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The Hidden Risks in Japan's Financial System

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The risks in Japan's financial system

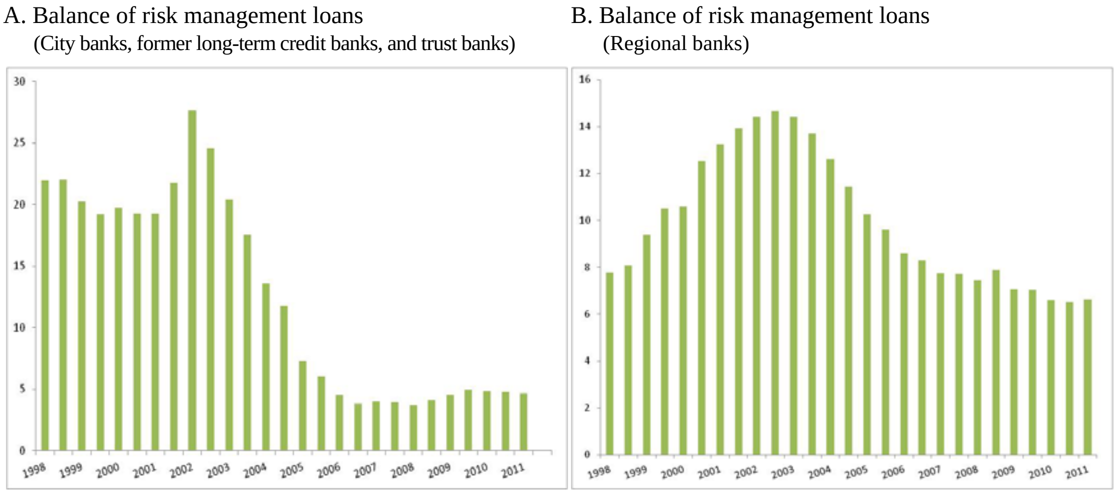
The sovereign debt crisis originating in Greece has spread rapidly to other European nations, and is also jeopardizing the soundness of European financial institutions which hold large amounts of public debt. In Europe, many banks, including major banks, are experiencing funding difficulties, and a return of the financial crisis of fall 2008 is feared. In the U.S., many banks which have not fully extricated themselves from the aftermath of the financial crisis are also suffering difficulties. In comparison to these problems in European and U.S. financial systems, the Japanese financial system appears stable. Japanese financial institutions were not much exposed to the toxic securitized products that triggered the recent financial crisis, and the amount of their non-performing loans has not increased. As I will discuss below, however, the official figures for non-performing loans do not reflect the actual situation, and that large sums in non-performing loans have come to be hidden since the financial crisis. Moreover, the fact that Japan's financial institutions hold enormous amounts of Japanese government bonds implies dangerously high interest rate risk. Japan should come up with effective measures to contain the credit risk and interest rate risk facing its financial system.

Non-performing loans appear to be declining…

Figure 1 shows the balances of non-performing loans held by large banks (city banks, former long-term credit banks, and trust banks; 11 banks as of 2011) and regional banks (regional banks and second-tier regional banks; 106 banks as of 2011). Looking at the amount of risk management loans (most popular definition of non-performing loans for Japanese banks) for large banks (Figure 1A), we see that the amount of non-performing loans quickly fell after it peaked in March 2002, reflecting the efforts of the banks to reduce the non-performing loans under the reform program pushed by Heizo Takenaka, who was the Minister of Financial Affairs then. Since March 2006, the amount of non-performing loans has been below five trillion yen. While the amount of non-performing loans increased slightly following the so-called Lehman Brothers shock, the amount has been declining since September 2009.

The regional banks also reduced the amount of non-performing loans after the peak of March 2002, although the pace was slower than was the case for large banks, and the amount fell below 7.5 trillion yen by March 2008 (Figure 1B). In the period ending September 2008, the amount of risk management loans increased by about 0.4 trillion yen, but immediately declined. We cannot observe adverse effect from the global recession.

