction in interest rates on deposits, which in any case were low. During the first quarter of 2003 nominal interest rates on deposits were on average eight base points below the 2000 level – that is the level before the zero interest rate policy was launched. On the immediate level this has eased costs for the commercial banks. However, it is hardly possible to lend out these deposits at a profit on the interbank market – for the interest rate is almost zero. As the deposits business also involves costs for the bank (booking costs, wages, security on deposits etc.) simply holding deposits can be a loss-making business.[7] Altogether the spread, that is the difference between the average interest rate paid on deposits and the interest rate on loans, which is the base to banks' earnings, has rather fallen since the start of the zero interest rate policy. At present there are indications that, given the present conditions – excess liquidity in the banking sector and weak domestic demand – the costs and risks of the intermediation business can only be passed on to borrowers to a limited extent.

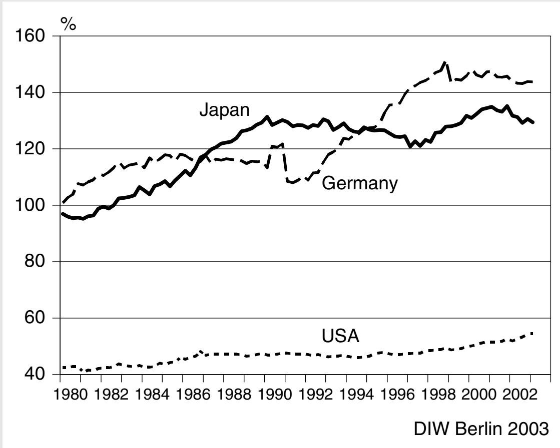
A brake on lending

Since the 'bubble' burst at the end of 1989 the lending business in Japan has developed very slowly. In the last few years the nominal volume of lending is actually declining – although the Japanese financial system (like the German one) is regarded as bank-based. In bank-based financial systems mainly the commercial banks, and not so much the share and capital markets, are used for corporate financing.[8] Accordingly, the quotient 'loans by commercial banks in relation to GDP', which is frequently used to assess the size of the banking sector, is clearly above the comparable figures for the United States, where a more market-based financial system is established (cf. figure 2). The same holds for Germany. However, in Japan this figure has been falling recently. The fall in the level of lending is not a sufficient indicator of a credit squeeze, i.e. supply-side restrictions on lending. On the contrary, there is much to suggest that demand-side factors, such as macroeconomic stagnation, combined with a relatively weak trend in investment and a high number of corporate insolvencies are playing a big part. That is particularly apparent from the shrinking of the spread, for this shows that the banks have few possibilities to sell on their loans.

Figure 2

Share of Commercial Bank Loans in GDP

First quarter 1980 to first quarter 2003



Sources: IMF; International Financial Statistics CD-ROM, July 2003; DIW Berlin calculations.

The fall in lending has been accompanied by a considerable shift in the weights towards state borrowers. Lending to the private sector has dropped dramatically, and the latest figure for its share in total lending is only about 75%. That is far below the comparable German and US ones (cf. figure 3). Within the private sector the major decline has been in lending to small and medium-sized firms. They often depend on commercial banks for loans because they have little access to other sources of external funds. But larger companies also seem to make only partial use of alternatives to the traditional bank loan, for the fall in lending has been accompanied by a clear slackening in the issue of corporate bonds.

The decline in lending to the private sector is matched by an increase in lending to the state, which on principle bears less risk of default than loans to private borrowers. In view of the difficulties commercial banks are currently facing in establishing an appropriate risk premium for the lending business in the financial market it is a reasonable strategy for them to avoid the risks of the private sector as far as possible – and consequently to invest in 'safe' government paper.

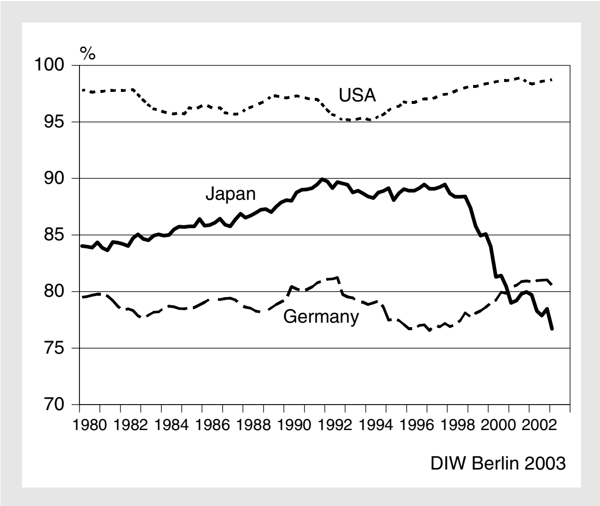
International integration needed

Japan has been trying to reform the banking sector itself and build up a financial intermediation that meets international standards for years. In fact, the banking reform is now making progress. A lack of adequate accounting

