

Masaaki Shirakawa: International banks amid global financial crisis

Address by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Information Forum of the International Bankers Association, Tokyo, 27 January 2009.

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1. Introduction

I am honored to be given the opportunity today to address the Information Forum of the International Bankers Association (IBA). I was told that this is the first time for the Governor of the Bank of Japan to address the Forum of this Association. And it might be an opportune moment, perhaps the most appropriate in your 25-year history, when the turmoil in global financial and capital markets remains and financial institutions and central banks are faced with various challenges.

As an association of international financial groups, commercial banks, securities firms and representative offices in Japan, the International Bankers Association was established 25 years ago. Since then it has been making efforts to exchange views between member financial institutions and to enhance their dialogue with the Japanese authorities. Through those activities, the association has contributed substantially to the development of Japan's economy and financial markets. Before starting my speech, I express my respect for the efforts you have been making over the years.

In my speech today, I will briefly refer to the roles that international banks including other financial institutions play in Japan. I will, then, look back on the developments in financial markets at home and abroad since the collapse of Lehman Brothers, followed by policy responses by the Bank of Japan and lessons for the activities of international banks, especially the importance of liquidity management. In conclusion, I will touch on the roles and challenges of the Bank of Japan to ensure financial system stability.

2. Roles of international banks in Japan

I begin with talking about the history of international banks in Japan. While the National Bank Act was enacted in Japan in 1872 and the Bank of Japan was established in 1882, international banks first operated in Japan in 1863, five years before the Meiji Restoration. Last year marked a memorable 150th anniversary of treaty of commerce between Japan and western countries, and for Japan that started international trade at the end of the Edo era, a means of trade settlement with overseas countries was needed first. At the time, it was the international banks in Japan that carried out the trade settlement functions by way of foreign exchange. Yukichi Fukuzawa, who is on a ten thousand yen bill and the leading educator toward the end of the Edo era and the Meiji era, sailed across the Pacific Ocean to the United States in 1860 as a member of an official mission of Japanese government. In his autobiography, he referred to an episode that cash bags filled with travel expenses were torn in a great storm and greenbacks were scattered inside the cabin. Only four years later, on a government's mission to Europe in 1864, the international banks in Japan prepared foreign exchange money orders so that the mission members could cover their travel expenses without physically carrying cash. While it is only a small episode in the beginning of the modern banking system in Japan, it demonstrated that international banks were the pioneers of modern financial services in Japan.

Since then, international banks have played important roles in Japan's financial markets in various aspects including adoption of new financial techniques, discovery of new markets, and introduction of advanced risk management. In fact, while the share of international banks in loans and deposits only accounts for about one percent, the latest survey conducted in April 2007 showed that, the share of international banks was 67% in foreign exchange

transactions and 68 % in derivatives transactions. The share is also high in call market funding and, especially before the outbreak of the subprime mortgage loan problem in the summer of 2007, it amounted to about 40%.

The presence of international banks is also evident in terms of the banking operations of the Bank of Japan. The Bank currently has current account transactions with 64 banks and 18 securities firms which are from other countries. The international banks' settlements using current accounts of the Bank are about 17 trillion yen in value and about 13,000 in number of transactions per business day, which are 13% and 25% of the total, respectively. Furthermore, international banks play a key role in daily open market operations by the Bank. For example, in the Bank's primary funds-supplying operations against pooled collateral at the head office, there are 17 international banks in 39 eligible counterparties.

At the same time, the increased presence of international banks suggests that the developments in overseas financial markets and the activities of overseas financial institutions are exerting a stronger influence than in the past on the host country's economy. A good example is the recent developments in Central and Eastern European countries. In those countries, European banks outside the region have recently played important roles in the financial systems. However, amid the current crisis, those European banks' lending to local firms declined rapidly and that partly accounted for the deterioration of economic activity in that region.

Such situation is, to some degree, also relevant to Japan. International banks have been the dominant liquidity provider to Japan's real estate market for the last several years. However, since around autumn 2007, real estate business of those international banks rapidly shrank, which led to a decline in transactions in the real estate market. In addition, international banks have been showing a strong presence in the field in which Japanese financial institutions have not been necessarily involved enough, such as securitization business, private equity business for bad loans, M&As, and long-term lending to local governments. However, the presence has been changing as international banks' liquidity constraints have become acute.

