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Strategy Towards the "Big Bang" --
The Industrial Bank of Japan's Approach

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Japan's "Big Bang" Financial Reform

The Japanese "Big Bang" is a broad reform plan for Japan's financial system announced in November 1996 by Prime Minister Ryutaro Hashimoto (Table 1-1). The goal of this ambitious financial liberalization plan is to revamp Japan's financial markets and industry which have been adversely affected by the bursting of the bubble economy or, in other words, to make Tokyo an international market comparable to those of New York and London by the year 2001.

One important issue is the bad loan problem of Japanese banks which triggered the discussion of reform. Non-performing loans (NPL) of Japanese financial institutions as of September 1996 stood at 29.2 trillion yen, or approximately 4.1 percent of total loans (Table 1-2). This is the total for all insured depository institutions in Japan. There are about 1,000 such institutions, including 150 commercial banks. If we focus on the 20 major banks, the amount of NPL is some 17 trillion yen, or 4.5 percent of total loans.

The amount of NPL, however, has been substantially reduced from the 38 trillion yen level of September 1995, mostly due to the bailout of the jusen, Japan's troubled mortgage financial institutions. The direct impact of the NPL may have already reached its peak, although this is still subject to the future performance of the Japanese economy.

Table 1-3 shows the manageability of the NPL by depository institutions. The total cushion (the sum of capital equity, unrealized gains of land and securities, loan loss provisions and other collateral) is about 2.5 times larger than the amount of NPL, even without counting business profits.

The "Big Bang" reform rests on three major principles, namely "free," "fair," and "global." Stemming from these principles are nine specific action items:

1. Promotion of mutual entries among financial industries (banking, securities and insurance)

In the post-war Japanese financial system, financial industries have been treated as strictly separate from each other. The banking sector has been further compartmentalized into commercial banks, long-term credit banks, trust banks, etc.

However, already in 1993 (Table 3), mutual entries into the turf of banks, trust banks and securities firms were deregulated. Nevertheless, there are several important restrictions for cross entry (i.e., prohibition of equity-related business for securities subsidiaries of banks) which remain to be liberalized. In addition, a holding company structure will be allowed for financial institutions.

2. Abolition of restrictions on certain financial products

This item is based on the separation principle of long-term and short-term banking as well as expansion of the activities in which banks and securities companies can engage. Examples are liberalization of the issuance of straight bonds by city banks, selling by banks of insurance-related products, investment trust products, asset-backed securities, and also various securities or commodities related to OTC derivatives, etc.

3. Liberalization of commissions, especially stock brokerage commissions

4. Abolition of the authorized foreign exchange bank principle

5. Deregulation of various asset management-related restrictions, such as the asset appropriation rule

6. Requirement for thorough and substantial disclosure

This requirement includes revision of accounting standards or application of the so-called “prompt corrective action rule” to depository institutions.

7. Strengthening of punishment for violations

8. Preparation of the legal system to make possible the introduction of new financial products to the Japanese market

Examples are revisions of certain provisions of the Securities Exchange Act and Commodity Exchange Act which have effectively barred the introduction of certain derivative products.

9. Establishment of a global supervisory cooperation regime

This is the basic outline of the Japanese “Big Bang” reform. Although the details still need to be worked out, the time table for reform has already been set (Table 4). A substantial part of these deregulations will occur by the end of 1999, except for those related to the insurance business. Deregulations which will occur early on include asset management-related liberalization, liberalization of foreign exchange regulation, lifting of certain restrictions on securities subsidiaries of banks, and liberalization of certain settlement functions to securities companies.

The “Big Bang” is truly a substantial reform, although some important areas, such as the treatment of governmental financial institutions and the taxation system, remain barely touched.

As for public financial institutions, virtually nothing has been done during the course of the "Big Bang" discussions to change the status quo. These institutions account for 26 percent of total personal financial assets through deposits to postal institutions and so on and 17 percent of total business loans to the corporate sector through loans by the Japan Development Bank and others. With regard to the taxation issue, it is evident that taxes on yields from Japanese treasury notes need to be abolished for the sake of the internationalization of the Tokyo market. But these issues have been barely touched upon. In addition, very little progress has been made so far in the insurance related fields.

