

Bank of Japan presents summaries of articles published in the November edition of its Quarterly Bulletin

Bank of Japan, Communication, 1/12/98.

Profits and Balance-Sheet Developments of Japanese Banks in Fiscal 1997

Overview

Operating profits of Japanese banks in fiscal 1997 amounted to ¥5.4 trillion, down by 14% from the previous fiscal year.¹ This decrease was primarily due to the following factors: (1) the disappearance of a temporary increase in trust fees (income) of trust banks in fiscal 1996; (2) the modest fall in net interest income on domestic operations due mainly to narrowing interest margins; and (3) the slight decrease in gross profits on international operations as a result of the expansion of the “Japan premium” and the downsizing of overseas branches and subsidiaries.²

Transfer to the special loan-loss provisions (SLP) and loan write-offs including those in trust accounts³ amounted to ¥13.3 trillion, which is almost the same figure as the peak recorded in fiscal 1995.⁴ Due to a considerable amount of transfer to the SLP and loan write-offs, both recurring losses (¥5.2 trillion) and net losses (¥4.8 trillion) marked record highs.⁵

Risk-based capital adequacy ratios at end-March 1998 at many banks exceeded those at end-March 1997. This improvement was due mainly to banks’ efforts to reduce their risk-adjusted

¹ “Japanese banks” refers to All Banks, comprising the member banks of the Federation of Bankers Associations of Japan (*Zenginkyo*), which consists of 10 city banks, three long-term credit banks, seven trust banks (excluding foreign-owned trust banks and trust banks that started business after October 1993), the 64 member banks of the Regional Banks Association of Japan (referred to as regional banks), and the 64 member banks of the Second Association of Regional Banks (excluding Hanwa Bank, which was liquidated in January 1998; referred to as regional banks II). Figures in this report exclude data for Hokkaido Takushoku Bank, Tokuyo City Bank, and Kyoto Kyoei Bank.

“Operating profits” signifies earnings from core banking operations and is calculated by subtracting “transfer to the allowance for possible loan losses,” “general and administrative expenses,” and “debenture issuance expenses” from the sum of “net interest income” (the excess of interest income on such items as loans and securities over interest expenses on such debts as deposits and debentures), “net fees and commissions” (net income on fees and commissions received/paid on funds transfers and other service transactions), “net trading revenue” (applied to banks with trading accounts; gains/losses on transactions for trading purposes such as trading-related derivative transactions and gains/losses on year-end valuation at market or fair value), and “net other operating income” (e.g. net gains related to bond and foreign currency transactions).

² The temporary increase refers to profits resulting from the write-back of the special reserve funds held by trust banks. Special reserve funds are accumulated to provide for situations in which the value of a loan trust falls below the amount of the principal. The ratio of required reserve funds to the amount of the principal was lowered from 3% to 0.5% by a revision of a government ordinance. Trust banks wrote off nonperforming loans in trust accounts, using part of the temporary profits in trust fees. The remainder of the profits was accounted as trust fees included in net fees and commissions in banking accounts.

³ In accordance with the Loan Trust Law and the Trust Business Law, trust banks guarantee the principals of banking-type trusts (loan trusts and jointly managed money trusts). Therefore, loan write-offs in trust accounts are included in the total figures of transfer to the SLP and loan write-offs.

⁴ The amount includes loan write-offs, transfer to the SLP, losses from the sales of nonperforming loans to the Cooperative Credit Purchasing Company (CCPC), and other renunciations of claims.

⁵ Reflecting the fact that banks began to be allowed to value listed stocks at cost, losses from stock write-downs declined significantly. As a result, net stock-related gains increased to ¥2.9 trillion, three times higher than those in the previous fiscal year. Net stock-related gains/losses are calculated by subtracting the sum of losses from stock selling operations and stock write-downs from gains on stock selling operations.

assets and various measures taken by the government in December 1997 to stabilize the Japanese financial system.

Although several years have elapsed since the bursting of the economic "bubble", transfer to the SLP and loan write-offs reached levels as high as the peak recorded in fiscal 1995. This reflected the emergence of large corporate bankruptcies and the introduction of a new self-assessment system on banks' asset quality to primarily determine appropriate loan-loss provisioning and loan write-offs under the Prompt Corrective Action (PCA) directives.

One of the key policies for Japanese banks will be to remove nonperforming loans from their balance sheets by such means as selling collateral real estate, in addition to steadily disposing of nonperforming loans and disclosing further information about their business. These efforts could moderate serious impacts of fluctuations in collateral real estate prices on the asset quality of Japanese banks, and thus ensure the reliability of the information included in their balance sheets, and finally restore market confidence in their soundness. In addition, the sales of collateral real estate enable banks to plan flexible management strategies; and reinvestment of the cash inflow from the sales will improve banks' profitability.