3. Financial and capital markets since the collapse of Lehman Brothers

Global economy and global financial markets

Now let me turn to the developments in global financial and capital markets. Since the collapse of Lehman Brothers, the global economy and financial markets have changed dramatically. The fourth quarter figures for GDP, industrial production, and exports have started to be released in various countries, and a sharp decline that could be indeed expressed as "jump off a cliff" has been witnessed simultaneously worldwide. The Bank of Japan released last week the economic outlook, and the median forecast of Japan's economic growth for fiscal 2009 among Policy Board members was substantially revised downward from 0.6% as of end-October 2008 to -2.0%.

The principal factor behind the simultaneous and rapid slump of the global economy since autumn last year was the mounting global financial crisis triggered by the collapse of Lehman Brothers.

The first phenomenon after the collapse of Lehman Brothers was the growing concern for counterparty risk in funding markets and associated malfunctioning of those markets. Consequently, the volume of transactions plunged and market liquidity declined not only in uncollateralized markets, but also in collateralized ones such as foreign exchange swap market. Against such a backdrop, the functioning of credit market declined, and private economic agents suffered in their fund-raising. Banks faced liquidity concern in addition to the losses and the capital shortage, and their lending stance became cautious. The declined functioning of the financial system exerted a negative impact on economic activity, which in

turn adversely affected the asset quality of financial institutions and investors. What is happening now is the adverse feedback loop between the financial system and the economy.

The global economy is facing difficult challenges, and such a situation is attributable to the phenomenon that leverages markedly increased around the globe in the periods preceding the current financial crisis. Consequently, what is necessary now is the unwinding of excessive leverages, or de-leveraging, so to speak. Without that, it is difficult to expect full-fledge recovery of the global economy. At the same time, if de-leveraging evolves rapidly and the provision of credit to private firms and household sector shrinks substantially, economic activity contracts sharply. To bring the global economy back onto a sustainable growth path, a delicate balance would be required between encouraging unwinding of excessive leveraging and preventing that unwinding from evolving too rapidly within a short period of time.

Domestic financial markets

The turmoil in global financial markets also had a substantial impact on Japan's financial markets. Before the collapse of Lehman Brothers, both the short-term money market and the credit market in Japan were relatively stable, reflecting the fact that Japan's financial institutions' exposure to structural products was relatively small. Rather, such relative stability increased the attractiveness of Japan's financial markets internationally as fund-raising markets, and yen funding by non-residents became active during the preceding periods up to the collapse of Lehman Brothers, as shown in issuing samurai bonds 40 percent more year-on-year basis. However, situation of domestic financial markets literally changed dramatically by the collapse of Lehman Brothers.

The first change was the funding difficulties of international banks in the yen money market due to growing concern for counterparty risk. In the uncollateralized call market, funding by international banks became difficult amid declining market liquidity, and the two-tiering of interest rate emerged that the funding rates of international banks became higher relative to domestic financial institutions. Also in the collateralized money market, such as the repo market, the tendency to avoid transactions with international banks became widespread. After the burst of the bubble economy, concerns were expressed about the creditworthiness of Japan's financial institutions in overseas markets and they faced a so-called Japan premium in dollar funding in late 1990s. The opposite took place this time.

The second change is the distortion of pricing, or dislocation, due to the decline in market liquidity. That is obvious at a glance by looking at JGB's yield curve, the pricing of the floating rate JGB and inflation-linked JGB, and swap spread which is the difference between the swap rate and JGB yield. Before the collapse of Lehman Brothers, international investors including hedge funds played a role of market liquidity provider through arbitrage transactions. However, after the collapse, their arbitrage transactions became inactive due to the decline in risk-taking capability, and market liquidity declined substantially.

The third change is the declined functioning of domestic CP and corporate bond markets. In the CP market, issuance suddenly became difficult and the issuing rate has risen to a level above that of the financial crisis in 1998. In the corporate bond market, issuance by firms rated single A or below has virtually been suspended. In addition, the new issuance of samurai bonds, which had been steady up to last summer, remained almost suspended.

4. Policy responses by the Bank of Japan

In response to those rapid changes in conditions, the Bank has been promptly taking various measures since last autumn.

