Toshihiko Fukui: Toward the further enhancement of financial services in Japan

Speech given by Mr Toshihiko Fukui, Governor of the Bank of Japan, at a meeting of the Council for Financial Innovation, Tokyo, 4 November 2003.

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Today, I would like to talk about Japan's financial system and share with you my thoughts on the future of financial services.

I. Current State of Japan's Financial System and the Challenges It Faces

The Bank of Japan has sought to maintain financial system stability and promote economic recovery, by providing ample liquidity under the quantitative easing policy, to overcome deflation. The Bank has also supported efforts by the financial services industry, using various means, to strengthen the soundness and functioning of the financial system. Our strategy is two-pronged, aiming both to overcome deflation and to solve the financial system problem at the same time.

As I have just noted, we face two problems simultaneously. While deflation hampers the resolution of the nonperforming-loan (NPL) problem and delays the revitalization of the financial system, the malfunctioning of the financial system exacerbated by the NPL problem weakens momentum for economic recovery. Both at home and abroad, there are some who argue that we should focus exclusively on one of these two problems. I believe, however, that most people with a deep understanding of the issue would agree with us that these two problems are inseparable. In short, we consider it important to work steadily and continuously toward both economic recovery and the revitalization of the financial system.

Japan's financial system has faced several critical moments over the past ten years or so. The failure of a number of large banks and securities companies is still fresh in our memories. Many complicated issues remain to be resolved. For example, in addition to the NPLs that may be more directly attributed to the bursting of the asset price bubbles, there has been a constant stream of new NPLs stemming from structural problems in the Japanese economy, which has made the NPL problem more difficult to resolve. Furthermore, efforts on the part of the financial services industry seem to have been largely negated by the continued decline of real estate and other asset prices, as the persistent economic stagnation has lowered the expected economic growth rate.

It is true, however, that progress has been made in reform related to financial services and markets. Frameworks have been established for the resolution of failed banks and for injections of public funds into troubled banks. Necessary revisions have been made to tax and accounting systems, and bankruptcy laws. In addition, inefficient and outdated trade practices that existed in the relationship between banks and their corporate clients are being reviewed, as evidenced by the accelerated unwinding of cross-shareholdings.

Consequently, it seems that gradual but concrete and visible progress, particularly among major banks, has been made in resolving the NPL problem that has shackled banks' business performance.

A. NPL Problem

The following three points are fundamental to overcoming the NPL problem: first, appropriate measurement of the economic value of loans and the subsequent provisioning of sufficient reserves; second, removal of NPLs from banks' balance sheets; and third, accurate determination of the viability of troubled firms, followed by appropriate and prompt measures to reconstruct or reorganize these firms with close cooperation between the firms themselves and banks. The Bank proposed these measures in its report titled "Japan's Nonperforming Loan Problem," released in October 2002.

Adoption of the discounted cash flow (DCF) method, a measure recommended by the Bank, led to a general increase in banks' loan-loss provision ratios in their financial statements for fiscal 2002. Furthermore, in fiscal 2002, major banks' NPLs to borrowers classified as "bankrupt," "effectively bankrupt," or "in danger of bankruptcy" declined by more than 11 trillion yen on a gross basis. Their NPLs as disclosed under the Financial Reconstruction Law amounted to 21 trillion yen as of the end of

March 2003, down by more than 30 percent from a year ago. Some banks recorded the ratio of NPLs to total loans below 4 percent.

Various initiatives are also being made in the area of corporate turnarounds. Private-sector corporate restructuring funds, both Japanese and foreign, have become more active. The government-backed Industrial Revitalization Corporation of Japan has announced restructuring plans for eight firms as of the end of October.

Japan's financial system is expected to enter a virtuous circle in which the monitoring function of the market and more intensified competition will effectively encourage banks to take further actions to reduce their outstanding NPLs. Resona Group substantially increased its loan-loss provisioning in an attempt to drastically shorten the time required to regain financial soundness, and this attracted considerable attention in the market. The new management seems to have decided to take actions that put the highest priority on the prompt recovery of its credibility in the market after receiving public funds. We commend its actions as representing a bold step toward dealing with its problems.