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Checklist for Risk Management (Revised 1998 Edition)

Objectives of the Checklist

The Bank Supervision Department of the Bank of Japan initially compiled the Checklist for Risk Management (hereafter: the Checklist) in December 1987. To provide examiners with guidance in reviewing the adequacy of risk management at individual banks during on-site examinations, the Bank completely revised the Checklist in May 1996, and it was distributed to financial institutions under the Bank's supervision as well as to various other financial institutions in the belief that it could serve as a reference as they undertake initiatives to check and strengthen their risk management systems.

Over the two years since the last revision, major revisions of institutional systems have been undertaken in Japan reflecting drastic changes in the financial and social environment, and in order to deal with the deterioration in business performance of Japanese financial institutions. Furthermore, consensus has been reached and various reports have been released relating to risk management in the international arena such as that of the Basle Committee on Banking Supervision, against the background of steady progress in financial deregulation and refinement of risk management skills.

Meanwhile, as part of the review of its bank supervision functions accompanying the enactment of the Bank of Japan Law of 1997, the Bank Supervision Department revised and expanded the 1996 edition of the Checklist for Risk Management, and distributed the revised 1998 edition of the Checklist to financial institutions under the Bank's supervision and various other financial institutions on June 19. With a view to securing transparency of bank supervision, the revised 1998 edition of the Checklist has been made generally available as much of it should be useful to nondepository financial institutions not directly subject to the Checklist (securities companies, tanshi companies, etc.), depository financial institutions not under the Bank's supervision (some

shinkin banks, credit cooperatives, agricultural cooperatives, labor credit associations, etc.) and nonfinancial business firms.⁶

Major Features of the Revised 1998 Edition

The new edition of the Checklist for Risk Management has been revised and expanded to reflect developments in the financial conditions and institutional reforms in Japan since the previous revision (May 1996), as well as international discussions regarding risk management. In compiling this edition, the Bank also considered and applied experience gained using the previous editions of the Checklist and opinions and comments gathered from financial institutions under the Bank's supervision.

The overall framework in the new edition is unchanged from the 1996 edition. The Checklist is categorized by type of operation (I. Management and Internal Controls, II. Lending Operations, III. Market Operations and Asset and Liability Management [ALM], and IV. Business Operations and Electronic Data Processing [EDP]). The sample questions for examining the progress in risk management of financial institutions under each checkpoint are organized starting from basic matters and progressing to technical details. Like its predecessor, the revised 1998 edition includes some items which even banks with advanced risk management skills require more time to achieve. The Checklist is therefore not a minimum standard by which all banks must abide; rather, it is meant to be used flexibly by as many financial institutions as possible as a guideline for their business operations.

Concretely, items related to legal compliance have been largely expanded in Section I (Management and Internal Controls) to include important points such as whether the management fully recognizes the importance of legal compliance and takes the lead in establishing compliance awareness within the financial institution, and whether there is a systematic framework with concrete procedures for implementing legal compliance and whether it functions adequately. In its revision of Section I, the Bank considered and included the aims set forth in the "Framework for the Evaluation of the Internal Control Systems" released by the Basle Committee on Banking Supervision. In Section II (Lending Operations), a new item regarding financial institutions' self-assessment of assets has been added in response to the introduction of the self-assessment system. Necessary amendments have been made in Section III (Market Operations and ALM) to deal with the inclusion of the trading account, with due consideration given to the "Principles for the Management of Interest Rate Risk" released by the Basle Committee on Banking Supervision.

Application of the Checklist in the Bank's Examinations of Risk Management

The Bank's examinations review both the strength of financial institutions and their risk management ability, which prevents the emergence of losses and sustains their soundness. The Checklist for Risk Management is used as a handbook by examiners when assessing the risk management capability of financial institutions. Simultaneously, with a view to smoothly carrying out our on-site examination of risk management and to have a sufficient exchange of opinions with the subject financial institution, the Bank requests the institutions concerned to evaluate their abilities using the Checklist at each examination.

⁶ The full text of this article is available on the Bank of Japan website at www.boj.or.jp/en/index.htm.

Needless to say, financial institutions must take the initiative in establishing their own risk management system based on their own judgment, hence the actual system will differ according to the individual institution's management strategy and business performance. In this sense, the Bank does not intend to apply the Checklist uniformly to all financial institutions, but will utilize it giving full consideration to the situation of each bank.

