

Bubble Burst and Japanese Banking Industry^(*)

by HIDEO ORGASAWA, Chairman of UFJ Foundation

(Continued from the last issue)

However, the conditions of the delayed non-performing loans just continued to get worse, and even all these resources were insufficient. Figure 9 shows the gap between banks' profits and the losses on disposals of non-performing loans, a gap that expanded year by year.

sult, Japanese banks' capital bases shrank.

Under regulations set by the Bank for International Settlements, banks that conduct international businesses must maintain capital equal to at least 8% of their loans and other risk assets. These are known as the BIS guidelines. If a bank's capital ratio falls below 8%, that

erations were becoming increasingly global.

The easiest way to maintain a capital ratio of at least 8% is to shrink the denominator when the numerator shrinks. That means that if banks' capital shrinks, then they must restrain their lending. As I mentioned earlier, banks had had to restrain their lending during the period of financial system instability, but they also had to restrain their lending again to keep their capital ratios above the minimum required level.

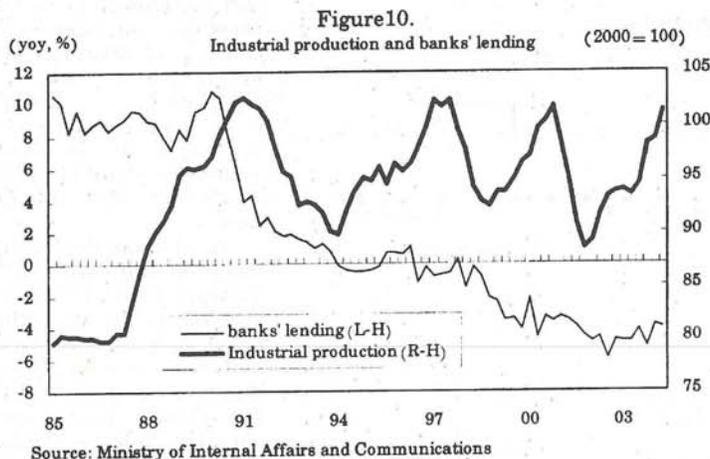
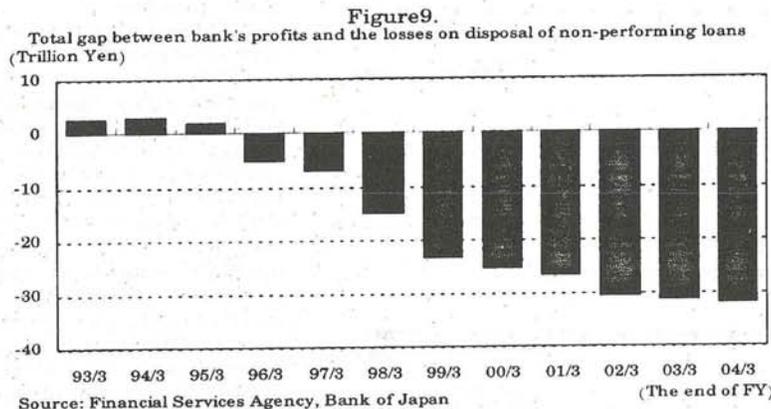
This generated criticism that the banks were stubbornly continuing to restrain lending, and this was keeping the economy from staging a full recovery. In other words, people believed that if only banks would increase their lending, the economy would improve.

This would mean that to improve the economy, banks would have to eliminate the non-performing loans that were the root cause of their restraint in lending, while at the same time increasing their capital. If capital increased and banks' business stabilized, this would also contribute to the stability of the financial system.

I personally, however, do not necessarily believe this view is correct. Figure 10 shows the relationship between the Japanese economy and banks' lending. As you can see, in 2000 and again recently, the economy recovered even though banks' lending remained restrained.

From the corporations' perspective, bank lending is borrowing. Corporations made efforts to shrink their balance sheets, which had inflated during the bubble period. Those efforts are continuing even today, and corporations continue to pay down debt, to strengthen their financial position. With corporations trying to reduce their debts, banks were in no position to increase their lending even if they wanted to. The slump in bank lending was not a problem that could be solved unilaterally from the banks' side; it was also a problem on the corporate side.

