Road to Revival Amid Mega-Competition

By Yoshida Satoshi

Japan's "Big Bang" sweeping financial system reform was launched on April 1, Some of its initial steps took effect, with the revised Foreign Exchange and Foreign Trade Control Law and the Bank of Japan Law, stock trading commissions partially liberalized, and a ban on financial holding companies lifted. However, banks, securities companies and other Japanese financial institutions are in a depressed and even pessimistic mood.

Why is this? One reason is a delay in writing off swollen non-performing loans that have gone sour in the aftermath of the burst of the late 1980s economic bubble. Another is slumping prices of real estate and stocks that used to underpin the credibility of financial institutions as "latent assets" with unrealized profits. A third problem is the collapse of cozy "inner circles" in which all financial institutions, both strong and weak, were protected under the Ministry of Finance's policy of keeping them afloat like a convoy of vessels. And a fourth is a moral hazard or loss of moral awareness among bankers as seen in the arrest or police summons of their colleagues for entertaining senior Ministry of Finance and Bank of Japan officials to an unreasonable extent. In fiscal 1998 ending next March, there will be two distinct groups of financial institutions—one group emerging from the chaos and the other dropping out—signaling the start of a test for them to shift from a period of restructuring to that of rebirth.

Most banks in deficit

Most Japanese banks, including all the nine largest commercial banks, known as "city banks," are in the red on their current accounts. For their 1997 accounting year ended March 31, 1998, Japan's 19 top banks wrote off a total of ¥10 trillion in problem loans, up from the ¥6.17 trillion disposed of the previous year. The huge amount of bad loans written off in the past years indicates that disposal of such loans is in a final stage. In the 1980s, banks in the United States were in crisis while Japanese banks monopolized the top ranks on a global list of banks. In the 1990s, the landscape on the world banking scene has been reversed, with many Japanese banks having revised downward both pretax and net earnings projections for the latest accounting year ended March 31 from levels forecast last year.

Major commercial banks, long-term credit banks and regional banks are enjoying record profits from regular operations—lending and deposit taking—as the cost of raising funds has remained low thanks to record-low domestic interest rates, allowing banks to receive much higher interest on loans than that paid on deposits and thus earn handsome interest margins. But they eventually end up in the red as they close the books, because they have to write off massive bad loans—including those to insolvent borrowers—and sell off securities priced lower than their cost at purchase.

Banks have been chalking up deficits on the books for nearly 10 years since the collapse of the bubble economy, or since 1989, when stock market prices hit record highs. One reason is that banks did not know how much they had to write off as non-performing loans. The combined total of publicly announced bad debts held by commercial banks, long-term credit banks, trust banks and regional banks amounted to ¥21.7 trillion as of Sept. 30, 1997.