The measures taken by the Bank are classified broadly into three categories. The first category is the cut of the policy rate. The Bank lowered its target for the uncollateralized

overnight call rate last October and December by 0.2 percent, respectively, to 0.1 percent. The second category is various measures to ensure financial market stability. The substantial provision of yen liquidity and US dollar funds-supplying operations fall into this category. The third category includes measures to facilitate corporate financing. Those include the expansion of eligible collateral related to corporate debts, and special funds-supplying operations to facilitate corporate financing, which are low interest rate funds-supplying operations against corporate debts as collateral. In addition, while extraordinary for a central bank, the Bank starts outright purchases of CP from the end of this month. While the measures I have just mentioned are all important, let me explain in more detail about the policy measures to maintain financial market stability and outright purchases of CP.

Substantial liquidity provision to ensure stability of financial markets

What is crucially important in a financial crisis is to maintain financial system stability. In that regard, Japan has a bitter experience. In autumn 1997, the default of a mid-sized securities firm in the interbank money market triggered rapid shrinking in market transactions. Once the confidence, which is basic premise of financial market transactions, collapses, its recovery takes time, resulting in substantial damage to the economy. The developments in global financial markets and the global economy since the collapse of Lehman Brothers bring me a sense of *deja vu* of what happened in Japan 10 years ago but on a worldwide scale.

To maintain financial market stability amid financial crisis, substantial liquidity provision by a central bank is indispensable. In that regard, the Bank has taken various measures.

First, the Bank has been striving for aggressive liquidity provision to maintain the stability of the domestic yen fund market. The introduction of a facility to pay interests on the reserves in October last year enabled the Bank to aggressively provide yen liquidity, without affecting the level of the call rate that is set based on monetary policy considerations.

Second, the Bank started US dollar funds-supplying operations in Japan. The US dollar provision by central banks of countries other than the United States had been conducted by the European Central Bank and the Swiss National Bank since the end of 2007. Given that functioning of foreign exchange swap market also declined in Japan since the collapse of Lehman Brothers, the Bank started the US dollar-supplying operations, in close coordination with the U.S. and other major central banks. The Bank obtained necessary US dollars through swap transactions with the Federal Reserve. In the current global financial crisis, swap transactions between central banks have been used for securing non-dollar currencies as well, and, as a temporary measure until the end of April 2009, the Bank of Japan and the Bank of Korea increased the maximum amount of the bilateral yen-won swap arrangement from three billion US dollars equivalent to twenty billion US dollars equivalent. The temporary increase strengthened the Bank of Korea's capacity to immediately supply yen funds when Korean financial institutions urgently need the yen.

Measures to facilitate corporate financing

For central banks, those liquidity provisions are orthodox responses to a financial crisis. By contrast, the outright purchases of CP entail an effect of facilitating corporate financing and containing the contraction of economic activity through mitigating the fear of liquidity dry-up, which firms worry. In fact, since the announcement of the measure in December, the issuing environment of CP has somewhat improved. However, the outright purchases of CP are an extraordinary measure in that a central bank directly shoulders credit risk of individual firms. The premise of free market economy is that central banks provide liquidity at large, and private financial institutions and financial markets perform the function of individual resources and credit allocations. For that reason, it is essential to clarify the basic principles in what cases a central bank carries out such extraordinary measures. The first principle is that a significant decline in the market functioning of corporate financing is observed, leading to tight corporate financing conditions on the whole. The second principle is that the outright

purchases of corporate financing instruments are judged necessary in light of the Bank's mission to ensure price stability and financial system stability.

Even in the cases in which a central bank's outright purchases of corporate financing instruments are judged as necessary, based on the principles I have just mentioned, very careful design is required in actual implementation. Deep involvement of a central bank in credit allocation of individual financial markets and individual firms might lead to a paradoxical consequence, such that markets which are functioning relatively normally would be impaired by the central bank's own action. In that regard, it is not the case that more purchases are more effective. In addition, if the central bank incurs losses, it might undermine confidence of general public in the central bank's policy conduct and ultimately in the currency. Keeping those points in mind, the Bank has laid out three elements to be considered. The first element is a perspective of neutrality, which prevents discretionary credit allocation to individual firms. The second is to conduct the purchases for a necessary period and on an appropriate scale. That would ensure that the purchases are a bridging measure until the market function recovers. The third is to ensure the Bank's financial soundness. Since the losses of the purchases impose costs on taxpayers, it is important to avoid the concentration of credit risks in a specific firm.

