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BANK REGULATION IN JAPAN

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Who is the regulator?

The banking regulator in Japan is the Financial Services Agency (FSA), which also regulates securities, insurance and other financial service industries. The Bank of Japan (BOJ) is the central bank and the lender of the last resort. The BOJ is not a regulator but its objectives include “contributing to the maintenance of an orderly financial system”. Pursuant to Article 44 (On-Site Examinations) of the Bank of Japan Act,¹ the BOJ conducts on-site examinations of financial institutions based on a contract with them for the purpose of appropriately conducting or preparing to conduct prudential policy actions such as emergency loans, for which eligible collateral is not required, as stipulated in Articles 37 through 39.² Some securities firms operating in Japan, Japanese firms as well as the security affiliates of overseas investment banks have a current account with the BOJ and access the discount window, with the BOJ conducting on-site examinations of them. In 1965, the BOJ extended an emergency loan for a large securities company, and did this again in 1997.

Until 1998, it was the Ministry of Finance (MOF) that was responsible for bank regulation. In 1998, in the midst of the financial crisis, the Long-Term Credit Bank of Japan (now the Shinsei Bank) and the Nippon Credit Bank (now the Aozora Bank) were de facto nationalized or “placed under special public management”, in Japanese regulators’ jargon. These banks were too large and complex to fail, and the above action was taken in light of “systemic risk”. At this time, however, Japan had not devel-

oped a permanent legal framework for “systemic risk exception” and the Diet, the Japanese legislature, had to work very hurriedly on the emergency legislations. Later in 2000, the “systemic risk exception” clause was made permanent by adding necessary language to the Deposit Insurance Law.

The time was then more than ripe for a major overhaul and strengthening of the regulatory structure, and the regulatory power was placed with the newly established FSA. The MOF is now responsible for financial stability issues, from the viewpoint of fiscal soundness.

FSA and the financial crisis

It is only natural that the crisis Japan experienced in the late 1990s and early 2000s was very Japanese in its nature, its cause and the way in which it was overcome.

Japanese households hold approximately half of their financial assets in deposits, compared to about one eighth in the United States and about a third in Germany and France. Depository institutions are the primary channel of flow of funds in Japan, and the deterioration of their asset quality placed an enormous burden on Japan’s economy.

The deflationary economic environment made the situation even worse. The deflation of the late 1990s through the early 2000s added to the problem because the value of collateral real estate kept falling. The BOJ kept interest rates very low but was faced with the zero boundary of nominal interest rates. The BOJ’s policy rate was reduced to 0.5 percent as early as 1995, reached zero in 1999 and started rising in 2006, but in July 2008 it was still 0.5 percent.

How did Japan’s financial system overcome the crisis within a deflationary environment? How was the FSA able to resolve the problems of dozens of smaller institutions as well as those of a few very large ones, failures of which could have caused global financial panic?



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¹ <http://www.boj.or.jp/en/type/law/index.htm>

² Article 37 (Temporary Loans to Financial Institutions, etc.), Article 38 (Business Contributing to the Maintenance of Stability of the Financial System) and Article 39 (Business Contributing to Smooth Settlement of Funds).

The whole policy toolkit had to be put to use. In 1996, a new set of rules tailored for expeditiously resolving financial institutions was enacted by the Diet. “Prompt corrective action” was given more concrete and numerical indicators on the need for such action. The Diet also enacted a blanket guarantee for five years of deposits as well as all other liabilities of financial institutions. The Deposit Insurance Corporation of Japan (DICJ) provided financial assistance to the assuming institutions including 18.6 trillion yen in grants.³

In planning and conducting these policies of resolution, Japan learned many lessons from the experience of the United States. Japan also shared with the United States the experience of asking taxpayers for funds to protect the stability of the financial system. More than ten trillion yen was paid by the taxpayers and the rest by the surviving financial institutions through the deposit insurance system. Japanese taxpayers also provided an explicit guarantee for the borrowings by the DICJ to finance its operations for resolutions with the financial assistances and for capital injections. The BOJ provided the DICJ a significant liquidity support.

In order to stabilize the financial system and revitalize the economy, capital injection of a significant volume was much needed. As far as capital injection is concerned, however, there was less experience from overseas in recent history to learn from. Japanese authorities injected 12.4 trillion yen⁴ into the banks through purchasing preferred or common stocks and extending subordinated loans. In the two cases of 2003, the systemic risk exception clause in the Deposit Insurance Law was activated. The above amounts of money are certainly very large and could be compared with Japan’s nominal GDP, which is approximately 500 trillion yen.

In parallel with these actions, the FSA conducted several rounds of “special inspections” of major banks from 2001 to 2004 to accelerate the process of identifying the bad assets and the disposal thereof.

