

## **Hirohide Yamaguchi: Challenges for Japan's financial system after the financial crisis**

Speech by Mr Hirohide Yamaguchi, Deputy Governor of the Bank of Japan, at the symposium co-hosted by the University of Tokyo and Development Bank of Japan, Tokyo, 10 December 2010.

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### **Introduction**

It is my great honor to have an opportunity to speak at a symposium co-hosted by the Center for Advanced Research in Finance, the University of Tokyo, and the Research Institute of Capital Formation, Development Bank of Japan.

While the global financial crisis that erupted about two years ago, triggered by the failure of Lehman Brothers has not been completely over, the situation has significantly improved. Progress has also been made in establishing an international framework for preventing the recurrence of the recent global crisis in the future. Meanwhile, Japan's Financial System has been relatively stable, compared with that in the United States and Europe, but some challenges have become clear as the effects of the crisis reached here in various forms.

In those circumstances, it is indeed topical to discuss today how the future of Japan's financial system should be, and I am looking forward to the discussions by the experts. For my part, I will briefly review the financial crisis and talk about the future of Japan's financial system and challenges for Japanese financial institutions.

### **I. Global financial crisis and Japan's financial system**

#### **A. *The international financial system after the Lehman shock***

These two years following the failure of Lehman Brothers have been indeed a tumultuous period for the global economy and the international financial system. Following the failure of Lehman Brothers, a financial crisis erupted on a global scale, and the global economy deteriorated simultaneously and rapidly. Subsequently, due to the effects of exhaustive policy responses by the governments and central banks, the global economy gradually started to recover around the spring of 2009 and profits and funding conditions of major U.S. and European financial institutions improved significantly. However, against a backdrop of European fiscal problems including those in Greece and Ireland as well as heightened uncertainty about the future of the U.S. economy, there have been phases in which financial markets have become unstable again since the spring of 2010. In the United States and Europe, amid continued balance sheet adjustments, bank lending has been sluggish and credit costs have been somewhat at high levels. The international financial system is still in a fragile state.

#### **B. *Effects on Japan's financial system***

Looking at the impact of the global financial crisis on Japan's financial system, there was relatively a large decline in the functioning of CP and corporate bond markets. On the other hand, the direct impact on financial institutions central to Japan's financial intermediation remained relatively small, compared with that on U.S. and European financial institutions, and the stability of the financial system as a whole was maintained. Three reasons can be pointed out.

First, and probably the major reason, was that Japanese financial institutions had been generally cautious about taking risks based on the experience of the financial crisis since the

1990s. Specifically, their investments in complex financial products such as collateralized debt obligation had been low and they had not adopted, unlike major U.S. and European financial institutions, the originate-to-distribute business model in a full-fledged manner.

Second, in terms of incentive, there was relatively low pressure from shareholders who pursued short-term returns and the remuneration system of financial institutions' managers was also not conducive to short-term risk-taking activity.

Third, as a result of the efforts by the public authorities to enhance the robustness of the financial system, including an establishment of a resolution framework for financial institutions, concern about the surfacing of systemic risk did not heighten among depositors and market participants.

Nevertheless, the global financial crisis has also affected Japan's economy in various forms such as a deterioration in economic activity, a fall in stock prices, and a decline in market functioning. Japanese financial institutions have also been hit accordingly in the form of impairment due to a decline in stock prices and of an increase in credit costs. In the meantime, the challenges Japanese financial institutions have been faced with, such as the weakness of core profitability and vulnerability against stock price fluctuations, have been highlighted again. I will come back to the details later.

## **II. Prospects for Japan's financial system**

### **A. Changing environment surrounding Japan's financial system**

The topic of today's panel discussion is "Whither the Financial System?" It is quite a difficult question, but in the hope of providing some reference to the discussion, I offer some consideration of how Japan's financial system should be after the financial crisis both from macro and micro perspectives. As it might be useful to consider first what changes are expected in the environment surrounding Japan's financial system in the future, let me start with the following three points.