In any case, the thing that gave the banks the power to resume lending was the government's policy deci-



Without enough profits to cover their losses, banks' results end up in the red. These losses in annual earnings tend to erode the capital that banks accumulated in the past. This would be all right if banks were in a position to issue new shares and top up their capital, but it is not that easy to procure fresh capital. As a re-

bank must withdraw from international business. To make such a decision would be extremely difficult and painful for a bank. If Japanese banks could no longer engage in international business themselves, they would be unable to serve their Japanese corporate customers, whose op-

sion to inject public funds to the banks in an effort to stabilize the financial system. Next let's have a look at the response of government authorities to non-performing loans.

6. Japan's financial problems and the response of financial authorities

For a long time after World War II, Japan's financial authorities pursued a policy course of never allowing any bank to fail. A bank that found itself at a business impasse would typically be absorbed by a bigger bank or made into a subsidiary.

In the 1990s, however, after the bubble burst, more and more financial institutions found

themselves in precarious circumstances, straining the ability of this system to respond. The major banks themselves, which are supposed to be extending a helping hand, found their own strength sapped by the need to deal with their non-performing loans.

As a result, by the mid-1990s, financial authorities found they needed to exercise strict checks on the risk that a financial institution might fail. They saw a risk that a sudden failure might lead to instability throughout the financial system. For example, a system was devised to take measures to stop operations at any bank whose capital ratio fell below a specified level. Banks had to audit their own loan assets; for any loans that fell to non-performing status, and set aside reserves or write them off.

To prevent depositors from feeling any insecurity, the so-called "pay-off system" was temporarily suspended. Pay-off system is a system where deposits are guaranteed by the Deposit Insurance Corporation up to a certain amount. Consequently, deposits whose value exceeded that predetermined level might not be repaid, depending on the particular circumstances of the failed bank. The suspension of this system meant that, for a certain time at least, deposits were guaranteed to be repaid in full.

This was the background when the first financial system crisis occurred in the fall of 1997. To respond to this situation, Japan's financial authorities injected public funds into major banks before they failed; in other words, the government made loans to private-sector banks, in an effort to prevent any recurrence of financial system instability.

The banks, however, wanted to keep these injections of public funds

small, to avert concerns that large injections of public funds meant the banks were in poor financial condition.

After that, the economy continued to sour, and non-performing loans continued to increase, leading up to the second financial system crisis in 1998.

This meant a second round of injections of public funds. This time they were much bigger, and were applied to broader targets that included regional banks as well as major banks. A total of ¥60 trillion, namely US\$520 billion, was amassed to cover the funds that would be needed for depositor insurance, funds for disposing of failed banks, and the additional injections of public funds.

Since the government's policy had always been not to allow any bank to fail, at this time there was still no clear law that defined what to do if a bank should fail. Financial system instability would be eased if there were clear guidelines on what would happen if a bank should fail. If a government investigation were to discover a strong risk that a bank was about to fail, it would be possible to deal with a bank before it actually failed. This is what motivated the government to devise a system that established a framework for how to deal with such a bank, whether before or after bankruptcy, to help minimize the damage of a bank failure.

In this way, Japan managed to somehow get through its two financial crises, but financial authorities were still far from relaxing: they could see that non-performing loans were still on the increase. Japan's financial system instability was becoming a matter of international concern. Many people in other countries were calling on Japan to do something quickly about its non-performing loan problem, because of

the risk that financial system aberrations in Japan could spread to markets in other countries. The Japanese government promised these critics it would take action quickly, and a comprehensive solution to the non-performing loan issue, and Japan's financial system stability, became a matter of international agreements.