The most important outcome of these measures was the acceleration of the disposal of bad assets and the resultant improvement of asset quality of the financial institutions. The non-performing loans (NPLs)

based on the Financial Reconstruction Law reached a peak of 43.2 trillion yen or 8.4 percent of the total credit for “all banks” at the end March 2002 but came down to as far as 11.9 trillion yen or 2.5 percent as of September 2007.⁵

For the first few years of its history, the FSA had to walk a tightrope, taking a number of emergency actions that have led to the relative stability of Japan’s financial system in the recent years.

Financial regulation after the crisis

The emergency nature of bank regulation in Japan is now being “unwound” to one corresponding to “peace time.” The blanket guarantee of deposits was removed in 2002 and 2005 in two steps. A majority of the capital injected into the major banks has been collected. Ashikaga Bank, a large regional bank with more than 4 trillion yen of deposits that was nationalized in 2003, was denationalized this year.

Fortunately, Japanese financial institutions were not much involved in the subprime mortgage and other credit bubbles in recent years, partly because their business is less dependent on an “originate and distribute” model. A recent FSA release shows that the exposure and the related losses on the sub-prime mortgage related products of Japanese financial institutions are not small but a systemic disruption is not likely.⁶

What the financial regulator of Japan needs to do now is not near-term crisis management but a mid-to long-term remaking of the regulatory framework through developing a new way of communication with the regulated institutions.

Throughout the recent years, dominated by the resolution of failed banks and “special inspections,” communication between the FSA and the regulated institutions tended to be the one between the FSA on the offensive and the financial institutions on the defensive. It is a shared view among the banking regulators in many countries that, in order to make the regulatory framework forward looking and pre-emp-

³ See “Implementation of Financial Assistance and the Recovery Situation”, p. 70, “Annual Report 2006”, DICJ.

⁴ See footnote 3.

⁵ “The Status of Non Performing Loans as of end-September 2007”, February 15, 2008, Financial Services Agency of Japan.

⁶ “Exposures of Japanese deposit-taking institutions to subprime-related products and securitized products based on the leading practices summarized in the FSF report”, June 6, 2008, Financial Services Agencies of Japan.

tive, the regulators must be well informed of the current developments in the industry to maintain the stability of financial system.

Change of tone at the FSA

A look at the English website of the FSA reveals a small change. While the website carries only five speeches in English by senior FSA officials for the six years from 2000 to 2005, for the one and a half years from 2007 to July 2008 there are seven speeches. This increase could imply that the FSA wants to disseminate something to an overseas audience, but what? Looking at the FSA's Japanese website, two issues given top attention are "Strengthening the Competitiveness of Japan's Financial and Capital Markets" and "Better Regulation".

It is not surprising that the FSA of Japan works hard to make the Tokyo market stronger and more competitive. The Tokyo market is not exercising its potential to its fullest extent. It should prepare a better environment so that the Japanese financial industry can better serve its customers by more efficiently providing the household sector with better access to investment opportunity and the corporate sector with funds for further growth, at the same time making settlement services more and more efficient and reliable. Once the Tokyo market is better able to serve its domestic customers, it will also offer the Asian region a more efficient financial infrastructure, which will lead to a win-win situation for Tokyo and other financial markets in the region.

As for "better regulation", which is a very important element of the initiative to make the Tokyo market more competitive, it is not clear that the FSA claims that the phrase "better regulation" is their invention, but thought should be given why they describe their policy initiative using a foreign phrase of possibly British origin.

Many regulators around the world are of the view that the three objectives of financial regulation are financial stability, customer protection, and market integrity. With these objectives in mind, the FSA states that the four pillars of "better regulation" are 1) the optimal combination of rules-based and principles-based supervisory approaches, 2) prompt and effective responses to high-priority issues, 3) the encouragement of voluntary efforts by financial

institutions, and the placing of greater emphasis on incentives for them, and 4) improving the transparency and predictability of regulatory actions.

Financial regulation by the Ministry of Finance before the establishment of the FSA was criticized for being non-transparent, too close to industry and too discretionary. The FSA from its inception had to demonstrate that it was transparent, adequately distanced from the industry and working to the written rules rather than unwritten practices, while clarifying the criteria for their actions so as to make them more predictable.

For some time in the recent past, "discretionary", in the financial community of Japan, had the connotation of "lacking in transparency and predictability". With this background, the first pillar of "the optimal combination of rules-based and principles-based supervisory approaches" is of much importance, because a "principles-based" supervisory approach implies that, based on a certain set of principles, the financial institutions and the FSA are to agree on a judgment for each case through applying relevant principles and taking into account specific elements of the case. This process does not work well if mechanical objectivity is rigorously required. Therefore, this approach will require some exercise of discretion in a transparent manner.

