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Bank of Japan

Challenges for Japanese Financial Institutions after the Financial Crisis

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Introduction

Thank you for having me at the Retail Finance Strategy Conference 2009. It is my great honor to have an opportunity to speak in front of you who have been in the front line of business.

Japanese financial institutions have been significantly affected by the current global financial crisis. The impact has spread over to the area of retail banking through deteriorating the business performance of small- and medium-sized firms and sluggish sales of mutual funds. I will talk today about my views on the challenges for Japanese financial institutions after the current crisis, and offer my thoughts on approaches to meeting the challenges. I hope my speech can shed new light on your thinking of retail banking strategies.

I. Looking Back at the Global Financial Crisis over the Past Year

It is more than a year since the failure of Lehman Brothers in the autumn of 2008. Once turbulent global financial markets have recently regained stability mainly due to ample liquidity provision by central banks around the world. The global financial system has also been gradually regaining stability, thanks to, among others, the effects of injections of public capital into major U.S. and European financial institutions. Meanwhile, the global economy deteriorated rapidly up to the spring of this year, but has been on a recovery path supported by policy responses on the fiscal and financial front as well as firms' efforts in production adjustment.

To start with, the crisis resolution is only halfway through both on the economic and financial fronts. The balance sheets of financial institutions in the United States and Europe have been deteriorating, including loan assets, and the completion of their adjustments are likely to take some more time. I would say that the global financial system as a whole still retains vulnerability.

Arguably, the essence of the current global financial crisis is the generation and burst of the credit bubble. While many reasons have been pointed out, I will point out particularly these three.

First, as accommodative financial environment continued on a global scale up to the middle of the 2000s and price stability and high economic growth were achieved, many 'excesses' were generated in the risk-taking activity of various economic entities.

On the real economic activity front, for example, against a backdrop of the sustained rise in housing prices, the household sector in the United States increased borrowing and significantly increased consumption. On the financial front, new types of transactions such as securitized products and derivatives prevailed, and leverage increased. Such 'excess' in real economic activity, asset prices and financial markets influenced each other to generate further 'excess.' Once the credit bubble burst, the unwinding of the leverage began, and liquidity in the global financial markets rapidly contracted. On the real economic activity front, firms were forced to curtail aggressively their production due to the pile up of inventories, and the global economy contracted significantly.

Second, as what is the other side of same coin of the macro aspects that I have just mentioned, the micro financial institution behavior also went too far under inadequate risk management or overconfidence.

Since the turn of the 2000s "the originate-to-distribute model" became common among major financial institutions in the United States and Europe, and it has been said that, in such a process, loan screening lacked substance at financial institutions that were the originators of loans. Financial institutions that were supposed to have transferred credit risk through distribution were forced to repurchase securitized products after the crisis occurred, and were reminded of a major misconception about their risk recognition at the time of distribution. Even as for liquidity risk, in retrospect, it was revealed that financial institutions significantly underestimated the market liquidity, mainly of securitized products. Such lack of proper risk management and others led to financial institutions' excessive risk-taking activity. However, once the unwinding of leverage began in tandem with the outbreak of a financial crisis, financial institutions in the United States and Europe incurred massive losses, which made their risk-taking stance rapidly cautious. That was typically shown in the current decline in lending of financial institutions in the United States and

Europe.

Third, it cannot be denied that somewhat slow responses by the policy and supervisory authorities in the United States and Europe to the generation of the credit bubble preceding the crisis also eventually amplified the current crisis.

One reason for that was the difficulty the policy authorities and supervisory authorities had faced in identifying the location and the size of risks, due to the expansion of the so-called shadow banking by insurance firms, monoline companies, and hedge funds. That was one of the factors behind the recent review of regulatory and supervisory systems overseas. On the monetary policy front, it can be pointed out that central banks had not organized their thoughts with respect to the containment of the credit bubble, including how a central bank should respond to asset price developments. Namely, while there was a standpoint to argue that 'a central bank should not apply monetary policy to asset price developments but should carry out aggressive monetary easing after the burst of a bubble,' there was another standpoint to argue that 'considering the magnitude of the adverse impact on the economy following the burst of a bubble, a central bank should conduct monetary policy to avoid the generation of a bubble.' In short, there was no consensus among the central banks around the world on how to ensure macroprudence. Based on the current financial crisis, central banks have commonly recognized the importance of analyzing and assessing the financial system as a whole by eyeing the relationship between the real economy and the financial system from a viewpoint of macroprudence. And, how to cope with asset prices on the monetary policy front is expected to be further discussed in the future.