B. Reduction of Exposure to Stock Price Volatility

Progress is also being made in banks' efforts to unwind their shareholdings, which, together with the NPL problem, pose a major threat to their financial condition.

This is of course not to say that banks should not hold stocks for any purpose whatsoever. Considering the potentially high price volatility of stocks as well as the fact that cross-shareholdings are not held for portfolio investment purposes and cannot be sold in a timely manner, these shareholdings may have a serious and unpredictable impact on banks' business given their limited capital base. Banks can protect their business from stock price fluctuations by reducing cross-shareholdings. Moreover, by reducing the allocation of capital to stock price volatility, banks can free up some of their capital to support firms. It is worth noting that banks have made steady progress in reducing their exposure to stock price fluctuations. In fact, the total shareholdings of banks fell by 48 percent to 21 trillion yen over the past two years.

To support the efforts of banks, the Bank started purchasing stocks held by them in November 2002. The total value of stocks purchased by the Bank amounts to 1.8 trillion yen to date, and in September, the Bank decided to extend the stock purchasing period by one year. Needless to say, the market should be the place in which stocks are traded. Fortunately, trading volumes on the stock market have been high since May, and the market seems to be recovering its function. In September, the Banks' Shareholdings Purchase Corporation was reformed so that it could function more effectively. Banks are expected to make further steady progress in reducing their shareholdings now that there are three outlets in place to absorb their stock sales-the stock market, the Bank, and the government-backed organization.

C. Implications and Conditions regarding the Removal of Blanket Deposit Insurance

Let me now turn to the removal of blanket deposit insurance in April 2005. What conditions should be satisfied before the removal? In identifying these conditions, we need to envision what the financial system will be like after the removal of blanket deposit insurance. I would like to call attention to two points.

First, Japanese firms will have to survive severe competition and drastic changes in the global economy. Participants in the market will be subject to constant replacement, as burgeoning firms and new firms enter while some existing firms are restructured and nonviable ones exit. The corollary is that it is impossible to avoid the emergence of new NPLs and losses arising from defaults at banks.

This leads to the second point. Banks will also be subject to frequent new entry, exit, and mergers and acquisitions, under the strict governance of shareholders and depositors. We cannot return to the period of high economic growth where, *de facto*, there were no bank failures.

In this sense, the removal of blanket deposit insurance may represent the last hurdle for banks to overcome before they enter the next stage of competition. In doing so, it is desirable that banks be perceived as having passed over the hurdle on their own, not under the government's initiative as in the past. I believe, therefore, that the following conditions are necessary when removing blanket deposit insurance.

Japanese banks, particularly large banks and core regional banks, must regain credibility among financial market participants both at home and abroad by proving that they have stable earnings power. To that end, they must establish schemes for prompt disposal of NPLs and improve risk management techniques, including those for dealing with stock price volatility.

Banks' stock prices have recently been recovering rapidly, although these rises reflect the revision of overly pessimistic views about banks' business performance. Banks must work to reinforce this positive assessment in the market, and this will require a wide range of effective measures to improve their profitability. In resolving the NPL problem, for example, it is important to avoid increases in credit costs arising from further deterioration in the quality of existing NPLs, by strengthening the measures for revitalizing troubled firms and removing NPLs unlikely to be collected. If banks can contain credit costs to roughly the level necessary to cover newly emerging NPLs, we can assume that they should at least be able to post stable net income.

If banks find themselves short of capital for dealing with NPLs, they should first raise additional capital in the market. We cannot, however, rule out cases where, within a limited time frame until the blanket deposit insurance is removed, banks prove unable to strengthen their capital base by themselves. The current scheme for public funds injection pursuant to Article 102 of the Deposit Insurance Law is designed to be permanent and functions as the last resort to prevent systemic risk from materializing. I believe that, as a comprehensive measure in the face of the removal of blanket deposit insurance, a new scheme should be established whereby injections of public funds are available to banks in difficulties, even in cases where the materialization of systemic risk is not imminent.

