The Question of Caps on Deposit Insurance Refunds

By Tani Sadafumi

The Japanese government had planned to cap insured refunds of all deposits at failed banks, starting in April 2003, but it basically abandoned this plan at the end of July. Government members such as Yanagisawa Hakuo, Minister for Financial Services*, stressed that the new plan actually signified a resolve to push forward with structural reform, but there is no doubt that it also signifies a change in policy. Prime Minister Koizumi Jun-ichiro's government made this policy shift when it was caught in a hard place between political demands and economic realities.

At the present time, in the event of a failure of a financial institution, the government guarantees the repayment of all liquid deposits (deposits cashable on demand). Since April 2002, the government has insured fixed deposits, but only up to a limit of ¥10 million plus interest. The policy had been that, starting in April 2003, this cap would also be applied to ordinary deposits and other liquid deposits. Thus, the former marks the removal of the limited deposit guarantee, and the latter the removal of the full deposit guarantee. The plan to end the full guarantee was viewed as a symbol of structural reform, and the Koizumi Cabinet, always keen to raise the banner of reform, was being watched closely to see what it would do in the face of strenuous calls to postpone removing the full guarantee.

The government's sudden change in policy became evident on July 30. The Prime Minister called the Minister for Financial Services to his residence that evening, and asked him to consider full insurance for settlement accounts within the framework of the stipulated policy of terminating full guarantees, in order to avoid confusion in Japan's financial system. The next day, the same request was made to the Financial System Council, a government organ.

Until then, the government had kept insisting that all refunds would be capped in April 2003. The Chief Cabinet Secretary, Fukuda Yasuo, had stated that the government would end all remaining blanket guarantees, and that it had no intention whatsoever of changing this policy or postponing its implementation. The Minister of Finance, Shiokawa Masajuro, had said that the government was firm in its resolve to end blanket guarantees. And the Minister for Financial Services was quoted as saying that their end was a mainstay of structural reform needed to strengthen financial institutions, and that the government intended to implement the policy as planned.

In hindsight, we can now better understand what Takagi Shokichi, Financial Services Agency (FSA) Commissioner, implied when he said at a July 29th press conference that the government would "basically" stick to its policy framework. This inference was not noticed at the time. So it is natural that the policy change was seen in financial circles as "surprising – a bolt from the blue" (Teranishi Masashi, Chairman of the Japanese Bankers Association).

It did seem sudden, but actually the FSA had begun around May to refine measures dealing with deposit insurance cap issues. The Agency was aware of the risk of a shift in funds on two fronts (see immediately below), and was beginning to realize that suddenly removing all the remaining full guarantees on deposits could trigger another disturbance in the financial system and act as a brake on the economy, which was moving, however haltingly, toward recovery.

The refund cap was applied to fixed deposits in April 2002, and this caused a shift in funds from fixed to ordinary deposits. Bank of Japan (BOJ) statistics on the money supply in July show that the total amount of fixed-term deposits dropped 13.6% from July 2001, while total liquid deposits rose 36.6% during the same period. This is because depositors now favor safe ordinary deposit accounts – fixed deposits offer only a very low interest rate in any case, at a time of ultra-low rates. This shift is not only being seen in the deposits of the very rich. Ordinary deposit accounts are the receptacle for the business settlement funds of small and medium-sized enterprises (SMEs), the idle funds of local governments and the reserves that condominium management groups need for repairs.

The other shift in funds is occurring among financial institutions. Statistics show that by the end of July 2002 city banks had experienced an 8.8% deposit increase over July 2001, whereas the second-tier regional banks and credit banks, whose financial base is comparatively weaker, witnessed a 2.2% decline during the same period. In addition, deposits at foreign banks with branches in Japan jumped 28.3% in the one-year period from the end of May 2001, even though deposits at those banks have no government guarantee whatsoever. The American credit-rating agency, Standard & Poor's, ranks the Bank of Tokyo-Mitsubishi at the top of all major Japanese banks, but even this rating is five ranks below that of Citibank of the United States. These trends indicate that depositors place a great deal of importance on a bank's creditworthiness.

These realities prompted the Japan Chamber of Commerce and Industry, an SME umbrella group, to call on the government to postpone its termination of the remaining full guarantees on deposits. SMEs generally cannot borrow from major banks, regional banks or foreign banks, so they depend on loans from smaller financial institutions to maintain their cash flow. If deposits were to drain away from those smaller institutions, the SMEs' source of funds would dry up, making it hard for them to survive. The second-tier regional banks, credit banks and credit cooperatives all called with one voice on the government to proceed with caution and postpone its plan to cap refunds.

