March 24, 2009

Bank of Japan

Address at a Meeting with Banks' Top Management on Provision of Subordinated Loans

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At the Policy Board meeting held on March 17, the Bank of Japan decided to explore a new framework for providing subordinated loans to banks. We have invited today representatives of banks which are subject to international capital standards to explain the background and the Bank of Japan's view on the decision.

The funding conditions for firms have deteriorated rapidly since last autumn due to the increased strains in global financial markets after the collapse of Lehman Brothers. While financial institutions have retained the financial intermediation function accordingly by increasing lending, the environment surrounding financial institutions has become increasingly severe due to the stock price plunge and the domestic economic downturn. Fund raising in financial markets for funds over the fiscal year-end has mostly been completed, but the firms continue to face difficult funding conditions. While the CP market has started to restore its function, funding in the capital market has been limited to the firms with high ratings. Looking ahead, while demand for funds to secure liquidity for the year-end and the fiscal year-end and demand for working capital due to the rise in raw material prices until last summer will decline, demand for funds to continue and to restructure business are expected to gain momentum.

There might be a case in which the financial intermediation function will not be carried out smoothly from a macro perspective, if the strains in global financial markets increase and financial institutions become more conscious of possible capital constraints in the future. If financial institutions become more conscious of taking credit risk and all financial institutions take the same action simultaneously, the adverse feedback loop between the finance and the economy may intensify through financial institutions' restraining from accumulating their assets, leading to the fallacy of composition, although the action is judged as rational for each individual institution. As a result, that might weaken the capital strength of each financial institution.

From that point of view, concern is for the influence of a possible decline in stock prices. While the amount of stocks currently held by financial institutions is significantly reduced compared with the early 2000s, it remains unchanged that they hold substantial market risk associated with stockholdings. Although stock prices have recently somewhat rebounded, the financial systems in the U.S. and Europe have remained unstable. It should be avoided that each financial institution's consciousness about a possible decline in stock prices triggers the aforementioned fallacy of composition.

Against such a backdrop, the Bank has decided to begin exploring specifically the provision of subordinated loans to the banks that are subject to international capital standards. This measure aims at ensuring the smooth functioning of financial intermediation and the stability of Japan's financial system, by enabling Japan's banks to maintain sufficient capital bases even in severe financial and economic environments.

By the measure taken by the Bank, financial institutions are provided with three channels to raise capital; (1) capital raising by financial institutions through markets, (2) capital raising based on the Act on Special Measures for Strengthening Financial Functions, (3) borrowing subordinated loans from the Bank. Subordinated loans by the Bank will work effectively in conjunction with the other two measures to raise capital. In addition, providing such a safety-net measure would enhance the robustness of Japan's financial system and the functioning of financial intermediation even under the stressed conditions.

For a central bank, this kind of direct provision of quasi-capital funds is an extremely extraordinary measure. However, considering the future stress scenario of the financial system, the Bank has judged that, from the standpoint of a central bank, it is necessary to do its best to maintain the smooth functioning of financial intermediation and ensure the stability of the financial system even by conducting this extraordinary measure.

The Bank expects financial institutions to grasp the thinking behind the measure and to strive to maintain the smooth functioning of financial intermediation with further efforts of boosting capital bases. Needless to say, risk management is extremely important for financial institutions, which cannot be emphasized too much. However, under the current circumstances, as I mentioned above, the surfacing of the risk stemming from the fallacy of composition should be avoided. To that end, it is important for the management of financial institutions, while conducting sound business operations, to boost capital bases with envisioning the consequences for Japan's economy.

The Bank also expects financial institutions to pay due concern for the smooth communication with their client companies to convey business policies and lending stances.

It is the basic premise that the stability of the financial system should be ensured in order to return to a sustainable economic growth path under price stability. From the standpoint of a central bank, the Bank is determined to make its best effort to secure the stability of the financial system. We would appreciate your continued support and cooperation. Thank you.