

## **Can Japan's Ailing Banking System Be Cured?**

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Good morning, ladies and gentlemen. I am very pleased to join you at this conference of Japan Society and the Center on Japanese Economy and Business, Columbia University. Bill Clark and Hugh Patrick gave us the topic of today, "Can Japan's ailing banking system be cured?". To speak about it is obviously a daunting task not just for me but also for any policy makers in Japan. I suspect they have been declined by many Japanese government officials before me. While I would be proud to be the speaker of the last resort -- although I am not so sure if the last resort is such a wonderful thing -- Hugh Patrick told me I was actually their first choice.

### **1. Sense of Emergency Receding**

Japan's economy appears to have entered a short cyclical recovery driven by progress in inventory adjustment worldwide. Surprisingly enough, optimism about the Japanese economy is growing again within the government after equity prices rebounded from the February low point. Japan's economy has experienced three short-term recessions during the past decade. A financial crisis repeatedly emerged during each recession period. Each recession was followed by a short and weak recovery mainly supported by inventory build-up in the manufacturing sector. Overall, GDP has declined throughout the decade, since 75% of GDP consists of the non-manufacturing sector, in which huge non-performing assets are concentrated.

The fading sense of emergency on the part of the government indicates that a serious deficiency lies in the national governance system. A caveat must be placed against the optimism,

which is the exact same phrase I used in my speech in Washington D.C. in the spring of 1999, when the Japanese economy was about to enter cyclical recovery for the second time. Now I say same diagnosis, same prescription. I have to warn again by quoting an old Japanese saying, “*Hotokeno-Kaomo-Sando-Made*”, which means Buddha condones no more than three times.

## **2. Reality of Japan’s Banking Problem**

Maladies of the banking system are quite apparent. We should always start with the recognition of grave magnitude of non-performing assets. One year ago, Prime Minister Koizumi announced that his administration would concentrate on disposal of non-performing assets. What was proposed in reality, however, was to set a little more than 12.2 trillion yen of non-performing assets off the balance sheet within the next two to three years.

The Financial Services Agency (FSA) disclosed the outcome of the special inspection of major banks on April 12. This inspection covered 149 large indebted companies, the result of which reportedly adds only as little as three or four trillion yen to the narrowly defined disposition target of NPLs.

I hope this special inspection would be an initial step in disposing non-performing loans accumulated on the balance sheets of Japanese banks. We have to keep in mind the reality that more than 80 trillion yen of so-called category II loans, or substandard loans, on a self assessment basis, which is equivalent to 16% of GDP, remain concentrated on real estate, general construction, retail/wholesale and non-bank sectors.

### 1) Capital shortage, deferred tax public capital

First, I suspect judging from special inspection results by the FSA, the Koizumi administration seems to have decided to postpone the resolution. According to the FSA, no major banks are

undercapitalized. As a superficial matter of BIS standards, capital might be sufficient. But in reality, in the major banks' Tier I core capital of 18 trillion yen, two tricky items are included. That is, 6 trillion yen of deferred tax assets, which represent allowances for the future income tax deduction, and 5 trillion yen of public fund, which is not common stock and is expected to be repaid in the future. In sum, the hard core capital, if I may use this word in front of this respectable audience, of major banks is only one third of the stated 18 trillion yen. Today, not only banking experts but also average people consider additional capital injection to the major banks to be necessary some time. Under the circumstances, we always have to be mindful of possible contingencies in the financial system.

## 2) Weak earnings, lack of risk based pricing, low ROE

Second, weak earning power of Japanese banks undercuts the positive effect of a resolution.

Japanese banks' return on equity (ROE) is below 15%, which is substantially low compared with U.S. banks which generally keep over 25%. Three factors can be pointed out: low interest rate spreads; low service fee earnings; and high credit cost. There have been structural and historical grounds that Japanese banks' lending practices have traditionally been based upon collateral evaluations, and they have established no effective risk-based pricing model derived from cash flow evaluation.

## 3) Governance problem, Mizuho case

Third, the corporate governance system should also be addressed. As a result of mega bank mergers, over 15 major banks have been now consolidated into four big groups. But I think the recent Mizuho problem, where ATMs and fund transfer computer systems clogged because of insufficient system integration testing in the process of mergers, raised old type corporate

governance question, since the trouble apparently could be avoided if the new management had the merger preparation process in order. Also it is reported that although computer system experts had in the early stage warned that trouble might occur, top management ignored that voice in order to keep the merger schedule unchanged. We have to rebuild the corporate governance system that can take back resilience of Japanese firms.