What, then, should the bank supervisory authorities, including the Bank, do to prepare for the removal of blanket deposit insurance? They need to prove that they have developed a sufficient crisis management system to prevent the materialization of systemic risk and ensure financial system stability. To prepare for cases where banks' financial conditions deteriorate significantly, the safety net comprises several measures for maintaining financial system stability. Two primary examples are the Deposit Insurance System and the Bank's function as the lender of last resort, including its readiness to extend emergency loans when necessary. The crucial issue from now on is to further devise ways to apply these safety-net measures in practice.

The government and the Bank have accumulated a great deal of knowledge and experience by working together closely in the resolution of failed banks, both large and small. As I mentioned earlier, we cannot rule out the possibility of bank failures after the removal of blanket deposit insurance. It has become all the more important that the bank supervisory authorities obtain from the market and the public the strong trust in their ability to ensure financial system stability, while further improving the environment for free and open competition. This can be achieved if they avoid any large, negative impact on the economy, without causing significant moral-hazard effect, by taking appropriate and swift action whenever the resolution of troubled banks becomes necessary.

The injection of public funds into Resona Bank was the first case pursuant to Article 102 of the Deposit Insurance Law, and it confirmed the effective functioning of the system. The bank supervisory authorities need to further enhance their practical skills for dealing appropriately with other potential cases.

II. Future Agenda for Japan's Financial System

Next, I would like to share with you my thoughts on several issues that are significant for the future enhancement of Japan's financial services.

What are the key issues ahead? Answers may vary depending on whether one is a depositor, an investor, a firm, or the manager of an entity that provides financial services. Many of the questions that come up in such a discussion should be left to the ingenuity of the private sector to solve. Therefore, today I would like to focus on one issue. Even if we assume that the NPL problem is successfully overcome, will Japan's system for credit intermediation prove adequate to the task of offering firm and effective support to the economy?

A. Problems in Credit Provision

The Bank has been providing ample liquidity to financial markets under the quantitative easing policy, and this has definitely helped to relieve various concerns as well as maintain financial market stability and underpin the economy. However, this liquidity provision by the Bank has not necessarily led to increased efficiency in the provision of credit by private banks. It is true that the NPL problem has been one of the obstacles for the system of credit provision, but there are other factors. For example, in spite of the fact that banks are not reluctant to make loans to eligible firms, firms still perceive that it is difficult to receive sufficient credit from banks. Such miscommunication makes the problem more complex. This implies that the problem lies not only in a lack of efforts among the agents involved, but also in structural flaws of the financial system that need to be corrected.

I would like to give some examples that illustrate this point. I will start by looking at the segmentation of the loan market. For instance, the ratio of bank loans without collateral or guarantees to the outstanding amount of loans is around 40 to 50 percent for major banks, due partly to the contribution of loans to large firms. On the contrary, for regional banks and *shinkin* banks, the ratio is only about 10 to 20 percent. This suggests that small to medium-sized firms' demand for loans, especially firms without sufficient collateral but with a high potential to increase cash flow, is not being fully met. In addition, given the fact that the secondary market for loan assets is still in its infancy and the relatively low liquidity in the corporate bond and CP markets, it appears that investors willing to take on credit risk are not being given adequate investment opportunities.

Meanwhile, we observe cases of insufficient segmentation of the functions related to credit provision. When bank loans to firms are provided based on short-term contracts, they are in fact refinanced many times, and so they function partly as quasi-capital. Banks are exposed to complex combinations of risks from sources that differ in nature, such as debt and equity, and this hinders the process of reallocating these risks appropriately among suitable investors.

Thus, I believe that the overwhelming priority is to review the current system of credit provision within which deposit-taking and lending business of banks play a dominant role. The system has long been in place and can be called an entrenched custom. The current system tends to concentrate various risks on banks' balance sheets. Therefore, to achieve more efficient credit provision, we need to not only identify the factors causing this concentration of credit risks at banks but also seek persistently to reduce them.