Impact of the "Big Bang" on Japan's Financial Markets

Next, what will be the impact of the "Big Bang" on Japan's financial markets (Table 5)? First, there is no doubt that competition will increase for each financial industry. Perhaps the most notable changes will occur in the securities industry. International comparison shows that Japanese securities firms have traditionally enjoyed a relatively high level of fixed commission fees. However, with the abolition of foreign exchange controls, individual Japanese investors will be able to place orders in overseas markets where commission fees are either very low or zero. In consequence, commission fees in the Japanese market will drop to the international level. Indeed, the "Big Bang" program asserts that, effective April 1998, commission fees for transactions exceeding 50 million yen will be deregulated. Already activities of foreign securities firms on the Tokyo Stock Exchange (TSE) are quite outstanding. The trading share of 21 foreign securities firms on the TSE in August 1997 was 32 percent, exceeding the combined share of 26 percent of the Big Four Japanese securities companies. In addition, foreign securities membership on the

TSE has increased to 23 out of 124 total members. Examples of entries this year are J.P. Morgan, NatWest and ABN-AMRO.

Second, a gradual shift of personal financial assets from deposits to securities, investment trusts, pension trusts, and so on will occur, and this will provide important business opportunities for asset management companies. As shown in Table 6, the size of personal financial assets in Japan amounts to approximately 10 trillion dollars, which is about one half of that in the United States. But the most striking difference is the weight of deposits. The combined weight of deposits in Japan is about 56 percent, versus just 16 percent in the United States. On the other hand, the weight of stocks in Japan is only 6.5 percent versus 33 percent in the United States, of which the real weight may be even closer to 50 percent if indirect investment through institutional investors is considered. Similarly, the weights of bonds and investment trusts in Japan are much smaller than those in the United States.

The potential is huge, therefore, for these financial assets to move from deposits to other forms of investment. This is where asset management companies, both domestic and foreign, can find new opportunities for expansion. The asset management business, traditionally confined to life insurance companies and trust banks, has already been deregulated to include banks and securities companies. This is the fastest growing area and the major battlefield of competition among financial institutions, including foreign players. This is why foreign asset management companies are rushing into the Tokyo market.

A third impact will be the possible capital outflow from Japan to other international markets as a result of the repeal of the Foreign Exchange Control Act, although such movement will be subject to changes in the yen interest rate.

What Does the "Big Bang" Mean to IBJ?

Now let us consider the case of the Industrial Bank of Japan, Limited (IBJ) (Table 7). IBJ was established in 1902, 95 years ago, as a special governmental institution with the dual mission of promoting the industrialization of Japan and contributing to the development of Japanese financial markets. Prior to World War II, IBJ was the most prominent provider of long-term funds to Japanese industry using governmental as well as private funds through the issuance of bank debentures. It also played a key role in the securities underwriting market, holding an 80 percent share before World War II.

After World War II, IBJ was privatized and in 1952 changed its structure to that of a long-term credit bank, which has the privilege of issuing bank debentures of one-year and five-year maturities as its major means of fund raising, but, at the same time, has certain restrictions on deposit taking as well as branch networking. In addition, American-style restrictions on banking, including prohibition of underwriting of stocks and corporate bonds, were introduced. As a result, IBJ's dominance in the underwriting business of corporate securities disappeared. However, IBJ has retained its predominant position in the underwriting of governmental corporations' securities, as well as that in the corporate bond trustee business (we call it commissioned bank business). IBJ also remains the top long-term loan provider to industry.

The current profile of IBJ is presented in Table 7. Although I believe size is not everything, the asset size of IBJ has been among the top 10 banks in the world. On the other hand, its domestic branches number just one-tenth or so of other major Japanese banks, and its staff numbers only about one-third that of other major Japanese banks.