Those are the issues that I particularly deem important concerning the generation and burst of the current credit bubble.

In the U.S. and European financial markets, there have been lively discussions on the rebuilding of financial institutions' business model, taking into account the experience of the current crisis. Many may feel it uneasy to apply directly the discussions overseas on financial institutions' business to Japanese financial institutions. Such feeling might come from the significant difference in how the current crisis arose in the United States and

Europe, and in Japan. Namely, for Japanese financial institutions, unlike the U.S. and European financial institutions, the first-round effects associated with the turmoil in structured product markets have been relatively marginal while the second-round effects associated with the economic downturn and the plunge in stock prices have been profound. Now I will talk about the characteristics of Japanese financial institutions and the challenges for them by also referring to the results of the analyses made in the Bank of Japan's biannual *Financial System Report*.

II. The Present State of Japanese Financial Institution Management

Characteristics of Japanese financial institutions' management

Japanese financial institutions and financial institutions in the United States and Europe are the same in terms of exerting the important financial intermediation function, but quite different in terms of business model and risk-taking stance.

First, in Japan, deposits are dominant in the financial assets of the household sector, and at Japanese financial institutions, both the major banks and the regional banks, traditional commercial banking that focuses on deposit-taking and lending still carries much weight.

As previously mentioned, financial institutions in the United States and Europe have recently expanded the originate-to-distribute model, and, in terms of profit, have been increasingly relying on the fee business and the trading business. Japanese financial institutions, mainly the major banks, have been strengthening investment banking and asset management businesses. However, deposit preference in the household sector has been deeply rooted, and the pattern that financial institutions using their deposits as a source of loans and investments, mainly in government bonds, has not changed much. As a result, while the ratio of borrowing from financial institutions to firms' aggregate funding except for stocks is about 20 percent in the United States, that ratio reaches 50 percent in Japan. Also from that point, you can see that the flow of funds through deposits and lending in Japan is still dominant.

Second, in terms of transaction relationship between financial institutions and customers, while financial institutions are gradually shifting to focus on the profitability of individual transactions, the stance of building a long-term stable business relationship based on overall profitability appears to persist.

Such focus on the long-term transaction relationship is by no means unique to Japanese financial institutions, and is also observed in U.S. regional banks. However, in the United States, such business relationship with customers seems to have been changing with the expansion of securitized markets. In addition, in the area of small firm lending, small business loans that simplify the screening process have increased mainly in major U.S. banks. That can also be considered as an expansion of lending business that is not based on the long-term customer relationship.

Also in Japan, the long-term relationship between financial institutions and customers once called a main-bank system has been gradually waning and transactions that attach importance to individual profitability have been emphasized. Small business loans were also once actively used in Japan. Financial institutions have come to provide fine-tuned services to depositors according to their outstanding amount of deposits and the frequency of the use of services, and have not necessarily consider their profitability in the context of long-term transaction relationship. However, such changes in the transaction relationship proceed only gradually and it appears that the financial institutions' basic stance of pursuing the long-term stable transaction relationship with customers has not changed substantially. For example, the practice of cross-shareholdings between financial institutions and large firms still remains, albeit declining in size. It seems that the regional financial institutions have also been focusing on the long-term transaction relationship with local firms as in the past.

Third, in terms of risk-taking, Japanese financial institutions generally appear to have been maintaining a cautious stance.