#### *Strengthening of global regulation and supervision*

First, financial regulation and supervision will be strengthened on a global basis. On regulations, vigorous discussions are ongoing internationally, and the issues covered are quite wide, ranging from banks' capital adequacy and liquidity, leverage, remuneration, and accounting. In terms of supervision, the scope will be widened mainly to cover those which have not been taken up sufficiently in the past, such as the so-called shadow banking system.

Let me talk about some recent developments. For example, in terms of banks' capital, an internationally common new regulatory framework, namely, Basel III, has recently been agreed on. Both the quality and the quantity of bank's capital will be enhanced, albeit gradually, through increasing the ratios of common equities and Tier I that have a high loss absorbing capacity at the time of bankruptcy. Like the so-called "Volcker Rule" in the United States, there are also moves to directly regulate banks' high risk businesses such as proprietary trading and investment in hedge funds.

Through next year, the issue of moral hazard associated with systemically important financial institutions (SIFIs), namely, the "too-big-to-fail problem," is expected to be discussed, including how to specify SIFIs and what responses will be necessary in preventing the failure of the specified SIFIs or in minimizing the impact once they fail. If I can offer my opinion on that issue, given the essence of the issue of avoiding moral hazard, it would be desirable to take a flexible approach. Namely, in accordance with the situation in each country, appropriate responses should be chosen from various options including not only a bank capital surcharge but also a liquidity surcharge and strengthening of supervision, and establishment of a resolution framework.

### *Increase in new demand for funds*

Second, as the contents of demand for funds financial institutions are faced with at home and abroad change, there is a possibility that new demand for funds will increase. For example, emerging economies are expected to continue to be the driving force of the global economy, and thus fund demand for improving infrastructure and for firms' business fixed investment as well as for asset management associated with an accumulation of personal financial assets in those economies, is expected to further increase. Turning to the domestic areas, in the process of firms exploring new growth strategies and rebuilding the supply system for goods and services, there could be new fund demand for research and development as well as business relocation. Moreover, as the industrial structure is expected to change further, there will be increased importance of fund demand associated with corporate rehabilitation and realignment such as M&A finance and DIP finance and of fund demand from emerging companies that challenge new areas. Moreover, needs for asset management mainly by elderly people are expected to diversify and increase.

### *Changes in business models for globally active major financial institutions*

Third, business models of globally active major financial institutions might change. Specifically, the originate-to-distribute business model that had been actively used prior to the crisis will relatively decrease in number and the proportion of commercial banking business that put more emphasis on the relationship with customers is likely to increase: that is called "back to basics." Moreover, as business regulations such as the Volcker Rule will be implemented and regulation and supervision will be reviewed in order to restrain "too-big-to-fail," it is likely that the moves toward mere scale expansion and toward excessive risk-taking will be restrained. In terms of funding, as awareness about liquidity risk heightened considerably through the experience of the financial crisis, more emphasis would be put on retail deposits, which have more stability than short-term wholesale funding such as repo transactions. Such changes in business models of globally active major financial institutions could have an impact on the business models and the competitiveness of Japanese financial institutions.

## **B. *Future of Japan's financial system: macro perspective***

I will next touch on how Japan's financial system should be in the future from a macro perspective, namely, a perspective of financial system structure. Needless to say again, Japan's financial system has long been characterized by financial intermediation centering on banks. In this situation, from a perspective of improving the functioning and stability of the financial system, many have argued as follows. It is desirable to have not only bank-based financial intermediation but also financial intermediation through the capital market, inclusive of the so-called market-based financial intermediation. To that end, it will be necessary to increase the supply of risk money and eventually enhance the diversification of households' asset investment. In fact, many policy measures have been taken to bolster such moves, including enhancement in market infrastructure, improvement in market transparency, and investor protection.

If we revisit the discussions based on the experience of the recent crisis, it can be summarized as follows.