The specifics of the CP purchasing scheme is as follows. From the first perspective of neutrality for credit allocation, the Bank will purchase from financial institutions that are the counterparties of the Bank by fair and transparent means of competitive auctions. In addition, from the second perspective, the purchases will be conducted for a limited time up to March this year, and the Bank uses an auction in which somewhat a high minimum bid rate is set. The minimum bid rate is set to be more favorable than the market interest rates when the market is malfunctioning, but not more favorable than the market interest rates of normal times. With this setting, bids will naturally decrease in number as the market function recovers. In addition, from the third perspective of ensuring the Bank's financial strength, the Bank will purchase a-1 rated CP that are eligible as the Bank's collateral, with setting upper limits by each individual firm. Keeping in mind that the outright purchases could be a means of meeting firms' funding needs including the redemption of corporate bonds toward the end of a fiscal year, the total amount to be purchased is set so as not to exceed three trillion yen and will be temporarily conducted until the end of March this year. The actual purchases of CP will start this month. In addition, the Bank is now considering the outright purchases of corporate bonds with a remaining maturity of up to one year.

5. Lessons for financial institutions' international activities: importance of liquidity management

Next, by changing the subject, in light of the impact of the current global financial crisis on financial institutions' businesses, especially on international activities including those of overseas bases, let me consider what kind of lessons should be drawn. Here I focus on the importance of liquidity management, which is deemed particularly important.

The importance of liquidity management

The first lesson is that, it is necessary to keep remembering that a notion "liquidity is always there" would not hold. In retrospect, a situation that could be characterized as "abundant liquidity" continued for several years preceding the current crisis. Here, "abundant liquidity" does not only mean the level of cash, but also includes a sense of reassurance that one can obtain funds anytime and a sense of reassurance for market liquidity that financial assets can be sold anytime at prevailing market price. However, as the current financial crisis has shown, liquidity could suddenly dry up. Once liquidity concern arises, the forced selling of assets occurs as market participants rush to obtain fund liquidity, and the market price will diverge from the value of cash flow that the corresponding assets generate. That suggests

that profits and capital position will be affected by the extent of liquidity as well. In designing business models, financial institutions need to recognize the possibility of liquidity dry-up.

Liquidity management in overseas bases

The second lesson is the importance of establishing a liquidity management system of international banks that conduct businesses at bases other than home countries. As mentioned before, liquidity cannot always be obtained, which reassures the importance of retail deposits that are relatively stable funding source. In that regard, for internationally active financial institutions, it would not be easy to take such retail deposits from customers in countries they operate. In terms of funding structure in Japan, international banks rely their funding on foreign exchange swaps, repo transactions, and fund transfer from head offices in home countries through intra-office accounts. In any event, the funding in currency other than home currency eventually depends heavily on funding conditions in the market. Such line of thinking suggests that it is extremely important that the foreign exchange swap market, which converts home currency into another country's currency, is operating normally. The striking change in global financial markets after the collapse of Lehman Brothers was the decline in the functioning of not only the uncollateralized fund market but also of the foreign exchange swap market, which made it difficult to obtain funds in foreign currency, regardless of individual financial institution's creditworthiness.

Smooth liquidity management by a financial institution cannot be achieved only by using its own cash, deposits, and borrowing capability. It also depends on the condition of market liquidity of financial assets. However, if a financial institution tries to secure its liquidity level sufficient enough to cope with an extreme stress situation, the financial institution has to hold sizable amount of risk free and short-term financial assets and thus cannot pursue its intrinsic function of financial intermediation. In that context, liquidity management by a financial institution itself, market-level efforts to maintain market liquidity, and proper exercise of the lender of last resort function by a central bank, would be the three indispensable factors. With respect to liquidity management by a financial institution itself, the Basel Committee on Banking Supervision released a guidance paper on liquidity management last September, and there it presented sound practices for enhancing liquidity management by conducting appropriate liquidity management, including that of foreign currencies, according to the characteristics of each market in which financial institutions operate.

