An Uncertain Fresh Start

Gov't-run Financial Institutions Streamlined

By Katsuhiko SAKAI

Japan's eight government-run financial institutions underwent a sweeping realignment in October 2008 after supporting the country's postwar economic growth with long-term, low-interest loans using huge "fiscal investment and loan program" funds funneled from the postal savings system. Coupled with the year-earlier postal system privatization, the realignment represents the completion of reforms initiated by the Koizumi administration (April 2001-September 2006) to transfer operations and authority from the government to the private sector. The overhaul is designed to reform the channel from which public funds are provided, downsizing these government-run financial institutions that had been criticized for growing excessively large and squeezing the private sector.

Of the eight institutions, the National Life Finance Corporation (NLFC), the Japan Finance Corporation for Small and Medium Enterprise (JASME), and the Agriculture, Forestry and Fisheries Finance Corporation (AFC) were integrated with the international finance division of the Japan Bank for International Cooperation (JBIC) to become the Japan Finance Corporation (JFC). The JFC is set to merge with the Okinawa Development Finance Corporation into the only Japanese government-run bank in fiscal 2012. The Development Bank of Japan and the Shoko Chukin Bank were privatized. The Japan Finance Corporation for Municipal Enterprises was transformed into the Japan Finance Organization for Municipal Enterprises as an entity that is owned and managed by local governments.

Gov't-run Institutions' Weight Growing amid Credit Crunch

The JFC is now a government-owned stock company pursuing transparent, efficient operations. Its outstanding loans totaled some ¥24 trillion at the end of March 2008. The JFC consists of four units to take over the four predecessors' respective operations. The JBIC is legally positioned as more independent than the other three units because of its international operations and retains its name externally, which is used in combination with the JFC.

While the four JFC predecessors' 234 branches in Japan have been consolidated into 152, some financial services that were not offered in some regions have been made available throughout the country. This is one advantage of the shakeup. Although the AFC had only 22 branches, for example, the JFC's Agriculture, Forestry, Fisheries, Food Business and Consumers Unit now stations officials in all prefectures but Okinawa. Before the integration, the four old corporations had provided independent financial services without coordination as their respective controllers within the government had bickered over leadership. If the four JFC units successfully pursue cooperation, they will make it possible to offer diversified customer services. A rising number of regional small and medium-size enterprises (SMEs) are expected to take advantage of the JBIC's know-how for expanding into overseas markets.

In implementing the realignment, the government sought to limit the size and scope of policy-based financial services and make clear the position of such services as a supplement to private-sector services. Ironically, however, calls have recently grown for enhancing the role of government-run financial institutions as private-sector institutions have toughened their lending criteria amid an economic slump in Japan induced by the global financial crisis. These calls also reflect moves to reconsider the Koizumi reforms that some people say have been implemented too quickly. Since the US subprime mortgage problem emerged in the autumn of 2007, government-run financial institutions' loans have steadily increased to support cash flow for SMEs and farming families affected by a credit crunch among private-sector institutions. The JFC is now expected to increase its presence. "It will be difficult for the JFC to uniformly reduce outstanding loans," JFC Governor Shosaku Yasui told a news conference just after the inauguration of the new institution.

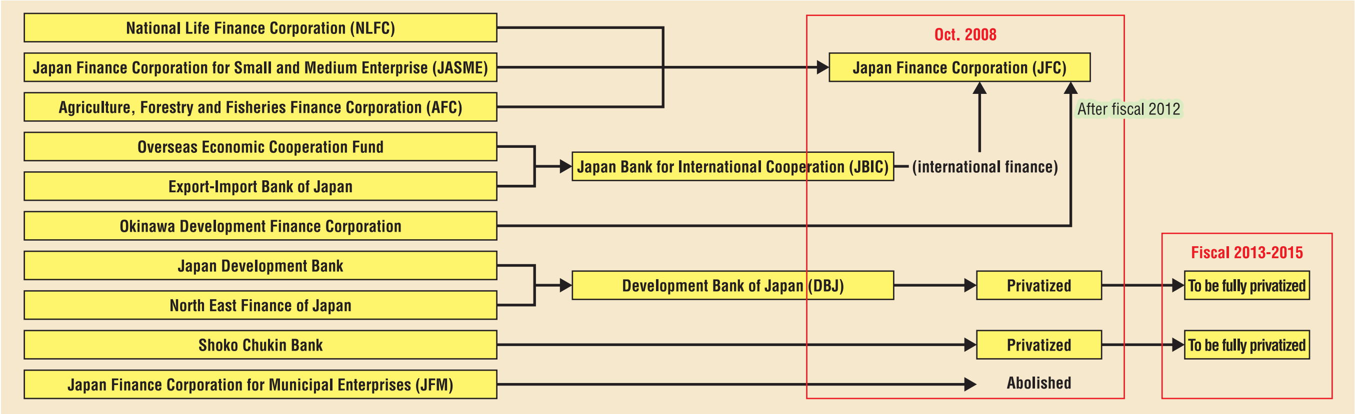
Privatized Institutions Groping for Survival

Of the two privatized institutions, the Development Bank of Japan (DBJ) has been transformed into a stock company with ¥1 trillion in capital provided fully by the government. During a transitional period of five to seven years, the government will gradually sell shareholdings in Shoko Chukin Bank as well as the DBJ. By 2015 at the latest, their privatization will be completed with government shareholdings all sold. The DBJ has taken advantage of the government's creditworthiness to raise funds at low cost and provide long-term, low-interest loans for social infrastructure development, including the transportation and energy areas, regional development and assistance to SMEs. As the role of policy-oriented financial services declines, the DBJ will develop into a profit-making entity through structural reform.