Figure 1 Risk management loans (Units: Trillion yen)



(Source) Financial Services Agency, Status of Non-Performing Loans, End-March, 2011, Table 6 (http://www.fsa.go.jp/en/regulated/npl/20100205.html)

When these figures are considered in isolation, it may appear that Japan's financial system has remained sound, being largely unaffected by the global financial crisis and the subsequent recession. While the amount of non-performing loans held by large banks has increased slightly, non-performing loans for regional banks have declined against pre-crisis figures. This is puzzling because the global recession had a significant effect on the Japanese economy.

How come the amount of non-performing loans held by Japanese financial institutions did not increase, then? The main reason is the changes in the stance of financial supervision after the global financial crisis. As the global recession worsened, Japan's Financial Services Agency (FSA), in the name of facilitating finance for small and medium-sized enterprises, encouraged banks to continue providing funding for troubled SMEs. It is not difficult to imagine in the background lobbying by politicians for whom SMEs represent an important base of support. In order to ease the provision of bailout funds to SMEs by banks, the FSA relaxed the supervisory framework several times after the crisis. The changes included modifications of the method of classifying non-performing loans. With these changes, some loans which would previously have been classified as non-performing are now deemed performing.

Relaxation of supervision to help SMEs

The first major regulatory change came on November 7, 2008, less than two months after the collapse of Lehman Brothers. The FSA published the Measures to Facilitate the Easing of Lending Terms for Loans to Small- and Medium-Sized Enterprises, which narrowed the definition of restructured loans, a category of classified loans[1]. Previously the FSA's Inspection Manual for Deposit-Taking Institutions had stated that a loan with relaxed terms can still be classified as "normal" if the company has a comprehensive business reconstruction plan that would make the loan performing in around three years. Now, arguing that it was in the nature of SMEs that they required more time for business reform, the FSA allowed the banks to classify a restructured SME loan "normal" if a company has a reconstruction plan which would make the loan performing in around five years (including cases in which the company would proceed in accordance with the plan and the loan become performing after 5 years but within 10 years). This change made some loans that would have been classified as restructured loans previously to be classified as normal. With such modification, the reduction of the balance of non-performing loans held by regional banks (which have large SME customer bases) between September 2008 and March 2009 that we saw above is not puzzling. According to FSA data, of 1.837 trillion yen in loans for which conditions were relaxed in the first quarter of 2009, 840 billion yen (or approximately 46%) was not classified as restructured loans because reconstruction plans were formulated during the quarter[2]. Given that this figure does not include loans which were reclassified later because the reconstruction plans were formulated well after the terms for the loans were relaxed (for example in the second quarter of 2009), much more than 50% of restructured loans must have been reclassified as normal.

The relaxation of financial supervision continued. On December 12, 2008, the Capital Ratio Regulations were partially revised[3]. Under the pretext of taking a risk-diversification effect into consideration, the risk weight for SME loans less than one hundred million yen is 75%. Prior to the revision, the one hundred million yen threshold was applied to the total amount of loans including those with guarantees by a credit guarantee association. The revision excluded the loans guaranteed by a credit guarantee association in the calculation, thus increasing the amount of SME loans with the lower risk weight.

On March 27, 2009, the FSA's Inspection Manual for Deposit-Taking Institutions was partially revised to encourage even the weakest financial institutions to support troubled

SMEs. The financial institutions that are implementing management reinforcement plans under the Act on Special Measures for Strengthening Financial Functions are put under scrutiny of the FSA and they become subject to sanctions if they fail to achieve several accounting targets specified in the plans. The revision indicated that such sanctions are not automatically applied for the efficiency ratio, and that considerations should be made for any efforts the institutions made to facilitate the provision of credit to SMEs[4].