Importance of improving market infrastructure

The third lesson is the importance of improving the infrastructure of the market and the payment and settlement system, which is derived from the aforementioned perspective of maintaining market liquidity. The sudden collapse of Lehman Brothers brought a state of turmoil into the Japanese financial markets. In particular, the number of settlement failures increased in the JGB repo market, which contributed to declining liquidity in the JGB market. However, without the efforts in recent years by the market participants and the central banks to improve the infrastructure of the market and the payment and settlement system including the establishment of clearing mechanism in the securities market such as the Japan Government Bond Clearing Corporation (JGBCC), default in the repo market might have had a contagion effect on the entire JGB market and the market turmoil could have been much more severe. A good example is the scheme for foreign exchange settlement, which is called "CLS," or Continuous Linked Settlement. The CLS links the payment systems of countries and makes a simultaneous payment of a pair of currencies associated with foreign exchange trading, which reduces foreign exchange settlement risk.

While it is hard to win understanding in normal times, the experience since the collapse of Lehman Brothers suggests the importance of a scheme to properly manage counterparty risk. Given the current situation, its importance is recognized anew. At present, in order to reduce counterparty risk in the OTC derivatives trading, the discussion on establishing post-

trading arrangements for derivatives has also started in Japan. The Bank expects private financial market participants to tackle those issues, and will also actively keep supporting the efforts of the market participants to improve the infrastructure of the market and the payment and settlement system and to review the market practices.

6. The role of the Bank of Japan toward financial system stability

The current financial crisis has highlighted various issues and challenges about the conduct of monetary policy by central banks, and the role of financial institution supervision and regulation. Let me mention three points about the role of the Bank toward the stability of the economy and the financial system.

A macroprudential perspective

First is the importance to have a macroprudential perspective in the conduct of policies, be it monetary policy or regulation and supervision of financial institutions. To ensure financial system stability, the main premise is that financial institutions themselves manage risks. However, the risks inherent in the financial system do not necessarily equal the sum of the risks of individual financial institutions. Let me take an example of residential mortgage-backed securities (RMBSs), securitized products that have residential mortgages as underlying assets, which triggered the global financial crisis. For individual investors, the risks seem to be diversified, thanks to securitization technology, but, if housing prices decline on national basis, the risk diversification effect will not work. In addition, it cannot be ignored that market liquidity is supported by the entry of many investors attracted by the continuing increase in housing prices. In other words, in recognizing necessary amount of capital, financial institutions need to take into account liquidity as well. In that context, it is extremely important not only to monitor the individual risks of financial institutions or products, but also monitor the risks inherent in the financial system as a whole from a macroprudential perspective. In such recognition, the Bank has been recently making efforts to conduct research from a macroprudential perspective and disseminate information, and part of the efforts is contained in our Financial System Report. The Bank would like to continue to strengthen and exercise its macroprudential function.

On-site examination and off-site monitoring

Second is the importance of grasping precisely the conditions of individual financial institutions, together with holding a macroprudential perspective that I have just mentioned. Economic growth eventually materializes by combining labor and capital equipment in an optimal way and utilizing the fruits of technological innovation. The function of financial intermediation supports that process from the financial side. Given this line of thinking, it is important to steadily understand how funds are used for what purposes and, in doing so, whether financial institutions are conducting proper liquidity management. The Bank of Japan conducts both on-site examination and off-site monitoring, and for the central bank as a lender of last resort, the current crisis obviously showed the importance that the central bank has hands-on knowledge. In that regard, close liquidity monitoring by the Bank has been effective in maintaining the relative stability of Japan's financial markets.

In the case of international banks, the Bank's on-site examination and off-site monitoring are conducted for their Japanese branches. However, to find out the potential risk factors and to properly evaluate their impact, the Bank needs to deepen the understanding of the financial groups' entire management policy and risk management strategy, the status of the bases in Japan within the group, and the governance structure. For those who are here today, I would like to seek your understanding and cooperation, more than ever, on the importance of the Bank's on-site and off-site monitoring.

International cooperation

Third is the importance of international cooperation. Major central banks have been closely exchanging views and information not only at Governor levels but also at staff levels with respects to various areas such as market operation, financial supervision, and settlement system. Such cooperation has become greater in the current crisis. The close cooperation is not only with the United States and Europe, but also with Asian countries. As expressed in the word “globalization,” it is true that financial markets are heading toward standardized and seamless ones. At the same time, it is also another fact that plenty of seam and lumpy factors remain. For that reason, the importance of information exchange and cooperation in the area of central banking business would be increasing further.

The Bank of Japan would like to communicate closely with you, conduct appropriate policy responses, and actively support market participants’ efforts toward financial system stability. Your cooperation is highly appreciated. Thank you very much.