First, the complementarity of functioning between banks and capital market is important. While the functioning of corporate bond and CP markets declined significantly in Japan during the crisis, bank lending substituted the financial intermediation function during such phase and underpinned the rapidly deteriorating firms' funding. Subsequently, when the functioning of the capital market was restored, bank lending started to decline. Therefore, it became clear again that the existence of multiple financial intermediation channels is important for the availability of firms' funding and the robustness of the financial system.

Second, the existence of multiple financial intermediation channels alone would not be sufficient to ensure financial system stability. Former Federal Reserve Board Chairman Greenspan once pointed out that one reason for Japan's protracted crisis was that its financial intermediation was concentrated on banks, and the financial system like that in the United States, which has a variety of financial intermediation channels, would be more robust against shocks to the financial system and the real economy. However, the fact that the crisis deepened in the United States implies that such view is not necessarily correct. What is important is that each financial system participant maintains business soundness and pursues solid risk management, and, at the same time, that the regulatory and supervisory authorities and central banks recognize where the risks lie in the financial system as a whole from a macro perspective and take proper responses. Namely, I believe it is critical for financial system stability to maintain not only the robustness of the financial system structure but also self discipline of financial system participants and the risk capturing capability of the authorities at a high level as a whole.

### **C. Challenges for Japanese financial institutions: micro perspective**

I will next talk about two specific challenges for Japanese financial institutions. I will touch on the challenges for the authorities in the final part of my speech.

#### *Selecting business models and sustained improvement in profitability*

The first and the biggest challenge for Japanese financial institutions is to raise their profitability in a sustained manner. Looking at the recent business performance of Japanese financial institutions, core profitability has been trending down due partly to a narrowing profit margin and declining lending outstanding. For that reason, an increase in profitability is an imminent challenge. In doing so, while it applies to every industry, it is essential to choose the optimal business model that utilizes an institution's respective realms of expertise. As I have mentioned earlier, competition in commercial banking business, in which Japanese financial institutions are mainly engaged, is expected to intensify at home and abroad. Japanese financial institutions that receive domestic stable personal deposits have an advantage, including funding for overseas activities, in terms of resilience against liquidity risk. Moreover, a characteristic of Japanese financial institutions that traditionally put emphasis on the customer relationship is an important element in terms of "information production," which is a key to conducting lending business, and could serve positively for businesses not only in Japan but also in overseas including Asian countries. Furthermore, Japanese firms and households, which are the main customers of Japanese financial institutions, are not in need of balance sheet adjustments like those in the United States and Europe. Therefore, in terms of the competitiveness of Japanese financial institutions compared with that of the U.S. and European financial institutions, I believe there is nothing to be pessimistic.

With that recognition, what is necessary for Japanese financial institutions is, at first, to hone their skills in identifying firms with growth potential and continue to strive to find new borrowers and also tap new fund demand from the existing borrowers. While a fundamental problem Japan's economy is faced with is a decline in medium- to long-term growth expectations, to overcome such problem, it is important that private firms promote their innovative activities and pursue a new source of growth at home and abroad. It is essential that financial institutions also firmly support such moves. In that regard, looking at the recent efforts by Japanese financial institutions, there have been proactive developments to utilize their respective characteristics, which is quite assuring. The major banks have been further expanding their businesses in Asian and other emerging economies regardless of customers' nationality, and the regional banks have been making efforts to tap growth areas in the regions, including distinct local firms. I hope that Japanese financial institutions will establish their respective business models and pursue proactive efforts including tapping new fund

demand, while skillfully gauging various changes in the business environment at home and abroad.

Second, it is also important to raise the core profitability of the existing borrowing firms through enhancing their governance. It has often been said in Japan that corporate governance that raises a firm's profitability has been weak. There are many views that, one way to overcome such weakness is to use equity funds, which have a strong tendency to search for yields, as leverage to strengthen corporate governance from outside. Financial institutions can play a significant role in that regard by being involved in creating investment funds. Moreover, the role of a financial institution as a lender is also not insignificant. Many Japanese financial institutions appear to have been relying too much on real estate collateral and personal guarantees when providing loans especially to medium and small firms, and governance after loan provision has not necessarily been sufficient. Financial institutions are required to bolster firms' growth constantly through deepening the ongoing relationship with them. In complementing such support, lending that uses movable assets, such as inventories, or accounts receivables as collateral – the so-called asset-based lending – or that utilizes covenants for medium and small firms can be useful options.