B. Toward Seamless Provision of Credit

The current system of credit provision needs to be changed so that credit risk is no longer concentrated too heavily at banks but is allocated to a wide range of investors. It is not simply a matter of choosing the best type of financing, whether it is traditional bank lending, securitization, or financing through capital markets. Rather, it is a matter of designing a system for credit provision that covers all types of financing and achieves the seamless provision of credit. I believe that there is a significant role to be played here by financial innovation, by which I refer to the progress in IT, enhanced financial engineering technology, and the financial theory that supports it. Seamless provision of credit enables the efficient use of capital necessary for taking on credit risks. It also aids the process of matching interest rates to borrowers' credit risks. The result is that funds are allocated more efficiently, and this contributes to economic growth.

In relation to this point, I would like to briefly touch upon government financial institutions. The principal function of government financial institutions is to complement the role of private banks, extend credit to borrowers that are selected in accordance with policy objectives at the time, and provide credit enhancement. However, due to the increase in postal savings and the resulting rise in funds under the government's fiscal investment and loan program (FILP), Japan Post and other government financial institutions seem to have expanded their business activity beyond complementing the role of private banks. People point out that the expansion most likely distorts the efficient allocation of credit in the economy. For this reason, the government has been reforming FILP and has started discussions on the privatization of Japan Post, which was established as a public corporation earlier this year. Discussion on the privatization should proceed based on the recognition that it is important to build a nationwide financial system better suited to the efficient allocation of credit.

C. Shift to a Financial System Capable of Seamless Provision of Credit

When banks and investors provide credit to borrowers, they measure the value and risk of credit based on borrowers' expected future cash flow. On this basis, they decide whether to take on the risk themselves or reallocate it. Therefore, the key to successfully achieving the seamless provision of credit is to ensure that a wide range of agents, including investors, banks, and other financial services providers, fully perform their respective functions, such as evaluating and taking on credit risks.

Hereafter, I use the term “credit risk” to represent the value and risk of credit. In what follows, I will elaborate on the three credit risk-related functions: the appropriate assessment of risks; the unbundling and repackaging of risks; and the effective reallocation of risks.

D. Appropriate Assessment of Credit Risks

First, credit risks should be assessed appropriately. To facilitate the smooth provision of credit, information regarding borrowers’ profitability and their financial condition should be analyzed thoroughly and the results of the analysis should be reported to potential lenders accurately. Financial data on borrowers are useful for this purpose, but the information publicly available on small or newly established firms is limited compared to that on large firms that have access to the capital market and disclose data on their financial condition. Banks, with their broad in-house networks of branches and sales staff, have an advantage over other financial services providers in originating credits through their ability to obtain and analyze information on borrowers.

Having said this, however, banks’ available capital is limited, as mentioned earlier, and this can be a constraint on their ability to not only originate credit but also bear credit risks on their own balance sheets. Banks must therefore use their capital efficiently by extending credit only when it matches their strategies and reallocating the remaining credit risk to other investors. Such a reallocation of risks should be beneficial to both banks and investors.

To this end, banks are expected to enhance their ability to assess borrowers’ creditworthiness appropriately and to reflect these assessments in their pricing of credit. Thanks to recent progress in financial engineering, various new methods to measure and control risks have been made available. These include quantitative evaluation of credit risks based on such data as credit ratings and bankruptcy ratios, as well as the portfolio approach that makes use of the law of large numbers. New financial products utilizing these methods have also been developed. Examples include loans with a non-recourse arrangement, standardized loans to small firms requiring no collateral and making use of scoring models, as well as consumer loans that require only simple loan screening procedures. Banks should be able to further expand the practical use of such methods throughout their in-house networks to expand their business activities.

For smoother reallocation of credit risks, the crucial factor is that the credit originator assesses the initial risk appropriately and sets the interest rate accordingly.

E. Unbundling and Repackaging of Credit Risk

Second, we need to enhance techniques for unbundling and repackaging credit risks. Instead of simply selling loan assets, originators can unbundle and repackage the credit risk inherent in loan assets using financial engineering techniques, thus satisfying the demand of a wider range of fund providers and investors. For example, when creating asset-backed securities (ABSs), cash flows from pooled assets are often classified into tranches, such as senior, mezzanine, and equity, reflecting different degrees of risks, and these tranches are sold to investors. This is because the value of pools of the original assets is likely to fluctuate considerably. Through the unbundling of risks, the differing risk preferences of various institutional investors, at home or abroad, can be satisfied.