#### 4) Cross-shareholding, BSPC

Fourth, cross-shareholding. Along with life insurance companies (Seiho), Japanese banks are one of the largest investors in the stock market. The banks hold over 40 trillion yen equities on their balance sheet for the purpose of maintaining a long-term relationship with their borrowers, but in reality they proved to be unprofitable assets. Thus, banks are expected to sell equities outright over 4 trillion yen within 2 years. At this juncture Bank's Shareholdings Purchase Corp., a government-sponsored equity purchasing entity, was established early this year in order to prevent a massive wave of selling from putting further downward pressure on the stock market. In my opinion, it is ridiculous. This simple share price supporting device addresses none of the fundamental problems associated with the cross-share holding and double gearing between banks and life insurance companies. Enhancement of corporate governance and improvement in transparency through full disclosure with a reliable accounting system is the only way to solve the structural problem.

### **3. Way Out**

#### 1) Common experience, i.e., U.S., Sweden, and Korea

In order to get out of the current crisis situation, what must we do now? Conventional wisdom suggests that it is just through the disposal of non-performing assets, and putting the real assets (for example, real estate, or viable divisions of failed corporations) back to work in the real economy in

an efficient way.

Then, how to do it? The answer is also quite simple:

- a) Establish stringent rules for evaluation of bank assets, provision sufficiently, and recognize losses;
- b) Remove NPLs off the balance sheet, and if necessary nationalize banks or inject public capital;
- c) Revitalize asset markets, by way of tax and legal system improvement.

These measures were adopted in the U.S., Sweden, and more recently in Korea. Especially, in Korea, 7% of the GDP has already been spent to clean up the balance sheets of the banks.

Aggressive asset disposal was quite effective in de-leveraging the corporate sector in Korea. As for bank restructuring, the Korean government took aggressive actions, such as capital reduction, drastic business re-modeling, management from outside the banks, and compulsory mergers. We already know what we must do.

## 2) Weak capital market function

At this juncture, the weak capital market function must be addressed. It is apparent that when a banking system does not function well due to huge non-performing assets, the capital market should play an alternative role as a financial intermediary. Japan's capital markets, however, have failed to attract not only overseas but also domestic investors until today. Of the 1,404 trillion yen household financial assets, only 7.2% is in equity markets and only 2.3% is in mutual funds, while 53.8% is in bank deposits and postal savings. Let me make four points in this regard.

First, investors don't trust Japan's accounting system. This must be improved, such as, a quick introduction of accounting rules for impairment of fixed assets.

Second, creation of a strong and independent SEC is necessary to ensure fair trading.

Third, an independence of the mutual fund industry from parent broker dealers must be protected for the purpose of enhancing transparency and restoring the trust of investors.

Fourth, capital gain tax should be effectively reduced to zero as long as the Japanese economy lacks risk capital in macro-economic terms.

I believe that as long as Japanese banks have limited capacity to manage assets well, we have to improve the capital market.

#### **4. Future Scenario**

In conclusion, I would like to show you three possible scenarios for the course of reform in the financial system:

- 1) “Compulsory and aggressive” resolution, just like Korea.
- 2) “Muddle through” approach; continue to conceal the current crisis situation, just like now.
- 3) “Preemptive,” sporadic nationalization, hopefully Sweden cases.

Many of you might think my remarks today as too pessimistic about the future of Japanese banking system reform. In the short term, I must admit that. But in the longer term, that is not correct. I have a bit more of an optimistic view in the long run, since the problem we are facing was originally caused by the speculative bubble burst. From the Tulip bubble in Holland in the 17th century and the South Sea bubble in England in the 18th century, various forms of economic bubbles have occurred, but history tells us that no nations have disappeared or declined simply due to the bubble burst.

However, behind the prolonged crisis lies our governance problem not only in the business sector but also in the political sector. As massive political scandals broke out in the Diet during these days, Prime Minister Koizumi and his administration seemed to be losing political determination to proceed with the resolution. In this sense, Japan's situation is such that "everything is politics." As I mentioned, every market participant acknowledges that banks' core capital is fragile, which means if accounting changes, capital shortage must be recognized and a crisis can suddenly emerge, meaning any political switch can be a possibility for drastic changes in the course of reform policy.

The problem we are facing is not the inability to envision solutions but the inability to put them in practice. As a politician, I believe what is most needed now is a political will to restore the functions of financial markets for the sake of national interests as well as for the benefit of the international economy. Thank you.