Behind that was a powerful effect of Japanese financial institutions' experience of incurring massive losses in the aftermath of the bursting of the bubble in the 1990s. One of the lessons learned from the bubble and its burst was the size of risk of concentrating credit on specific industries or firms. While it was difficult for some financial institutions to pursue active risk-taking until they completed their repayment of public funds, I believe that Japanese financial institutions as a whole generally appear to have been maintaining a cautious risk-taking stance based on the experience I have just mentioned.

Effects of the financial crisis and challenges for Japanese financial institutions

As seen above, Japanese financial institutions faced the current global financial crisis without being able to change substantially the existing management characteristics. As a result, the first-round effects of the crisis, namely the losses stemming from investments in U.S. securitized products and originate-to-distribute-type operations in the U.S. and European financial markets, has remained relatively limited as mentioned before.

The second-round effects brought about by the current financial crisis, namely, the losses stemming from the economic downturn and the plunge in stock prices have by no means been limited. Net income of Japanese financial institutions in fiscal 2008 made an about-turn to mark net losses of about two trillion yen from net profits of about two trillion yen in fiscal 2007, due mainly to the increase in credit costs and losses related to stocks. In that regard, the aforementioned characteristics of Japanese financial institution management seem to have rather worked in an adverse way to the deterioration in business performance. In other words, the current crisis has highlighted the basic challenges inherent in Japanese financial institution management. Let me elaborate those challenges.

First, low profitability of financial institutions.

While Japanese financial institutions' profits recovered significantly after the middle of the 2000s, it was mainly attributable to the reversals in loan-loss provisions, thanks to the progress in the disposal of impaired assets and economic recovery. For example, the sum of net income of Japanese financial institutions for the past 20 years is in the red. While the sum includes significant losses stemming from the disposal of impaired assets after the burst of the bubble, the net income of Japanese financial institutions remains quite low even if those losses are excluded.

The major reason for such low profits is the low interest income. Looking at the interest rate margins on loans (i.e., the interest rate on lending minus the interest rate on deposits), which is one component of interest income, for the past 20 years, the margin has been five to six percent on average for U.S. banks, while it has remained at slightly below two percent for Japanese financial institutions. The main reason behind such low interest rate margins of Japanese financial institutions is attributable to the fact that many financial institutions have basically been consistently in the interest rate competition as they compete with each other in the relatively homogenous commercial banking business with an aim to obtain a long-term stable transaction relationship. In short, the difference in business model by financial institutions is hardly observed. According to the analysis of the lending market in Japan, many financial institutions tend to enter the regions that have a large lending market, thereby intensifying competition. By contrast, in the U.S. market, there is no significant correlation between market size and market concentration, which suggests that certain segregation among financial institutions might be in place. While it is not clear why such a segregation was possible, it is clear that the segregation enabled financial institutions to avoid the needless interest rate competition.

Of course it is not the case that Japanese financial institutions themselves have not been doing anything to cope with such low profitability. Signs of expansion in the investment banking business, including M&A business, have also been continuing in Japan. Small business loans were once actively promoted. However, since credit costs increased significantly, many banks have recently been forced to downsize or withdraw from the small business loan operations. As for household asset management, the expansion of over-the-counter sales of mutual funds and insurance has been pursued. Moreover, at the major banks, the efforts to bring consumer credit companies, credit card companies, and consumer finance companies under the banks' umbrella were temporarily intensified. However, the profits from those affiliated companies have been sluggish, partly due to the changes in the environment they are in. After all, the fruits of pursuing new businesses have not been sufficient so far, and, at present, the new businesses have not contributed in a significant way to improving the profitability of financial institutions.

Second, Japanese financial institutions' profits are subject to the fluctuations in credit costs and stock prices.

In particular, as operating profits from the core business have been remaining low, a significant increase in credit costs and losses on stocks might immediately bring periodical income into the red. In fact, eight times in the past 20 years, the sum of credit costs and losses related to stocks reached a level more than that of operating profits from the core business.

While the level of credit costs fairly declined, reflecting the completion of the disposal of impaired assets, it started to rise again in fiscal 2008 due to the economic downturn. In addition, the outstanding balance of financial institutions' strategic cross-shareholding was reduced almost by half during the disposal process of impaired assets in the early 2000s for the major banks, and remains almost unchanged since then. That suggests that the practice of cross-shareholding between financial institutions and firms remains, and, at the same time, the current outstanding amount of shareholding is still a factor in inducing large swings in financial institution profits.