[7] Cf. OECD: 'Japan: Economic Surveys', Paris 2002, p. 85

[8] On principle, however, it needs to be recalled here that in any economy, regardless of whether the financial system is bank-based or market-based, considerable parts of investment are financed with the companies' own funds.

Figure 3
Share of Loans to the Private Sector in Total Commercial Bank Loans
First quarter 1980 to first quarter 2003



Sources: IMF; International Financial Statistics CD-ROM, July 2003; DIW Berlin calculations.

standards complicates its implementation. Complex ties between state, companies and commercial banking sector have characterised the picture for years. With increasing transparency the heritage and the conditions that gave rise to it become clear. In the banking sector this heritage is still evident as a big stock of non-performing loans. There is no doubt that financial intermediation in Japan still has to be regarded as a relatively difficult business.

Despite all the difficulties, Japanese banks still have considerable weight on international comparison. Three out of ten of the biggest commercial banks worldwide are headquartered in Tokyo (cf. table 2). Among these ten biggest banks only the Japanese ones are showing clear losses. So it can be assumed this is a phenomenon specific to Japan. The yield on those banks' equity capital is negative as well. At the same time costs are high on international comparison. Both the high costs and the losses can be explained by the difficulties in the domestic lending business. Against that background, stronger international engagements for Japanese financial intermediaries could offer an additional and important way to accelerate reform of the financial system. However, not all the Japanese financial intermediaries meet the necessary criteria, and so it appears to be essential to promote reforms and the establishment of international regulatory standards in the Japanese financial market at a brisk tempo.

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Table 2
The Ten Biggest Banks Worldwide in 2003

Ranking	Bank	Head office	Tier one capital		Assets (%)		Capital/assets ratio (%)	Profits (pre-tax) in billion US $	Return on Equity (RoE*)	Return on Assets (RoA**)	Costs/total income ratio	BIS equity capital ratio***	Non-performing loans/total loans
			In billion US $	Year-on-year change (%)	In billion US $	Year-on-year change (%)			(%)				
1	Citigroup[1]	New York, USA	59.0	1.0	1097.2	4.4	5.4	22.8	38.6	2.1	55.0	11.3	1.9
2	Bank of America Corp.[1]	Charlotte, USA	43.0	2.5	660.5	6.2	6.5	13.0	30.2	2.0	53.5	12.4	1.6
3	HSBC Holdings[1]	London, GB	38.9	–0.1	759.2	–1.9	5.1	9.7	24.8	1.3	59.4	13.3	3.0
4	JP Morgan Chase & Co[1]	New York, USA	37.6	–0.4	758.8	9.4	5.0	2.5	6.7	0.3	76.9	12.0	1.7
5	Credit Agricole Groupe[1]	Paris, France	35.7	3.8	609.1	3.1	5.9	3.8	10.6	0.6	62.2	11.7	4.5
6	Mizuho Financial Group[2]	Tokyo, Japan	29.1	–30.5	1080.8	–11.3	2.7	–18.8	–64.7	–1.7	55.4	9.5	6.9
7	Royal Bank of Scotland[1]	Edinburgh, GB	27.7	14.0	649.4	12.4	4.3	7.7	27.8	1.2	55.7	11.7	2.1
8	Sumitomo Mitsui Financial Group[2]	Tokyo, Japan	27.1	–12.5	844.8	–2.7	3.2	–4.9	–18.1	–0.6	94.5	10.1	4.7
9	Mitsubishi Tokyo Financial Group[2]	Tokyo, Japan	26.0	29.6	781.1	–0.5	3.3	–2.8	–10.9	–0.4	110.4	10.8	2.8
10	BNP Paribas[1]	Paris, France	24.1	5.0	744.9	–13.9	3.2	5.6	23.3	0.8	65.2	10.9	3.9

1 As per 31.12.2002. — 2 As per 31.3.2003. — * Equity capital profitability. — ** Net income divided by total loans and advances. — *** Calculated in accordance with the criteria of the Bank for International Settlements (BIS).
Source: The Banker, July 2003.