The Deposit Insurance Cap and Regional Financial Institutions

By Izumi Masaki

JUST six months are left until the full implementation of the deposit insurance cap, after which the guaranteed repayment amounts on bank deposits will be limited to ¥10 million and the interest. After the cap's partial application in April 2002, ordinary savings accounts too will be counted from this time. Moving into an era of increased selectivity, Japan's financial institutions will, more than ever before, have the soundness of their operations scrutinized by depositors and shareholders.

The deposit insurance cap had been postponed amid an unsteady financial system. To prevent a destabilization of the financial system, the government decided in October 2002 to implement a two-year deferment and to move full implementation from the original date of April 2003 to April 2005, when the non-performing loan (NPL) problem would have been resolved. Thus, within just six months of the partial application to term deposits, financial administrators were forced to make a policy about-face.

This change of direction came immediately when Takenaka Heizo took over the Minister of Financial Services from Yanagisawa Hakuo. The partial introduction of the deposit insurance cap had set in motion a far-reaching, accelerating shift of funds from small-scale credit unions and credit associations to major banks and the stronger regional banks, and transfers from time deposits to ordinary deposits, which enjoyed unlimited guarantee coverage. Feeling increasingly under threat, credit associations, credit unions and regional banks released a stream of statements opposing the full adoption of the deposit insurance cap. Contrary to what Yanagisawa had been asserting, with the NPL problem weighing heavy and stock prices tumbling, the surrounding conditions rendered a full adoption under the original timetable impracticable.

Sometime in between, the government introduced zero-interest settlement deposits, which were yet to have full guarantee protection after the complete adoption of the deposit insurance cap, and suggested postponing the full introduction of the scheme by a 5-month system response time. The plan was a last resort devised to provide fully-protected settlement deposits as a receptacle for an accelerating migration of funds in search of a safe place, and in this way push through a complete adoption of the deposit insurance cap. Ultimately, however, since neither the ruling coalition parties nor the financial services industry accepted the plan, this compelled a 2-year postponement of the full introduction, which had been a prominent point of the structural reform agenda of Prime Minister Koizumi Junichiro.

Settlement deposits featuring full guarantee coverage, unprecedented in the developed world, were included and thus codified in the revised Deposit Insurance Law, which went into effect in April 2003. Under the law, the three conditions that had to be met by this type of deposit account – (1) no interest; (2) provision of settlement services; and (3) payable upon demand – correspond to the checking accounts used mostly by corporations, so an easy-to-use new type of settlement account was specifically created for general customers. Many financial institutions are preparing to introduce this type of account to ready themselves ahead of the full adoption of the deposit insurance cap for unforeseen deposit outflows.

Fortunately, the full introduction of the deposit insurance cap next April is seen as an unalterable pre-set course, and unlike before, there exists no large chorus of opposing voices. The reason for this is that the pace of NPL disposal at major banks has been quickening under the government-initiated financial revitalization program, and the risk of serious destabilization of the financial system has been largely defused. Even so, however, there remain arguments cautioning against a full adoption.

For example, there are disparities in the economic recovery in major cities compared with the regions, and differences between large corporations and Small and Medium-sized Enterprises (SMEs) in the rate of their return to profitability. Under these conditions, financial positions remain weak at many regional financial institutions that have substantial transaction volumes with SMEs based in the regions. A number of informed observers warn of a full adoption of the deposit insurance cap, citing among other examples a depositor run on the Bank of Saga last year-end that caused an outflow of ¥40-50 billion in cash upon an irresponsible alert disseminated by cell-phone e-mail.

While the government on the one hand seeks to build confidence in its financial administration concerning the major banks, there exist strong worries over regional financial institutions. If the Japanese economy is to be reconstructed, reinvigorating regional economies and broadening the scope for employment opportunities are indispensable conditions, and nothing would be gained, according to some observers, if regional revitalization were to be put back due to the blows that would be dealt to local industries if regional financial institutions were to default. Thus, financial administration has been shifting its focus to creating healthy regional banks, credit associations and credit unions, which are seen as the regional economies' pillars of support.