While the challenges cannot be met easily, I expect financial institutions to consider them now as a golden opportunity and step up their efforts in order also to maintain and further arouse the vitality of Japan's economy.

III. Approaches to Meet the Challenges

Strengthening capital base consistent with risks

Next, I will offer my views on what kind of approaches might be necessary for meeting the challenges.

First, strengthening capital bases that are consistent with the risks held by financial institutions.

The review of the regulatory framework including the capital adequacy ratio for financial institutions has been discussed globally. It is expected that an initial draft of a new regulatory system will be presented between the end of this year to the beginning of next year, and after conducting quantitative research on the influence of a new system, a final draft will be completed by the end of 2010.

It is necessary to carefully examine how a new regulatory system would affect the financial system and real economic activity. However, it is critical for individual financial institutions themselves, independent of the discussions on such a regulatory framework, to strive to strengthen their capital bases that are consistent with the risks they hold.

After all, capital is the last resort as a buffer to absorb losses. What became a catalyst for the global financial system to gradually regain stability after the current crisis were the efforts by U.S and European major financial institutions to restore their capital through receiving public capital or raising private funds in the markets. Concerning Japan's financial system as a whole, macro-stress tests conducted in the Bank's *Financial System Report* showed that Japanese financial institutions' capital bases are not likely to decline substantially even in the situation where severe future macroeconomic conditions are assumed. However, as mentioned earlier, in the case of Japan, there is the problem that banks' profits tend to fluctuate according to economic developments, which lead to changes in capital. In addition, if financial institutions pursue a new business strategy to meet a variety of needs from firms and households, capital bases that can tolerate risks of a certain degree need to be enhanced. Both the major banks and the regional banks have recently been reinforcing their capital bases, which the Bank regards could lead to ensure soundness of individual financial institutions as well as the stability of the financial system as a whole.

Appropriate risk management

Second, the importance of appropriate risk management.

For a financial institution, risk management is essential in ensuring management soundness and maintaining the smooth financial intermediation function as well as a key to ensuring profits. In terms of credit risk management, Japanese financial institutions have been improving their screening skills, based on the experience of the bubble period during the 1980s, and have made fair accomplishments. However, the deterioration in firms' business performance triggered by the current financial crisis has progressed at an unprecedented pace. Taking that into account, it becomes important for financial institutions, in addition to improving their screening skills, to strengthen follow-up management, and further strive for supporting corporate rehabilitation. Moreover, the finely-tuned setting of lending interest rates according to credit risks continues to be an important challenge.

In terms of market risk management associated with stockholdings, the size of strategic cross-shareholding will be basically left to firms' and banks' business strategies. However, the current market risk associated with stockholdings of Japanese financial institutions as a whole remains to be high relative to capital bases, and a steady reduction in the amount of that risk is no doubt a critical challenge for financial institution management as well as for the stability of Japan's financial system.

Building a business model to strengthen profit base--focusing on retail banking

Third, building a business model to strengthen the profit base. While I will focus on the topic of today's speech, retail banking, reinforcement in the area of wholesale banking is also essential for strengthening the profit base. Retail banking could provide higher value-added services by managing it in an integrated way with wholesale banking. For the major banks, how to formulate coordination between wholesale and retail banking would be one of the keys to rebuilding their business model after all.

(1) Operations related to deposits, payment and settlement, and asset management

To that end, first I will take up the role of operations related to deposits, payment and settlement, and asset management.

After the current financial crisis, a phenomenon to be seen as 'back to basics' of financial operations has been occurring in the United States and Europe. Proprietary trading of complex products, such as securitized products and derivatives, has complicated the risk profiles of financial institutions and made risks difficult to manage. Based on such recognition, a move to return to the traditional business based on customer transactions has been emerging. The move includes a re-evaluation of traditional businesses related to deposits and payment and settlement while taking into account a viewpoint of improving the management of liquidity risk. Those businesses are, so to speak, the areas Japanese financial institutions have been good at.