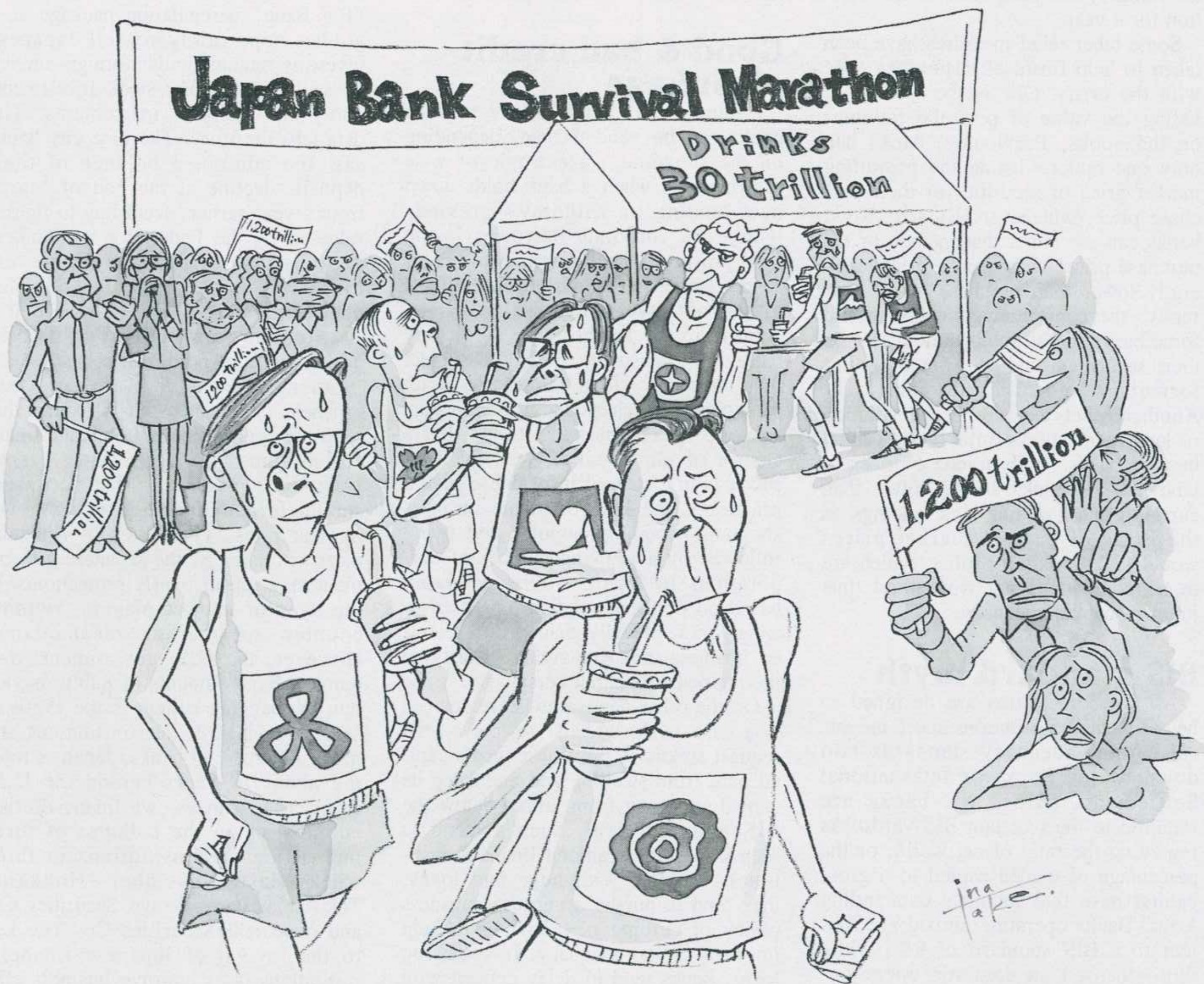
Bank loans are classified into four categories according to their prospects of collection. The above total of bad debts consists solely of the worst group —known as Category IV—which comprises irrecoverable or worthless loans frozen as bad debts. Grouped under Category III are loans which may result in losses due to grave anxiety about their collection. Category II loans require adequate risk control due to some uncertain factors such as delayed principal repayments or interest payments. All these categories included, the total amount of problem loans swells to ¥76.7 trillion.

Since the amount of bad loans depends on the earnings behavior of individual and corporate borrowers, it increases during a recession and declines during a boom. Loans under Category II are considered as relatively sound debts but could turn sour depending on economic activity. Financial institutions holding such loans are not optimistic about the prospects of collection.

One major challenge facing financial institutions today is how to ensure the transparency of their operations through public disclosure of related information. Ironically enough, banks which are willing to reveal all questionable loans, write them off and thus report losses, earn a good reputation from the market and consumers, and eventually boost their credit standings. In reporting semiannual earnings results in the fall of 1997, Bank of Tokyo-Mitsubishi and some other major banks chalked up losses from the disposal of bad loans for the April-September first half of fiscal 1997, while most other banks remained mum on their own potential loan losses. These front-running banks saw their credit standings improve clearly, but Hokkaido Takushoku Bank, which did not disclose even the total sum of bad loans, became insolvent and was dissolved last November.

Public support temporary

Two bills aimed at stabilizing the financial system were enacted into law last March and took effect immediately. The pair of legislative bills calls for a total of ¥30 trillion in taxpayers' money to be pumped into the banking sector in order to protect depositors and ensure



the stability of the financial system. However, this does not mean immediate injection of public funds. Under one of the laws, preferred stock and subordinated bonds issued by financial institutions are purchased with public funds, thus giving the issuers ample cash to beef up their capital adequacy. Taxpayers thus become shareholders in issuing financial institutions but face the risk of losses in the event the issuers become insolvent. Under the scheme, public funding is offered on condition of job cuts, consolidation of branches and other streamlining efforts by financial institutions. A total of 21 banks have utilized the scheme to raise ¥2.069 trillion—in exchange for the reduction of more than 16,000 jobs—in an initial step toward regaining financial soundness.

The Ministry of Finance has also taken a measure to help some financial institutions buy time before they are required to meet certain requirements. The ministry has introduced a system under which it can order institutions in poor financial shape to take action necessary to improve specified financial indicators. If they fail to do so, they may be eventually ordered to halt operations. The mechanism of "early corrective measures," comparable to an early warning system for national defense, was put into force on April 1, at the start of fiscal 1998. However, this is applicable only to banks operating internationally. In the case of banks engaged solely in domestic operations,

the ministry has postponed its introduction for a year.