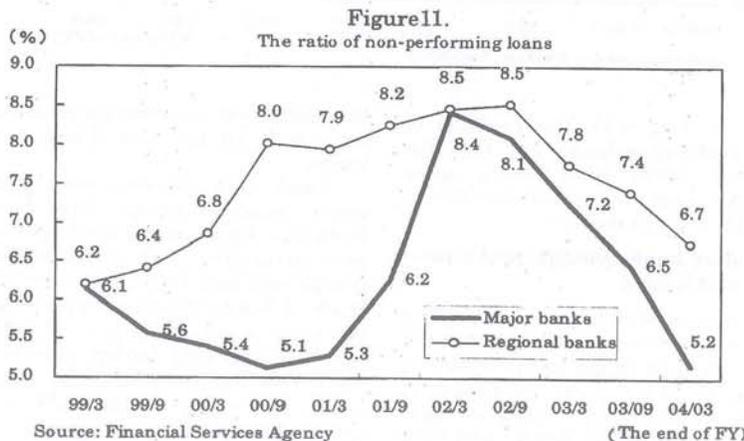
After the injection of public funds, Japan's financial authorities took a sterner position in monitoring the banks. A comprehensive solution to the problem of non-performing loans became a core government policy goal.

This effort resulted in decisions about specific procedures for dealing with non-performing loans, and concrete targets. The current goal under the government's financial reconstruction program is to reduce non-performing loans to 4% of the total loans by the end of March 2005.

The government began its special audits of major banks, a process involving detailed checks of the specifics of bank loans to major borrowers, to test market suspicions that banks were being too lenient in evaluating borrowers as well as to make steady progress toward the goals on non-performing loans.

To deal with non-performing loans, the government also established a public institution whose mission is to purchase non-performing loans from banks and dispose of them.

Japan has made great progress in disposing of non-performing loans. Banks are restoring their profitability through restructuring, increasing their capital, and taking a more aggressive stance in dealing with the problem. As a result, we can finally say that we have put the worst of the non-performing loan problem behind us. As of April 2005, the pay-off sys-



tem as was originally conceived will be reinstated.

There are still some issues, however, such as the lack of progress in dealing with non-performing loans at regional banks. Figure 11 shows trends in the ratio of non-performing loans. At major banks, the ratio had fallen to 5.2% as of March 2004, approaching the 4% target defined by the financial reconstruction program. In all probability, the major banks will succeed in meeting the target by the deadline of March 2005. At other banks, the ratio stood at 6.7% as of March 2004; while it is true the ratio had peaked out, it still remained too high for comfort.

The banks spent considerable

must also deal with the issue of how to return that money as soon as possible.

Banks are also refining their strategies for making further progress in disposing of non-performing loans. For example, one strategy has been the merger, aiming to expand their scale, reduce costs, and make up for one another's weaknesses. Before the bubble burst, there were 21 major banks in Japan. After that, bankruptcies, mergers and acquisitions reduced that number to 11. While some critics said banks were merging in hopes of becoming "too big to fail," the banks were not merely interested in size, they were seeking some form of advantage;

Compared with banks in Europe and the U.S., Japanese banks are said to face many kinds of problems: they make smaller spreads on loans, their profit structures are overly dependent on lending, and their capital is said to be too small for them to make risky loans or investments. Japanese banks will have to do something to address these weaknesses, at least a little.

Regarding interest-rate spreads, the number of banks has grown smaller, helping to eliminate the excessive competition that made it difficult to attract depositors or borrowers, and helping to restore a foundation upon which banks can secure stable profits. Figure 12 shows that banks' total spread has been widening a little bit at a time.