One question for financial institution management in Japan is whether the costs associated with maintaining deposit bases are commensurate with the profits. Retail banking is associated with a variety of unique factors that lead to an increase in costs, including ATM that operates 24 hours. Meanwhile, to charge fees for the current deposits whose balance dropped below the required minimum balance is not gaining customers' understanding. While how to balance the costs and profits is an important management judgment, it would be absolutely necessary for financial institutions to avoid the possibility of running below break-even. As financial institutions are expected to provide fine-tuned services to households reflecting their outstanding balance of deposits and the degree of use of services, it would be necessary to check the balance between the quality of services and the cost sharing.

In addition, if one assumes a situation in which households' asset accumulation further progresses and their asset management diversifies, it would be essential to enhance the services to support households' asset management. Such services are currently provided in the form of over-the-counter sales of mutual funds and insurance, and asset management services. By properly gauging the needs of customers and enhancing the provision of services, I believe it important that the fee business steadily takes root.

(2) Personal loans

Second, the role of personal loans. In Japan, housing loans have overwhelming weight and accounts for about 20 percent of the financial institutions' total lending.

Housing loans in Japan have been increasing steadily even under the current financial crisis. The problem is its profitability. According to the Bank's analysis, the profitability of Japanese financial institutions' housing loans has been consistently declining recently. For example, if the profitability of housing loans during the life of a loan that was lent in fiscal 2003 and fiscal 2007 is compared on a present value basis, it will decline by about six percentage points. If the default rates rise significantly in the future, it cannot be denied that banks' profits will plunge. The profitability of housing loans also warrants careful monitoring.

In addition, consumer loans such as card loans and car loans are an area where potential needs exist over time. With a view to its potential, the major banks have been increasing their capital subscription to consumer credit, credit card, and consumer finance companies. As explained earlier, those affiliated companies have not contributed to increasing the profits of financial institutions, while the future developments in the area of consumer loans warrant attention.

(3) Lending to small- and medium-sized firms, and provision of risk money

Third, fund provision to small- and medium-sized firms.

Firms' funding conditions rapidly deteriorated from the autumn of 2008 to the beginning of 2009, and have been recently improving, partly due to the recovery of CP and corporate bond markets. Many small and medium-sized firms still view their funding conditions as tight, and the Bank considers that the smooth fund provision to small and medium-sized firms continues to be an important challenge for corporate finance in Japan.

Looking at the future of Japan's economy, how to provide risk money to small- and medium-sized firms with high technology would be a challenge for the financial system. In that case, it becomes important to apply part of households' ample financial assets to risk money.

In Japan, while the importance of venture capital has repeatedly been argued, it has not grown in a significant manner so far. Providing risk money smoothly to firms that have a possibility of leading Japan's future economic growth is one important challenge in the area of retail banking. The Bank will keep monitoring with strong interest what type of financial institution will play a role of intermediation through what type of channel.

Concluding Remarks

The current financial crisis has posed various challenges to the Bank of Japan.

One of them is, from a macroprudential perspective and taking into account the interconnectedness between the real economy and the financial system, to analyze and assess the risk of the financial system as a whole. The Bank of Japan has been tackling such challenge through *Financial System Report* and others, and intends to further enhance its efforts as well as to continue to strive to properly gauge and assess the risk inherent in the financial system.

On that basis, the Bank considers that how to utilize such assessment in monetary policy or to utilize in further strengthening of financial institutions' risk management through on-site examination, off-site monitoring, and the activities of the Center for Advanced Financial Technology, would be our next challenge.

Amid changing global economic and financial conditions after the financial crisis, Japan's economy is also faced with a difficult situation from a longer perspective. For Japan's economy's long-term growth, it is essential to raise the productivity of the economy as a whole. To contemplate what kind of reform in the industrial structure is required and how that can be supported on the financial system front, would also be a challenge for the Bank of Japan. By sharing wisdom with you, the Bank will make the utmost contribution as a central bank.

Thank you.