Masaru Hayami: Financial system stability and future agenda - need to strengthen the capital base

Speech by Mr Masaru Hayami, Governor of the Bank of Japan, at the Fiftieth Anniversary Symposium of the Institute for Financial Affairs, Tokyo, on 14 July 2000.

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I am pleased to be invited to this Symposium celebrating the 50th anniversary of the Institute for Financial Affairs.

Before I begin, allow me to explain one rule regarding monetary policy meetings under the new Bank of Japan Law, which became effective in April 1998. The rule dictates that the Governor, Deputy Governors and Members of the Policy Board should not, in principle, make remarks about monetary policy and operations immediately before or after monetary policy meetings. This is intended to avoid any unnecessary speculation or confusion which might be generated by such remarks. We call this the "blackout rule". Since there is a monetary policy meeting next Monday, today happens to fall into the period when this blackout rule applies. Therefore, I will not talk about any matters relating to monetary policy and will refrain from answering any questions on the subject. I would appreciate your kind understanding on this.

Since I began my career as a central banker a long time ago, I have received a lot of intellectual stimulus from reading the publications of the Institute as well as participating in the study groups and conferences organized by it. And I would like to take this opportunity to thank the Institute for publishing the book on the balance of payments which my colleagues in the then Foreign Department wrote and I edited some 20 years ago in 1977.

On the occasion of the Institute's 50th anniversary, when we look back at the past 50 years of Japan's economy, we really have experienced a diversity of situations. Around the time of the Korean War, I was in Osaka and witnessed the reconstruction of the textile industry and the economic boom supported by the special procurements occasioned by that war. Other events in the past 50 years include the reconstruction period following the chaos just after World War Two, the high growth period, the oil shocks, the Plaza Agreement and the appreciation of the yen, the emergence and bursting of the bubble, and the current prolonged recession.

When talking about Japan's economy, some call the past 10 years the "lost decade", and during this period average annual growth was a meager 1%. Against this background, financial institutions have been gradually changing their management strategy while bearing the heavy burden of the past legacy.

Though Japan's financial system has faced an extremely difficult situation for the past several years, it appears that overall stability has finally been restored thanks to various measures. For example, in overseas markets, the difficulty that Japanese banks faced in raising funds around the beginning of last year and the Japan premium, which was the extra cost that they had to pay, have largely subsided against such background as the injection of public funds into major banks in March 1999. At international meetings like the G10 central bank governors meeting at the BIS, which in fact I attended a few days ago, we have seldom heard any concern or criticism about financial system stability in Japan. In addition, the ratings of Japanese banks, mainly those that have announced merger and consolidation plans, have begun to be upgraded.

And yet, it is true that there exist a number of agendas that we have to tackle to further strengthen financial stability, as evidenced by the recent collapse of Sogo Department Store. Today, I would like to talk about the need to strengthen the capital base, one of the most important agendas over the medium to long term.

Among many issues regarding the capital base, the first is the capital structure of Japanese banks. The risk-based capital adequacy ratio of internationally active Japanese banks was 11.8% at the end of

March 2000, out of which Tier 1 capital was 6.6%. In the case of US money center banks, the capital adequacy ratio was 13%, and Tier 1 capital 8 to 9%. It should be noted that in the United States, there has been no injection of public funds and deferred tax assets corresponding only to income for the following year are included in Tier 1 capital. If we calculate the Tier 1 capital of internationally active Japanese banks according to the US standard, it would decline from 6.6% to the 4% level. Indeed, there is clearly a big difference in the capital structure between major Japanese banks and US money center banks. In other words, there exists a difference, significantly larger than what is observed, between Japan and the United States in terms of the strength of banks' capital position.

Under such circumstances, Japanese banks need to strengthen capital base by increasing its key element. Furthermore, from the viewpoint of achieving multiple targets including not only the strengthening of capital base but also a reduction in capital cost and an increase in return on equity, banks should work toward the redemption of high-cost capital and an increase in internal reserves through higher profits.