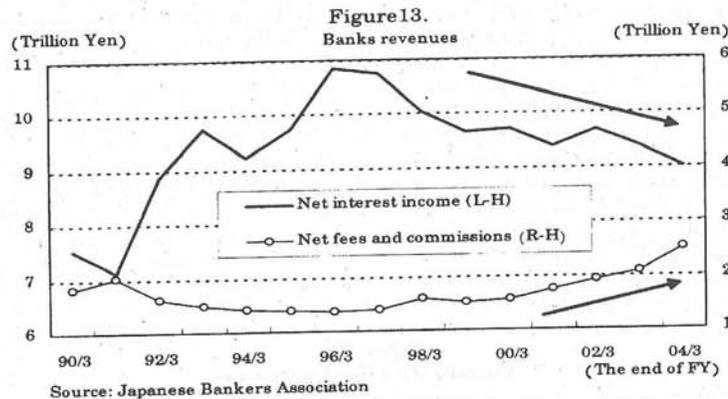
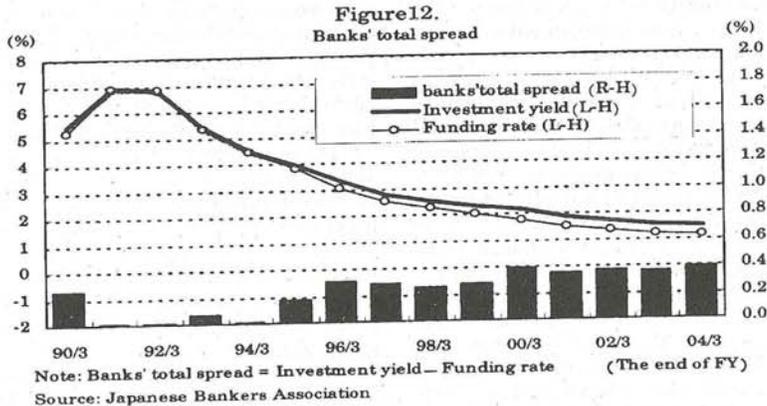
Banks' high level of dependence on lending has also been declining gradually, as the banks make efforts to increase their revenues from fees and commissions. At one point Japan's Big Bang held some painful associations, but the trends toward liberalization and deregulation have steadily opened new opportunities for profitability for the banks. For example, banks can now sell insurance and pension products, and beginning in December, banks are scheduled to begin brokering stocks. As Figure 13 shows, however, entering these new businesses is not always a simple matter, and revenues from fees and commissions remains low.

As for higher-risk loans and investments, with the banks' current low levels of capital it is not an easy matter to simply increase them. Still, there may be ways.

For example, in lending to small and medium-size enterprises with comparatively low credit ratings, there is a risk that if a bank lends to only such firm, and that firm goes bankrupt, the bank will fail to recover the full amount of the loan. But if a bank lends to 100 such firms, there is less chance that all 100 will go bankrupt at the same time, so the failure risk is distributed, and the risk of failing to recover the full amount of the loan is lessened.

If the loans to these 100 companies are used as collateral and securitized, the securities can be sold to investors, and the bank is no longer bearing any risk of bankruptcy, and it earns commission revenue. This process is known as securitization, and these kinds of transactions are gradually increasing in Japan.

Banks are also making efforts to develop other business opportunities.



time dealing with the problem of non-performing loans, and this distracted them from doing quite enough about the issue of strengthening their profitability.

7. Future bank management strategy and issues

The problem of non-performing loans may be over the hump, but the next problem facing banks is how to improve their own profitability. Some banks are still sitting on their injections of public funds, and they

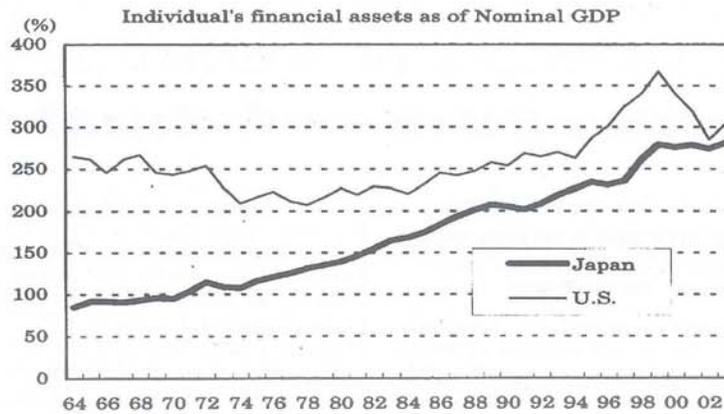
they could see no incentive in merging simply for the sake of becoming bigger.

Amid these circumstances, four major financial groups have been formed in Japan, under holding company structures. Two of these four groups - my own UFJ Group and the Bank of Tokyo-Mitsubishi group, are planning to merge as of next October. For the UFJ Group, this will mean we are entering the final phases of dealing with the problem of non-performing loans.