Some other relief measures have been taken to help financial institutions cope with the crisis. One is the method of listing the value of portfolio holdings on the books. Previously, banks had only one option—listing the prevailing market price of securities or their purchase price, whichever is lower. Now, banks can use either that method or the purchase price; with market prices generally lower than purchase prices currently, the conventional method would force banks to list book-value losses on their securities holdings, but the latter formula would eliminate such risk. Another relief measure is the addition of land revaluation profits to the capital base of banks. With purchase prices of land held by banks usually lower than current prices, valuing land holdings on the basis of current market prices would yield windfall profits, which are to be counted as net worth and thus improve capital adequacy.

BIS standard myth

All these measures are designed to help financial institutions meet universal capital-adequacy standards laid down by the Bank for International Settlements (BIS). All banks are required to meet certain BIS yardsticks regarding the ratio of net worth, or the percentage of owned capital to a gross capital base that includes outstanding loans. Banks operating abroad are subject to a BIS standard of 8%, while those focused on domestic operations must meet a less strict standard of 4%.

However, a credit crunch has ensued in Japan as all banks have frantically tried to reduce their capital base by holding down new lending besides seeking to boost net worth. Their reluctance to offer new loans has led to a shrinkage in the credit supply, badly affecting some corporate borrowers, particularly smaller businesses. Funds lent by banks are the lifeblood of economic activity. If funds do not circulate fully, the strength of businesses wanes—even in Japan, where technological levels of manufacturers are high and the quality of labor is good.

Good & bad credit shrinkage

Reluctance to lend on the part of banks can be good or bad, depending on the situation. An example of wise reluctance is when a bank holds down new lending or withdraws previous loans to a corporate borrower facing little prospect of business improvement, so the lender can avoid adverse effects of the borrower's eventual collapse. Seen from the lender's side, it is only natural as a business strategy to subject the borrower's loan request to strict screening and reject lending if the borrower's performance stands little chance of improvement or if the borrower is in a state of insolvency; such a practice is the kind of global business standard becoming popular and being followed by a growing number of corporations in Japan, where sympathy based on personal relationships used to weigh more heavily than profit-oriented business manners giving priority to the interests of shareholders.

On the other hand, unwise reluctance is a case where a bank rejects a loan request simply to prevent its gross capital base from swelling and thus keep its capital adequacy from falling below the BIS-required level. Such a trend is seen in particular among financial institutions saddled with huge bad loans; they tend to pursue a negative business policy of curbing new lending to help improve capital adequacy. In collecting loans, banks tend to delay contact with borrowers from whom loan recovery is difficult and instead hasten collection from sound borrowers such as fast growing venture businesses. In fact, it is often easy to collect loans from blue-chip companies.

Foreign competitors aggressive

Personal financial assets in Japan are estimated at ¥1,200 trillion, second only to those in the United States. With an eye on the huge market potential, major financial institutions around the world are pinning high hopes on the Japanese "Big Bang" deregulation package as a golden opportunity to sell Japanese investors mutual funds, foreign-currency savings accounts, stock investments and other financial instruments. The data tells the story. The nine city banks saw the combined balance of their deposits decline at the end of March from a year earlier, according to figures released by the Federation of Bankers Associations of Japan. However, Citibank of the U.S. and other foreign banks operating in Japan recorded a steep rise in their outstanding deposits during the same period.

Japanese consumers are not "buy Japanese" nationalists. It is natural that personal funds should flow into financial instruments offering better interest yields to depositors or that borrowers should turn to funds carrying lower interest rates. The series of financial measures taken by the Japanese government may appear overly protectionist in the eyes of market players, running counter to market mechanisms. However, the U.S. government, too, pumped huge amounts of public money into the banking system in the 1980s to salvage savings & loan institutions and major commercial banks. Japan is trailing about 10 years behind the U.S. experience, with its own financial crisis culminating in the collapse of three major financial institutions in three weeks last November—Hokkaido Takushoku Bank, Sanyo Securities Co. and Yamaichi Securities Co. The key to the revival of Japanese financial institutions is to improve business efficiency and ensure transparency of their operations, without being dictated too much by the BIS standards and credit ratings. A decade ago, when the U.S. banking system was in crisis, calls for a review of the BIS requirements were prevalent within the federal government as well as in the business community. Japan could learn a lesson from the bitter U.S. experience. JJTI

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