The second issue is how to measure various risks such as credit, market and operational risk by an advanced method and to align capital charges closely with these underlying risks. The Basel Committee on Banking Supervision chaired by Mr William McDonough, President of the Federal Reserve Bank of New York, is undertaking reform of the 1988 Basel Capital Accord. In June 1999, a consultative paper proposing a new capital framework was released and public comment was sought until March 2000. Currently, the Capital Accord is being reformed by incorporating the comments received from the public, with the reforms being put into effect two years from now.

The following points deserve particular attention. First, the new Capital Accord will incorporate market and operational risks, which are not taken into account in the current Capital Accord, in banking accounts. Second, it will measure credit risk more precisely and impose capital charges more appropriately.

For the past few years, banks have increasingly faced more complex and sophisticated types of risks. To satisfactorily deal with these risks as well as to win amid the severe competition that is to come, it is necessary that risks should be measured in an accurate way and appropriate capital charges set accordingly.

The third issue for financial system stability in Japan is how to deal with intensified competition triggered by the entry of foreign capital and non-financial firms into the banking industry.

One of the major topics in the financial community in recent years is that foreign capital and domestic non-financial firms, which have detected business opportunities in Japan's banking industry, have become active in purchasing failed banks and establishing internet banks. Some of these banks have announced their intention to focus on lending to small and medium-sized firms, which had been profitable.

There are also active moves to establish new types of banks which did not exist traditionally. One firm is considering providing payment services by installing automated teller machines in a myriad of convenience stores. Another one is aiming at offering various banking services efficiently through the internet to satisfy the diverse needs of customers.

The management environment surrounding banks has significantly changed. Competition has further intensified. Under such circumstances, the recent strategy of many banks, whether establishing holding companies, forming a megabank by merger or focusing on local communities, has emphasized consumer banking and customer targeting, focusing, for example, on small and medium-sized firms.

In consumer banking and customer targeting, competition is already intense among Japanese banks of all sizes, foreign banks and non-financial firms. To win the race, it is essential to have a detailed database regarding individuals and firms as well as to maintain a large network to reduce operational costs. For this, we need to take full advantage of the progress of information technology, which requires enormous investment. In this regard, whether or not one has sufficient capital to be able to finance such investment is the key to success.

Banks that plan mega-mergers emphasize business areas such as investment banking, project finance, global cash management and networking in Asia as their primary strategies. In these business areas, major banks in the United States and Europe have already constructed a fairly solid business foundation. Particularly in such business areas as global cash management and global custody, Japanese banks need huge investment and technology to compete with banks in the United States and Europe. The key to success in these business areas is investment in information technology and sufficient capital.

As I just described, strengthening the capital base and pursuing the efficient use of capital seems a typical case of "easier said than done". Nevertheless, when we look back at the recovery of US banks from the banking crisis in the early 1990s, we observe the following virtuous circle. First, banks' profitability improved thanks to restructuring. Then, their ratings were upgraded, which led to a reduction in capital cost and fund-raising costs. Such cost reductions contributed to higher profitability. Using increased profits, banks amortized high-cost capital by, for example, purchasing back preferred stock. Higher profits increased internal reserves, return on equity rose and ratings were further upgraded. These processes continued.

Efficient use of capital means that we need to select targeted business areas and concentrate resources on these selected areas. This reminds me of the fact that Mr John Reed, Chairman of Citicorp, decided to abolish its investment banking section. In the mid-1990s, return on equity in the investment banking section was as high as 13%. Nevertheless, Citicorp pursued its chosen strategy by abolishing the investment banking section and transferring all human and physical resources in it to the consumer banking section. There were various criticisms about Citicorp's decision, but it turned out to be successful. This episode shows that it is ultimately the decision of top management to achieve the strengthening of capital base and efficient use of capital.

There are five months remaining before we enter the 21st century. We strongly hope that in the coming century Japanese financial institutions will be internationally competitive and provide the best financial services on a global basis thanks to the efforts of all those concerned in the management of financial institutions.

We at the Bank of Japan will continue to make utmost efforts to maintain financial system stability by utilizing the experience and the lessons learned in the past 50 years, and to preserve independence and transparency, two fundamental concepts underpinning the new Bank of Japan Law.