For example, some banks are working on creating branches where customers can withdraw funds around-the-clock, or systems that allow them to transfer funds using the Internet.

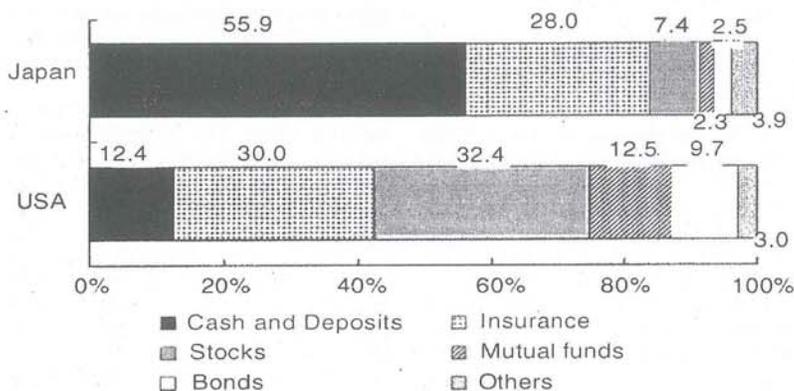
Japanese banks' greatest hope is to develop business opportunities with the large numbers of financially sound corporate customers as their businesses flourish again. It has been a long 10 years, but corporations' balance sheets are finally nearing the end of their reconstruction phase, and these companies will soon be in position to go on the offensive once again. Japan's best companies, in particular, have been aggressively developing their business overseas. If Japan's banks, as well, are able to respond to these increasingly global needs, that may mean an increasing

Figure 14



Source: Bank of Japan, Federal Reserve

Composition of individual's financial assets (as of Dec 2003)



Source: Bank of Japan, Federal Reserve

supply of new profit opportunities.

The financial assets of Japanese individuals are said to be total ¥1,400 trillion, or US\$12 trillion. If Japanese banks can bind their business to this massive pile of assets, there is hope for ever greater profitability. Figure 14 shows that a very large portion of Japanese individuals' financial assets is held in the form of bank deposits. Compared with the U.S., Japanese individuals take an extremely cautious approach to managing their funds. As a result, with interest rates at current low levels, there is a limit to how much Japanese individuals have been able to increase their assets. Consequently, I think individuals' asset management needs will grow more diverse in the future, and there is a strong chance that investors will move away from saving and toward

investing. If banks position themselves to grasp individuals' changing needs, then this will mean truly huge business opportunities.

8. Conclusion

I have been able to discuss with you recent developments in Japan's finance and economy, on the basis of my own experience. To summarize, what was the main cause of Japan's recent financial troubles?

For the answer to this, I wish to cite the thoughts of my friend Junichi Naito, Director-General of the Tokai Local Finance Bureau, Ministry of Finance, and who also taught as a professor of economics at Nagoya University.

Mr. Naito, in his own writings, poses the question as: "For what reason have Japan's economy and finance remained in such a prolonged

slump?" To which he responds, "Japan's financial system, established in the 1930s," -specifically the system by which competition was restrained, in exchange for protections and guarantees for the safety of the banks -"this system was destroyed in the final stages of financial liberalization." At the same time, "this can also be considered to be the result of the thoroughgoing penetration of the principle of self-responsibility."

These are my sentiments exactly. It is certainly true that there were several causes exacerbating the financial system problems, including the emergence and the bursting of the bubble, the resulting problem of the delays in dealing with non-performing loans, and the start of Japan's Big Bang. But the real, fundamental, underlying reason behind Japan's economic troubles has been that the old financial system was so rapidly destroyed and supplanted.

Now, the old system has been destroyed and the new one is in the process of taking its place; we find ourselves in the final phases of the transition period. A few banks went under during this transition, and mergers reduced the overall number of banks. Once we get past this transition period, however, Japan's financial system will be stable, and restored to a level of strength that will be fully capable of supporting economic growth; of this I am confident. ■

(*) Lecture delivered at the workshop held in November 2004 to commemorate the 10th anniversary of the Scholarship Program between UFJ Foundation with HCMC University of Economics.