Increases in hidden non-performing loans resulting from the Act concerning Temporary Measures to Facilitate Financing for SMEs

After the Democratic Party of Japan (DPJ) took the power in fall 2009, measures for the facilitation of financing for SMEs were enshrined in law. The Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs), which was enacted on November 30, 2009, stipulated that financial institutions should make efforts to respond favorably in the event that the recipients of small and medium-sized business loans or housing loans requested changes to the conditions of those loans. This resulted in a further change to the FSA's Inspection Manual to stipulate that, even if a debtor had not yet formulated a highly feasible and comprehensive business reconstruction plan, if the debtor was a small or medium-sized enterprise and there was a good prospect that the enterprise would formulate such a business reconstruction plan within the period of one year from the date on which the conditions of the loan were changed, the loan would be judged not to be classified as a restructured loan. In other words, on condition that a company simply claimed to have a prospect for the formulation of a business reconstruction plan, the company's loan could be classified as normal.

The Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs) was initially scheduled to be a temporary measure, in effect until the end of March 2011, but was later extended until the end of March 2012. From its enactment to the present, numerous SME business loans and housing loans have been subject to changes in their terms under the auspices of the Act. Figure 2 shows the status of changes in the terms of loans to SMEs up to the end of June 2011, as published by the FSA. In about one year and a half, SMEs have applied for changes in terms to loans totaling 42 trillion yen, and financial institutions have responded favorably to these requests in the case of loans totaling 39 trillion yen. Cases in which the applications have been refused represent a total value of no more than one trillion yen. Excluding cases in which applications have been withdrawn during the review or prior to a decision, terms have been changed for the loans representing 97.2% of the total amount.

Figure 2 Status of changes in loan conditions based on Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs)

(Upper figures: Number of occurrences; Figures within parentheses: Value [Units: Billion yen])

	Applications A	Approvals B	Rejections C	Applications under review	Withdrawals of applications	Rate of approval [B/(B+C)]
Large banks (11)	284,263 (14,567.5)	254,457 (13,399.1)	7,653 (394.7)	13,681 (500.7)	8,472 (302.9)	97.1% (97.1%)
Regional banks (106)	977,128 (27,395.3)	884,456 (25,283.4)	25,432 (646.9)	35,162 (841.6)	32,078 (623.0)	97.2% (97.5%)
Other banks (28)	19,075 (271.5)	14,917 (167.5)	2,082 (81.2)	991 (12.0)	1,085 (10.7)	87.8% (67.4%)
Total (145)	1,280,466 (42,264.3)	1,153,830 (38,850.0)	35,167 (1,122.8)	49,834 (1,354.3)	41,635 (936.6)	97.0% (97.2%)

(Note) The records cover the period from the date that the law took effect to the end of June 2011.

(Source) Financial Services Agency, "*Chusho kigyo kin'yu enkatsukaho ni motozuku kashitsuke joken no henko-to no jokyo ni tsuite*" ("Status of Changes to Loan Conditions based on the Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs)"), (http://www.fsa.go.jp/news/23/ginkou/20110901-1/01.pdf) (Japanese only)

Credit risk for Japanese banks is significantly greater than it appears

It is not clear how much of the loans for which terms have been changed are regarded as normally performing. However, if we consider that in cases of restructuring of loans carried out under measures for the facilitation of funding to SMEs prior to the enactment of the Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs), around half of the relevant loans were considered normal, and that conditions for exclusion from the category of restructured loans have since been further relaxed, with the "prospect" of a business reconstruction plan now sufficient, it is probably safe to assume that almost all of the loans for which terms have been changed would have been classified as non-performing under the previously enforced standards.