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Foreign Exchange and Derivatives Markets Turnover Survey (April 1998)

Outline of Survey

In April 1998, the Bank of Japan conducted the Foreign Exchange and Derivatives Markets Turnover Survey. This survey is conducted once every three years by the central banks or monetary authorities of participating countries and regions, and is coordinated by the Bank for International Settlements (BIS).⁷

The April 1998 survey was conducted by the central banks or monetary authorities of 43 countries and regions, which collected the data from approximately 3,200 reporting institutions in total.⁸

The Bank of Japan obtained the data from 255 Japanese banks, 101 foreign banks, 3 Japanese securities companies, 6 foreign securities companies, and 10 FX brokers.⁹

The BIS will aggregate and publish the data collected from participating central banks or monetary authorities on a global basis.

In this survey, the foreign exchange transactions are classified into three instrument types, and derivatives activities are classified into five instrument types.¹⁰ Transactions of each type of instrument are further broken down by currency or currency pairs, category of counterparties, and location of counterparties (local or cross-border).

The daily volume of turnover is adjusted for the local double-counting of transactions between

⁷ The first survey coordinated by the BIS started in 1986 for foreign exchange activity, and the derivatives section was added to the survey in 1995.

⁸ Participating countries and regions are as follows (the 26 countries and regions that participated in the previous survey are underlined): Argentina, Australia, Austria, Bahrain, Belgium, Brazil, Canada, Chile, China, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, the Philippines, Poland, Portugal, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, the United Kingdom, and the United States.

⁹ Foreign exchange brokers are to report only foreign exchange transactions (including cross-currency swaps and FX options), and securities companies are to report only derivatives activities.

¹⁰ Classification of transactions:

- (1) Foreign exchange activities:
Spot, outright forwards, foreign exchange swaps
- (2) Derivatives activities:
Interest rate-related derivatives: forward rate agreements (FRAs), interest rate swaps (IR swaps), interest rate options (IR options)
Foreign exchange-related derivatives: cross-currency swaps, foreign exchange options (FX options)

two reporting institutions in Japan. Meanwhile, double-counting of cross-border transactions between two reporting institutions will be adjusted by the BIS. Thus, a simple aggregation of the results of all participating countries and regions will not be equivalent to the global statistics released by the BIS.

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Regular Derivatives Market Statistics in Japan (Yoshikuni Statistics) (end-June 1998)

Outline of Survey

The central banks of the G-10 countries¹¹ and the Bank for International Settlements (BIS) have combined efforts to introduce new global derivatives market statistics based on the “Proposals for Improving Global Derivatives Market Statistics (Yoshikuni Report)” published by the BIS in July 1996. The data were first collected at end-June 1998. In this paper, the Bank of Japan releases the results of this first Regular Derivatives Market Statistics pertaining to Japan.¹² The BIS will later publish the global results of outstanding derivatives positions of the reporting institutions.

The aim of the BIS in implementing a survey on global derivatives markets is to increase market transparency and to facilitate monitoring by central banks of these markets in regard to the macroeconomic and macroprudential concerns through two reporting frameworks, the first being semiannual statistics on derivatives outstanding covering only primary dealers, and the second being triennial statistics on derivatives turnover and outstanding covering a wider range of dealers. This first release of the Regular Derivatives Market Statistics corresponds to the first, while the April 1995 Central Bank Survey of Derivatives Market Statistics¹³ and the succeeding April 1998 Derivatives Market Turnover Survey – whose results in Japan are also published at the same time – correspond to the second.

The survey is based on the voluntary cooperation of reporting institutions, and 18 primary dealers participated from Japan (out of 75 institutions globally).

The survey consists of data on consolidated outstanding derivatives positions (notional amounts, gross positive and negative market values) of the reporting institutions, broken down by four risk factors (foreign exchange, interest rate, equity, and commodity), instrument, currency, counterparty type, and maturity.

The main features of the survey results for Japan are summarized in the following annex. For more details, please refer to the Bank of Japan website at www.boj.or.jp/en/index.htm.

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Responses to Comments on the Proposed Revision of the Flow of Funds Accounts: The

¹¹ Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

¹² The results were released on September 30, 1998.

¹³ For the results of the April 1995 survey in Japan, please refer to “Results of the Survey of Derivatives Market Activity in Japan” in the May 1996 issue of the *Bank of Japan Quarterly Bulletin*.