The first step of such reform will be the expansion of stable fundraising channels. After the completion of its privatization, the DBJ will no longer be allowed to borrow funds under the government's fiscal investment and loan program (FILP) or issue government-guaranteed bonds. It has already increased borrowing greatly from such financial institutions as regional banks. As a result, the share of FILP funds in the DBJ's financial resources for fiscal 2007, which ended in March 2008, declined to 53%. The FILP share is set to fall below 50% as the DBJ plans to issue bonds overseas.

CHART

Governmental financial institutions reshaped



Source : Compiled by author

In April 2008, however, Moody's Investors Service downgraded its rating outlook for the DBJ from "stable" to "negative" for the reason that the DBJ's "disengagement from policy finance activities and the future change to its business model may lead to a decline in the probability of extraordinary support from the government over the medium term." The action by the US debt rating agency will lead to a rise in the DBJ's fundraising cost, reducing its profit margin on traditional lending.

Even after the full privatization, the DBJ is expected to develop a business model to provide long-term risk money combining investment and loans. The DBJ has been strong in the areas of rural development, environmental protection, disaster prevention, and science and technology where private-sector financial institutions have difficulties in doing business. But the profitability of financial services in these areas has not always been high.

In a bid to boost its profitability, the DBJ has provided subordinated loans that bring about higher interest income but are ranked below all other borrowing with regard to both the payment of interest and the repayment of principal. It has also expanded investment through trust funds. The DBJ has invested in such emerging companies as eBank Corp. and Bookoff Corp. in addition to Japan Airlines Corp. for which it has long served as a main bank. It plans to expand outstanding investment to ¥500 billion by the end of fiscal 2010 from ¥170 billion in fiscal 2006.

DBJ President Minoru Murofushi has made clear plans to enhance its overseas operations. "We would like to promote capital alliances with financial institutions at home and abroad," he told a press conference in October right after the bank's rebirth. The DBJ has already formed an alliance with a Chinese government-affiliated investment company in a bid to find a means of survival through highly profitable investment and lending deals in emerging countries.

DBJ Could Ally with Megabank

The DBJ have three possible options to choose after its privatization is completed. First, it could transform itself into an ordinary bank under the Banking Law. Second, the DBJ could specialize in investment banking services as a nonbank bank under the Money-Lending Business Control and Regulation Law. Third, it could become a financial group including banking and nonbank financial service firms. No specific option has been chosen so far. A banking industry source said the DBJ could be swallowed by one of megabanks if no specific option were chosen during the transitional period before complete privatization. The financially sound DBJ, with ¥12.5 trillion in total assets and blue-chip corporate customers, could be an attractive alliance partner for existing megabanks.

If the DBJ forms a capital alliance with any megabank during the transitional period, its neutrality may be lost. The House of Councillors Committee on Financial Affairs has adopted a resolution calling on the government to "give prudent consideration to the selection of purchasers of government-held DBJ shares and the types of shares the bank will issue in the future to prevent the bank's long-term corporate value from being prejudiced." Under the resolution, the government will cautiously select DBJ share sales targets. In the process of the selection, the DBJ's final shape is expected to become clearer gradually.

Shoko Chukin Shifting from Semi-gov't Entity to Private One

The Shoko Chukin Bank had been a semigovernmental entity owned jointly by the government and organizations of SMEs. Unlike other government-run institutions, Shoko Chukin has not had the government underwrite bonds with FILP funds and has handled deposits. It has effectively served as a private-sector bank. Upon its privatization, sources close to the bank said no major changes were expected. Toward the full privatization, however, it faces many challenges, including the improvement of information disclosure and law compliance systems and maintenance of its creditworthiness. The bank's lending race with existing private banks is likely to intensify. It will have to strengthen itself during the transitional period.

In a medium-term business plan released in April 2008, Shoko Chukin said it would increase its capital adequacy ratio from 8.31% in March 2007 to more than 10% at the time of complete privatization and boost pretax profit from ¥28.2 billion to ¥40-¥50 billion. But the business performances of SMEs, its major borrowing customers, remained stagnant even in the recent economic recovery phase and have begun to deteriorate further on recession fears. Investment in financial markets has grown more difficult in the aftermath of the US subprime mortgage crisis. It will not be easy for Shoko Chukin to achieve the targets in the medium-term plan. JS

Katsuhiko Sakai is a senior staff writer and deputy editor at the Economic News Division, Jiji Press.