As for recent performance, IBJ is not an exception among Japanese banks. We have been substantially affected by the bursting of Japan's bubble economy. As Table 8-1 shows, IBJ's gyomu jun-eki (core business profit) has improved significantly in recent years, including FY 1995 in which profits reached an historical high. However, the bursting of Japan's bubble economy has created a host of problem loans which affected the bank's profitability at below the gyomu jun-eki level. As Table 8-2 indicates, net income in FY 1995 was a negative 132 billion yen due to bad loan disposals of 856 billion yen. This red figure was the first in IBJ's over 90-year history. In FY 1996, however, IBJ has seen substantial recovery in its bottom line profit mainly due to improvements in asset quality. We made an additional disposal of bad loans in the amount of 261 billion yen during FY 1996, which is, however, just one-fourth the amount of the previous year's disposal. As a result, the amount of NPL as of March 31, 1997, was 824 billion, which is about 3.3 percent of loans outstanding and 40 percent reduced from the September 1995 level. IBJ's loan loss coverage ratio has improved to 67 percent which is one of the highest among major Japanese banks. At the same time, IBJ made right issue in November 1996, and as a result, its BIS capital ratio improved from 8.59 percent in March 31, 1996, to 9.04 percent in March 31, 1997. Table 9-1 shows the comparative picture of the coverage ratio of bad loans by capital and loan loss provision. IBJ's coverage is among the top, second only to that of BOTM.

What does the "Big Bang" mean to IBJ? As Table 9-2 indicates, in our point of view, the Japanese "Big Bang" offers IBJ a huge opportunity for business expansion. Although the environment will be fiercely competitive, we believe that all possible developments under the "Big Bang," including elimination of restrictions on securities and trust business subsidiaries, new areas of asset management business, introduction of the bank holding company structure and other general deregulation measures, will offer new and important business opportunities for IBJ.

Given this perspective, what will be our strategy? As Table 10 indicates, there are four major policies.

The first policy is to focus on IBJ's areas of comparative advantage as core businesses while making the most of and enhancing the value of our existing clientele. The details of this policy will be explained later.

The second policy is to re-engineer the corporate structure to match global competition, including reformation of various departmental structures in order to enhance product capability.

The third policy is to enhance the risk management system by reforming the organization to cope effectively with various risks which IBJ is facing.

And the fourth policy is to enhance IBJ's financial strength as represented by performance ratios such as ROE and the BIS capital ratio. A 10 percent BIS ratio is, for instance, a target of IBJ's medium-term plan for the three-year period ending March 1999.

In pursuing these policies, we keep in mind our five core business lines as follows: wholesale banking, derivatives and trading, investment banking (securities related business), asset management and corporate trust. At the same time, on the corporate structure side, we will reorganize the IBJ group's global operations by a matrix of clientele and product. In this reorganization we will utilize to the greatest possible practical extent, a bank holding company structure. Another focused policy for the IBJ group will be enhancement of professionalism, including reform of the personnel system to foster professionals and specialists.

Before exploring policy details for each core business line, we should review IBJ's comparative and competitive advantages. We believe there are six.

1. <u>A strong and unbiased corporate client base</u>

As Table 11 shows, IBJ's client base covers 85 percent of investment grade rated corporations. IBJ is also the largest lender to listed companies. In addition, as Table 12 indicates, IBJ's client base is unbiased with regard to any of the six major *zaibatsu* groups. It covers virtually all six groups.

2. <u>An extensive network of institutional investors</u>

IBJ is privileged to have built an extensive network of institutional investors through long time direct placement of IBJ debentures, the amount of which is second only to Japanese government bonds. Our coverage through monthly placement is 86 percent of all institutional investors.

3. <u>Performance in the securities business, asset management business and trust business</u>

Table 13 shows the achievements of IBJ Securities, now only four years old. As you can see, IBJ Securities' performance is second only to that of the Big Four securities companies and even surpassed that of Yamaichi according to the most recent reports of the first-half of FY 1997. Table 14 offers information on the asset management industry. IBJ N.W. Asset Management ranked number one in the field of discretionary contracts. While traditional securities houses are still ranked higher in terms of the investment trust business, IBJ Investment Trust Management ranks number one among bank subsidiaries management companies. Also, IBJ Trust and Banking's trust asset is top among the trust bank subsidiaries.