If this is the case, then published figures for non-performing loans are around 13 trillion yen lower than the actual figure in the case of the large banks, and around 25 trillion yen lower in the case of regional banks. Even if we were to be exceptionally generous and assume that only half of the value of loans for which terms have been changed under the Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs) have been classified as normally performing loans, the reported figures would still be 6.7 trillion yen too low in the case of the large banks, and 12.7 trillion yen too low in the case of regional banks. Since the total amounts of risk management loans as of March 2011 were 4.6 trillion yen for large banks and 6.6 trillion yen for regional banks respectively, the true figures for non-performing loans are estimated to be at least 11.3 trillion yen for large banks and at least 19.3 trillion yen for regional banks. For large banks, this figure is comparable to the amount of non-performing loans as of September 2004. For regional banks, the figure exceeds the peak amount recorded as of March 2002. The credit risk for Japanese banks is clearly higher than it appears.

Interest rate risk of Japanese government bonds holding

In addition to credit risk, Japanese banks are also exposed to interest rate risk arising from their holdings of Japanese government bonds. As is well known, Japanese government debt is enormous, and is increasing. Almost all recent studies conclude that the Japanese fiscal policy is unsustainable if the current stance continues. For example, a recent paper by the author with Takero Doi and Tatsuyoshi Okimoto concludes that an immediate increase of tax revenue of around 10% of GDP would be necessary to stabilize Japan's debt-to-GDP ratio in about 90 years. The paper also shows, however, such a drastic tax increase is highly unlikely given the observed history of fiscal policy in postwar Japan[5].

If the market comes to share the wide spread conclusion among researchers that the Japanese fiscal policy is unsustainable, the Japanese government will face difficulty in refinancing bonds, and the interest rates will go up. More than two thirds of the outstanding Japanese government bonds are held by Japanese financial institutions. Holdings of government bonds and regional bonds by Japanese banks amount to 142 trillion yen (as of March 2010). The Bank of Japan's Financial System Report in March 2010 estimates that if interest rates were to increase by 1%, the banking sector would face a capital loss of 4.7 trillion yen. This corresponds to 11.7% of Tier I capital for the accounting year ending in March 2010 or approximately double the industry's pre-tax earnings for the same period.

Rapid normalization of financial supervision and the formulation of a credible plan for fiscal consolidation are necessary

In summary, Japanese financial institutions face great credit risk and interest rate risk. Failure to respond to this situation would jeopardize a resurgence of the financial crisis, as we have been observing in Europe. The further injection of capital into financial institutions in order to enable them to withstand losses, as is being argued for in Europe, is perhaps one viable method. The time for such recapitalization is now, before the problems inherent in the Japanese banking system manifest themselves.

Even more important point is the fact that the problems have originated in government measures. In order to prevent the amount of hidden non-performing loans from increasing further, it is necessary to stop further extension of the Act concerning Temporary Measures to Facilitate Financing for Small and Medium-Sized Enterprises (SMEs) and to normalize financial supervision. In addition, the rapid formulation of a credible plan for fiscal consolidation will be essential to prevent a financial crisis triggered by a sovereign debt crisis.

Notes

1 http://www.fsa.go.jp/news/20/20081107-1.html
2 http://www.fsa.go.jp/news/20/ginkou/20090605-1/01.pdf
3 http://www.fsa.go.jp/news/20/20081224-1.html
4 http://www.fsa.go.jp/news/20/ginkou/20090327-3.html
5 Takeo Hoshi, Takero Doi, and Tatsuyoshi Okimoto (2011). "Japanese Government Debt and Sustainability of Fiscal Policy," *Journal of the Japanese and International Economies*, forthcoming.

Profile of Takeo Hoshi:

Professor, Pacific Economic Cooperation Chair in International Economic Relations, University of California, San Diego, and visiting researcher, NIRA.
His major research area is the study of the financial aspects of the Japanese economy, especially corporate finance and governance.
Professor Hoshi published the NIRA research report titled *Why did Japan Stop Growing?* (co-author: Professor Anil Kashyap, Booth School of Business, University of Chicago) in 2011.
He is the inaugural recipient of the 2006 Enjoji Jiro Memorial Prize, which is given by Nihon Keizai Shimbun-sha (Japanese equivalent of the Wall Street Journal) to three leading Japanese economists who work on policy issues every three years.

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