As I mentioned earlier, bank loans to firms in Japan are provided in the form of short-term contracts, although they are in fact rolled over many times, so they function in effect as quasi-capital. By separating credit risks inherent in these loans into equity and debt portions, risks for each portion can be efficiently reallocated to investors willing to bear them. An example of repackaging risks is a bank loan to a small but promising firm in which banks retain a right to purchase new stock when issued. In this way, banks may benefit from a rise in the firm’s value if its business succeeds, and banks and other shareholders can participate in the governance of the firm if necessary, while at the same time keeping interest rates on loans lower than otherwise.

Financial services providers ranging from banks, securities companies, and nonbanks to credit-rating agencies and auditing companies can contribute to the process of enhancing techniques for unbundling and repackaging credit risks.

F. Reallocation of Credit Risk

Third, the market function of reallocating credit risks needs to be strengthened. In this regard, we need to improve the infrastructure of credit markets, by which we refer to the markets for liquidating loan assets, syndicating loans, and trading ABSs. This would enable credit risks initially borne by credit originators, typically banks, to be reallocated among a wider range of investors, allowing additional capital resources both inside and outside Japan to be utilized more efficiently. It would also be useful to utilize the price discovery and verification functions of credit markets. For risk-based pricing mechanisms to work properly, the accuracy of prices must be constantly subject to review. Credit markets will provide information useful to confirm the accuracy of prices.

Concrete measures to improve the functioning of credit markets need to be taken by both the private and public sectors: for example, the establishment of uniform loan contracts, and a wider use of covenants covering cases of deterioration in credit quality.

Improving the functioning of the Japanese government securities (JGS) market would also help secure the sound development of credit markets. The JGS market provides rates that are free from credit risks and which become a benchmark for interest rates in other markets, including credit markets. The JGS market should be constantly improved to ensure that it becomes highly liquid and robust enough to consistently offer reliable risk-free rates under various circumstances. The Bank, in cooperation with both market participants and the fiscal authority, will continue to work to enhance the functioning of this market.

In Japan, however, a major issue is how to control the risk inherent in an expansion of the amount outstanding of JGSs issued. There is an immediate need to show to the public the blueprint of a new fiscal structure for the country.

III. Role of the Bank of Japan

By ensuring permeation of monetary easing effects throughout the economy, the Bank will continue to secure financial market stability and economic recovery, as well as improve the overall functioning of the financial system in the long run with regard to the efficient allocation of credit. We believe that these are prerequisites for achieving a vigorous economy suitable for the new era.

To achieve this goal, the Bank decided to provide ample liquidity more flexibly, and confirmed its commitment to maintaining the quantitative easing policy at the Monetary Policy Meeting on October 10, 2003.

In addition, the Bank will continue its wholehearted support of efforts being made in the financial services industry to improve the overall functioning of the financial system with regard to the efficient allocation of credit.

Since last year, the Bank has announced a number of measures in this regard. These include the release of a proposal for an early resolution of the NPL problem, including suggestions for introducing the DCF method for evaluating loans; the purchase of stocks held by banks; and the inclusion of asset-backed commercial paper (ABCP) on the Bank’s list of eligible collateral, and the launch of asset-backed securities (ABS) purchases, aimed at nurturing these markets. In addition, the Bank decided to hold a forum, starting this month, to discuss with a wide range of market participants how together we can improve the ABS market and other financial markets.

Furthermore, through our on-site examinations and off-site monitoring, we wish to deepen discussions with banks and other financial services providers on ways to better manage their business in line with the enhancement of the market functions.

The Bank will enhance the effect of monetary policy by continuing to review market operations, as well as contribute to strengthening the functioning of the financial and capital markets.

Let me conclude by saying that, as our efforts to enhance financial services in Japan bear fruit, I am confident that there will gradually emerge a completely new financial system, one which is innovative and provides the strong support to the country’s economy that it deserves.

Thank you for your kind attention.