4. <u>Capability in ALM operation and market operation in general</u>

Because of its unique position as the leading issuer of bank debentures, IBJ has developed a strong capability in ALM operation, especially in the yen-dominated financial markets. It has also been very successful in building its lending position in new markets such as the Japanese

Repo market.

5. <u>Global network</u>

We have 22 branches and agencies, 18 major subsidiaries, 10 representative offices, and three shucchojo in 25 countries. Through this global network IBJ has built up a nice record in products such as project finance and structured finance, as can be seen in Table 15.

6. <u>Low cost structure based on its wholesale nature</u>

IBJ's expense versus gross profit coverage ratio is 40 percent, as compared to the 54.2 percent of major city banks. All per capita profit and asset ratios are higher than those of the major city banks.

With these advantages as the base, the business strategy in each core business will be as follows.

First, with regard to strategies in wholesale commercial banking, we will seek to enhance the trust of corporate clients (Table 16). To this end we will focus on the emerging needs of clients in the fields of balance sheet management, tax management, and risk management. In addition, we need to re-engineer the loan business by focusing on origination, structuring and placement, by controlling assets through loan sales and securitization, and by exploring the possibility of creating a syndicated loan business or loan trading business in Japan. What is important here is that we need loans, but at the same time we need to think about the turnover of the loan asset.

Second, our basic strategy in the derivatives and trading business will be to develop a full-scale derivatives warehousing business in Tokyo (Table 17). Since we will be allowed to deal with equity derivatives, we need to take advantage of our broad client base.

Third, in terms of the investment banking business, IBJ is quickly catching up to the Big Four in the straight bond related business. The “Big Bang,” however, will provide us with an important additional playing field, the equity related business. Our initial focus here will be as follows: underwriting, sales and trading of equity linked bonds, equity derivatives trading, value added equity trading with institutional investors, IPOs and structured private equity arrangements and distribution, etc. (Table 18). The basic strategy for these new businesses will be to make full use of the existing expertise, clientele and experience of IBJ’s overseas subsidiaries, as well as affiliated securities companies.

Fourth, our strategy in the asset management business will consist of the following components (Table 19). In the field of institutional fund management, we need to focus on the discretionary management of pension and public funds. For that we need to add the capacity of the IBJ N.W. Asset Management Company. We also need to enhance our global asset management capability. As to tax qualified pension plans, we need to take full advantage of our strong relationships with sponsoring companies. Regarding the investment trust fund management business, we need to establish a reputable investment track record at IBJ Investment Trust Management. We also need to take advantage of our relationships with institutional investors.

Finally, IBJ’s strategy in the corporate trust business will have two strategic focuses: the global securities custody business which is being handled by IBJ itself and the pension tokkin which will be handled by IBJ’s trust bank subsidiaries, although in the long run these may be consolidated.

IBJ’s overall strategy can be summarized by introducing the management policy set out in our medium-term plan for FY 1996-1998, ending March 1999. As described in Table 21, IBJ's management policy is to build customer confidence and to be responsive to market trends. Objectives are: 1) to strengthen ties with corporate and institutional investor clients; 2) to improve our business and risk management structure; and 3) to integrate IBJ's strength in investment banking, asset management, and the trust business to form a "universal wholesale bank with a global presence."

In the United States, IBJ has five branches and agencies, one LPO, four major subsidiaries, and one foundation. We have approximately 1,200 staff in the United States. The total combined asset size is about 35 billion dollars which is the fifth largest among all foreign banking institutions in the United States. Our business here is very much wholesale, just as it is in Japan. As to our strategy for the United States, let me use a catch phrase from IBJ's medium-term plan for the United States which explains our goal: to be "a first class international wholesale bank with deep roots in the host community."