Bank of Japan's Final Decisions on the Revision

Introduction

The Bank of Japan compiled the flow of funds accounts (hereafter: FFA) first in 1958, covering data for the years from 1954 to 1957. Since 1996, it has been conducting a study aimed at the comprehensive revision of the FFA. Based on this study, the Bank made provisional proposals on details of the revision in early 1997, inviting users of the statistics to submit their views and suggestions to the Bank.¹⁴

The comments submitted were generally in favor of the revision. They also indicated that users hoped to employ the new FFA as a tool for monitoring the effects of financial system reform (the so-called Japanese “Big Bang”) and the continuing internationalization of the financial market. With regard to the details of the proposed revision, some comments supported the Bank’s approach, while others suggested alternatives relating to such aspects as sectoral and transaction classifications, and the methods and format used for publishing the FFA.

Substantial progress has been made with regard to the detailed treatment of Japan’s national accounts and the availability of data, both of which were not entirely clear when the provisional proposals for the revision were drafted. In conducting the study on the details of the revision since mid-1997, the Bank has kept these developments in mind and examined whether the comments submitted meet such criteria as (1) appropriateness of statistical treatment and data-recording methods; and (2) the usefulness of revisions based on those comments. The Bank has also reviewed issues that were still undecided in the provisional proposals. The Bank’s final decisions made through the above process are shown in tables, and this paper tries to explain the thinking behind them.¹⁵

Based on these final decisions, the Bank is now in the process of compiling the new statistics with a view to publishing them in 1999.

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Year 2000 Readiness in the Financial Industry in Japan

Introduction

With less than one and a half years before the year 2000, various industries in Japan are currently making a wide range of efforts to address the “Year 2000 problem”. The Year 2000 problem arises because many computers and application programs recognize the year by the last two digits instead of four. On January 1, 2000, those computers and application programs will represent the year as “00” and may assume the year to be 1900 instead of 2000. This can lead to incorrect processing of date-sensitive calculations by computers, which may cause disruptions in computer systems.

¹⁴ For details, refer to “Revision of Japan’s Flow of Funds Accounts” in the August 1997 issue of the *Bank of Japan Quarterly Bulletin*.

¹⁵ In addition to the points covered in this paper, numerous minor changes were made from the provisional proposals. This paper covers only the major points, and detailed explanations of individual sectors and transaction classifications will be provided separately.

If computer disruptions materialize, the adverse effects on financial institutions will be substantial because financial institutions rely heavily on computers, for example, host computers for the main accounting systems and information systems, and decentralized systems (i.e. local area networks [LANs] and personal computers [PCs]). If a financial institution fails to achieve Year 2000 readiness, it may not be able to confirm or manage settlement dates or transaction data, calculate interest rates or carry out accounting procedures, which can be a potential threat to its fundamental business of taking deposits, extending loans, and carrying out settlements.

There is a possible systemic risk if one financial institution or one payment and settlement system fails to achieve Year 2000 readiness. Banks and securities companies are mutually connected through various payment and settlement systems for settling transactions. If a financial institution fails to achieve Year 2000 readiness, the computer disruption could be passed on to other ones through their interdependence in financial transactions and settlement. If a computer failure due to a lack of Year 2000 readiness materializes in a settlement system, not only financial institutions but also end-users or customers will be affected because they may not be able to withdraw or transfer funds through cash dispenser (CD) and automated teller machine (ATM) networks.

The Year 2000 problem could seriously affect the business of individual financial institutions as well as the stability of payment and settlement systems. The Bank of Japan, with the cooperation of market participants, is therefore promoting Year 2000 readiness of individual financial institutions and payment and settlement systems.

This paper discusses how Japan's financial sector is addressing key issues of the Year 2000 problem and provides information on its progress in achieving Year 2000 readiness.¹⁶ After an overview of the results of the Year 2000 problem survey of financial institutions conducted by the Bank of Japan in June 1998, the paper presents (1) plans for external tests of payment and settlement systems; (2) global initiatives taken by international organizations including the Bank for International Settlements (BIS); and (3) an upcoming issue.

The paper focuses exclusively on the preparations being made by financial institutions and payment and settlement systems for the Year 2000 problem. It does not deal with preparations made by social infrastructures, such as telecommunications or utilities that support computer system operations, nor does it cover Year 2000 preparations of companies supplying host computers and software, although these deserve careful attention of financial institutions.

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¹⁶ This paper was originally published in the form of a brochure on August 14, 1998. For inquiries regarding the brochure, please contact the Financial and Payment System Office (tel: +81-3-3279-1111 [x2954], fax: +81-3-5255-6752) or the Bank Supervision Department (tel: +81-3-3279-1111 [x6442], fax: +81-3-5255-6755), Bank of Japan, at 2-1-1, Hongoku-cho, Nihonbashi, Chuo-ku, Tokyo 103-8660, Japan.