The weeding-out process among regional financial institutions has been gaining traction under the Koizumi administration, with a reduction of 170 institutions – mostly credit associations and credit unions – from 772 to 602 in the three-year period that ended in March 2004. Restructuring and consolidation have been continuing ever since. A solution to the issue of overbanking remains a work in progress, however, as demonstrated by the fact that a prefecture with three or more regional banks is labeled a region with excessive levels of competition.

The government's stance "to not introduce unnecessary instability to the regions" (Koizumi) prompted it to adopt a double standard in not requiring regional financial institutions to meet quantitative goals, as it did with major banks, in connection with demands for the rapid disposal of NPLs, thereby making the return to financial health prone to delay. At the end of March 2004 the NPL ratio of regional banks of nearly 7% was far above the major banks' average value of just over 5%, and included at least 10 institutions with ratios over 10%. Deferred tax assets, i.e. tax credits from taxable loan-loss charges that institutions hope will be refunded in the future, in some instances, reach around 60-70%.

Against this backdrop, Aug. 1 saw the coming into force of the Law Concerning the Reinforcement of Financial Functions, also called the "new public funds law," which will be applicable until the end of March 2008. Unlike the public-fund injections into financial institutions seen to date, which were premised on situations posing the imminent danger of destabilization of the financial system, the new law emphasizes strengthening the financial bases of primarily regional financial institutions to preempt financial-system destabilization. The government has established a ¥2 trillion budget allocation for this purpose. The Financial Services Agency has set up a preparatory examination system for business reinforcement plans (with 3-year terms) to be submitted by financial institutions, which serves as the decision basis for whether or not a public capital participation is to be underwritten, predicated on an application by a particular financial institution. Additionally, to prevent the facile injection of public-sector funds, it has been decided to implement a double-check system under which opinions will be sought from attorneys and accountants of the Council for Reinforcement of Financial Functions.

The key points of supervisory policies subsequent to a fund injection are, in the case of injections not leading to a merger or consolidation: (1) profitability trends (as measured in the percentage of net operating profit relative to total assets); (2) raising operating expense cuts and (3) lowering the ratio of NPLs to outstanding loans. Failure to attain even one of these quantitative goals by the end of the plan's term asks absolute liability such as management's retirement. If profitability has dropped below the initial level, even one year prior to the end of the plan, an improvement plan must be submitted, and issuance of a business improvement order will be considered if necessary. In the case of fund injections associated with merger or consolidation, since the understanding is that "restructuring itself requires significant business reform effort" (according to executive staff of the Financial Services Agency), failure to attain objectives is in principle not seen as a cause for management to retire. Issuance of a business improvement order will however be considered if profitability is 30% or more below target at the end of the plan's term, or if the expense ratio or NPL ratio have deteriorated since the time of the fund injection.

From the foregoing it is clear that by setting high hurdles for regional banks, etc., to obtain public-fund injections that do not lead to a merger, the momentum towards restructuring and consolidation will receive a further impetus before the full adoption of the deposit insurance cap. Simultaneous with an opinion held among regional financial institutions that "options for financial strengthening have increased with a view to the drastic disposal of non-performing loans," voices concerned about restructuring under the guidance of regulatory authorities abound because there also exists a risk of being cornered into filing an application under the new law as the result of a rigorous audit by the Financial Services Agency.

Japan's personal financial assets are on a scale of ¥1,400 trillion, of which cash and deposits account for at least 50%, while investments in stocks, investment trusts and other high-risk assets reach a weighting of around 7%. To correct the structures resulting from a long-continuing overemphasis on saving accounts, the government has been working to promote a national policy line calling for a change from "indirect finance to direct finance" and "from saving to investing." One example, with a view toward a new plan to follow the financial reconstruction program ending in FY 2004, proposes, in addition to investor protection rules, a comprehensive policy for financial strengthening, affecting not only banks but also securities firms and insurance companies.

The meaning of financial system normalization is shifting from the stage of NPL disposal to the reinvigoration of Japan's economy by establishing multiple channels for funds to circulate, with the full adoption of the deposit insurance cap no longer destined to become a symbol of structural reform, but just a milestone on the way to economic revitalization. Initiatives that build on new trends have been coming to the fore, such as regional banks entering into partnerships with securities companies and launching brokerage intermediary services at the bank counter. With the forthcoming full implementation of the deposit insurance cap, regional financial institutions will doubtless see a further acceleration in the reconfiguration of their business operations, including restructuring and consolidation. JS

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