Calls for postponement were also heard within the ruling party. At the end of July, the Liberal Democratic Party's

(LDP) Select Commission on Policies for Deflation, chaired by LDP Diet member Aizawa Hideyuki, announced its third set of anti-deflationary measures, the pillar of which was postponement of the plan to terminate full guarantees. Noda Takeshi, the leader of the New Conservative Party, added his voice to this argument, saying that ending the full guarantees would be like opening a window during a typhoon, and that the full guarantees should remain in effect until a resolution of the non-performing loan issue was in sight. Kanzaki Takenori, the Representative of the New Komeito party, concurred. The Koizumi government suddenly found itself boxed into a political impasse – it realized the danger of ending full refunds, but felt unable to go back on what it had publicly announced.

In the midst of this quandary, the FSA came up with what it saw as a clever idea – to push forward with the plan to end full refunds, but to fully insure one type of account for settlement deposits. At first, voices within the Agency had proposed that full protection be given to (1) corporate current accounts; and (2) a new type of zero-interest settlement account for individuals. Top-level officials in the Agency stressed that depositing money in a zero-interest account was like putting it in a safe-deposit box, and it was therefore natural that the full amount of such deposits should be refunded if a financial institution collapsed after the termination of full refunds for other types of accounts. The point being made was that it was natural that the positive factor of full protection should be balanced by the negative factor of no interest.

The BOJ Governor, Hayami Masaru, did not publicly state any disagreement with the government's new approach. He said that the new approach did not reflect a basic change in thinking and that, in his view, there had been no change in policy. However, he also said that full protection should be given at the lowest level possible, indicating his concern regarding the problem of moral hazard – that financial institutions and depositors would possibly take unusual risks. Aizawa saw no problem in the change in government policy, and said frankly that the change did not go far enough – that the government should not be ambiguous, but should simply postpone termination of the remaining full guarantees.

For its part, the FSA underestimated the reaction of those in the financial industry who would be affected. The problem is that zero-interest accounts for individuals will be a new type of account. At first, the top executives of smaller financial institutions welcomed the change in direction, saying that the concerns held by many SME managers with regard to settlement accounts had been resolved. But it became clear that creating the new type of deposit account would involve considerable expense and time. In addition, the large banks, which were not worried about an outflow of deposits, indicated an unwillingness to establish the new type of account because of the costs involved. Moreover, because of the risk of depositors spreading a rumor that banks which introduced the new type of account would be at risk, the entire financial industry, including smaller financial institutions, did not want to budge on this issue.

FSA Commissioner Takagi therefore met with top executives of major banks toward the end of August, and asked for their cooperation. The executives remained unwilling, saying that it would be extremely difficult to change their computerized systems to accommodate the new type of zero-interest account by April 2003. As a result of this opposition, the government decided to let the banks postpone the introduction of zero-interest ordinary deposit accounts for five months, until September 2003. This decision recognizes the fact that the FSA cannot compel the banks to work faster, in light of the computer system failures at the Mizuho Financial Group in April this year. But at any rate, the government, its hands tied, says it has not changed the framework for removing full deposit guarantees in April 2003 – under its forced logic, from April 2003 to the end of August that year, interest-bearing ordinary accounts will be seen as being basically the same as settlement accounts which have the full deposit guarantee.** One financial group leader pointed to the contradiction in the government's position in asking banks to raise profits while increasing costs at the same time. He criticized the Agency's goal of having all banks introduce the new type of account at the same time, saying that making banks pay extra costs by sailing with the slowest ships (i.e., the weakest banks) amounted to a return to the government's "convoy" policy.

It appears that the issue of accounts for individuals will be resolved as follows: (1) rather than proceeding with the costly development of a new type of account, banks will create two types of accounts out of the existing ordinary deposit accounts – those that provide interest and those that do not – with the zero-interest accounts fully insured; and (2) individuals will also be permitted to open current accounts, with certain conditions applying.

The government is stressing that the change in policy does not represent an abandonment of its aim to remove full guarantees. And yet, there can be no doubt that the original purpose of this aim was to develop a vibrant and healthy financial system. This basic aim is incompatible with permitting risk-free deposits of any amount to exist, far into the future.

Even financial industry regulators admit that the foundation on which Japan's financial system rests cannot be called solid, and that the Japanese economy is not strong enough to withstand a heavy shock (paraphrased from the words of Yamaguchi Yutaka, the BOJ Deputy Governor). The government has yielded to political demands regarding the termination of full guarantees, and this will probably increase economic instability, not reduce it. JJTI

* Yanagisawa was replaced as the Minister of Financial Services in the cabinet reshuffle on Sept. 30. Economic Minister Takenaka Heizo concurrently takes the position.

** On Oct. 7, under the initiative of the FSA and Economic Minister Takenaka, the government decided not to remove full deposit guarantees until April 2005.

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