Third, it is intrinsically important for financial institutions to play a role in encouraging metabolism, for example, corporate realignment. At the same time, it is also important that financial institutions also aim at metabolizing themselves through mergers, consolidation, or unbundling, in accordance with their own business models. For example, financial institutions that aim to be globally active could pursue the advantage of scale or scope through mergers and acquisitions. By contrast, for financial institutions that aspire to enhance their presence in niche markets, limiting functions and concentrating resources could be an important option. Those financial institutions' behavior is expected to not only improve management efficiency of individual financial institutions through increased competitiveness but also lead to increased profitability of the financial sector as a whole through efficient resource reallocation.

#### *Proper risk management*

The second challenge for Japanese financial institutions is proper risk management. In that regard, there is an increasing awareness among financial institutions, including those overseas, of the importance of the following: to gauge risk comprehensively, for example, by way of stress testing, without relying too much on specific quantitative methods such as VaR, and to share the recognition of risks not only in the risk management section but also including top management. In addition to such general challenge, a reduction in market risk associated with stockholdings, in particular, would be a specific challenge for the future.

As for market risk associated with stockholdings, many Japanese financial institutions have recognized the magnitude of price volatility associated with stockholdings and have been taking steps to reduce such risk as a management priority. Nevertheless, the pace of reduction in stockholdings has somewhat slowed recently due partly to sluggish stock prices and thus the due amount of market risk associated with stockholdings still remains. Of course, stockholdings could have implications as a part of corporate governance or could play a role as a tool to gain total profits including fee revenues. Even in those cases, however, it is important to firmly identify the risks and returns. On that basis, if it is judged that the risk is larger, financial institutions are required to steadily promote efforts toward the reduction of their stockholdings.

#### **Concluding remarks**

While I have been talking about the challenges for Japanese financial institutions, the recent crisis left various lessons for the regulatory and supervisory authorities as well as central banks. In relation to ensuring financial system stability, one lesson might be that "it is important to gauge with a sharp distinction between micro-level risks, such as risks of

individual financial institutions, and risks of the financial system as a whole.” By taking that point into account, the importance of the so-called macroprudence – which aims at accurately gauging the risks of the financial system as a whole, with due recognition of the relationship between economic activity, financial markets, and financial institutions, and taking necessary policy responses – has been increasingly recognized on a global basis.

In that regard, the Bank of Japan has been, from a standpoint of conducting monetary policy, monitoring a wide range of economic and financial developments at home and abroad and making in-depth research and analyses, as well as striving to improve infrastructure, including financial markets and the payment and settlement system. In addition, the Bank has been gauging business conditions of individual financial institutions through on-site bank examination and off-site monitoring, and information and perspectives obtained through such processes have been utilized in gauging the condition of the financial system as a whole and in risk analyses, and published in the *Financial System Report*. Also, the Bank took measures such as purchases of banks’ stockholdings and provision of subordinated loans aiming at ensuring the stability of the financial system as a whole. The Bank has thus been making various efforts on the macroprudence front.

Nevertheless, such efforts are only half done. For example, gauging macro risks is still not sufficient. From a viewpoint of strengthening macroprudential analysis, the Bank has been trying in the *Financial System Report* to broaden analyses to businesses other than banks, for example, insurance companies, to gauge macro financial imbalances, and to expand stress testing, but those efforts still remain at a stage of trial and error. In addition, the Bank is aware that, even if the macro risk is properly gauged, it still remains as a future challenge to examine what specific policy measures would be desirable to address the risk.

The Bank will, including the responses to the challenges I have mentioned, continue with the efforts to ensure stability of the financial system.