Constant dialogue between the FSA and industry will be a prerequisite in order for this approach to work. The flow of information must be two-way. On the one end of the flow is the FSA, but who is on the other end? For a regulatory framework to be "principles-based", individual players in the market have to be able to make their own judgment as to what to do or not to do. In this context, self-regulatory organisations (SROs) could play a greater role, because SROs could function as the forum where individual players get together with the latest information on what is taking place in the market to discuss how to help their members make a right judgment to protect their customers and maintain market integrity. The role to be played by SROs will differ from country to country, but the necessary scope of self-regulation needs to be secured in a manner best fit for the country.

From this point of view, "better regulation" means "better collaboration" between the regulator and the regulated. In other words, "better regulation" requires "better self-regulation."

Challenges ahead

Recent residential mortgage-related episodes in the United States and some of the EU countries since the summer of 2007 illustrate the importance for a regulatory framework to be able to promptly respond to ever changing business models of financial intermediation, which keep on causing ever changing problems.

Unfortunately, we cannot assume that all the problems are always detected and corrected early enough, which implies that there will be a situation in which some larger and/or more complex institutions encounter serious problems through mismanagement of their risks. A regulatory framework will not be complete without an effective legal and institutional framework to allow those players to fail and exit the market in an orderly manner.

The more players are too large and/or complex to fail, the more moral hazard will be with us. With an effective structure to allow those who are not viable to fail without disruption, there will be a smaller number of too large and/or complex institutions and moral hazard will accordingly be reduced. In this context, a regulatory framework will be better if it is equipped with a more usable tool kit for resolution of large and/or complex institutions without systemic disruption.

When faced with a potential financial crisis, all the safety-net players are required to collaborate very closely. For this to happen, the regulatory framework has to be such that allows for a constant flow of information among the players so that their capabilities are readily mobilized as soon as the need arises. Each country has its own way of distributing responsibility among the safety net players, depending on the history of financial regulation and the structure of the financial industry. We have recently seen, on both sides of the Atlantic, two sets of proposals of a major reform on the roles of safety-net players being presented in order to quell a potential threat to the stability of financial system.

In July 2008, the UK authorities proposed a regulatory reform by publishing “Financial Stability and Depositor Protection: Further Consultation”, in which a “special resolution regime” is offered as a legal and institutional regime that is tailor-made for resolution of financial institutions. The tools proposed in the new regime will include a transfer of part or all of the failing bank to a private sector third

party or a publicly-controlled bridge bank, a new bank insolvency procedure, the power to take a bank into temporary public sector ownership and so on. Japan has developed a similar regime that allows a transfer of part or all of the failing bank, “special public management” or “bridge bank” over the course of crisis and has used them in many resolutions of failed institutions that were large/small or complex/simple.

The proposed reform in the UK includes a recommendation on the roles and collaboration among the FSA, the Bank of England (BOE) and HM Treasury. Under the proposed regime, the FSA will initiate the resolution process, and the BOE will be responsible for deciding which resolution tool to use and the operation thereof. The Chancellor of Exchequer would authorize a BOE decision requiring the use of funds for which the Chancellor is responsible.

It is worth noting that the BOE is to work as the operator of the SRR. In Japan and the United States, the deposit insurer plays the role assigned to the BOE. In Japan, the DICJ determines the method of the resolution and obtains an approval from the FSA and the Ministry of Finance, and works as the operator of the resolution. The DICJ used to be a very small institution at its inception in 1971. However, as a wave of bank failures became reality in the mid-1990s and new responsibilities as the operator of a wider range of resolution tools were given to it, a rapid expansion of the DICJ followed.

In the US, it is the Federal Deposit Insurance Corporation (FDIC) that determines the method for resolution and implements it. During the peak years of resolutions of the thrift institutions for several years around 1990, the Resolution and Trust Corporation (RTC) was established on a temporary basis and it successfully expedited the clean-up of the US financial system. The FDIC was founded in 1933 and has been a large institution working as the operator of resolutions for decades.

As for the US proposal, the Department of the Treasury published “Blueprint for a Modernized Financial Regulatory Structure” in March 2008. This document offers three sets of recommendations. One is for the short term, another for the intermediate term. The third is “optimal” or for the long term, in which the Federal Reserve is chosen as “market stability regulator” with broad powers focusing on the overall financial system.

The United States has had a legal and institutional framework for resolution of depository institutions for a long time. After the years of the savings and loan crisis in the late 1980s and the early 1990s, the US financial system restored stability in the mid-1990s, which lasted for about ten years until the subprime mortgage market started sending disturbing signals. In 2005 and 2006, or the final two years towards the end of the stable period, there was not a single bank failure in the United States. But in those years, however, the subprime and other credit bubbles were quietly expanding only to burst in 2007. In July 2008, we saw the failure of IndyMAC, the third largest in US history.

As was the case with Japan in the 1980s, the monetary environment contributed to the problem and it is hard to deny that there was a delay in recognition of the problem by the US authorities.⁷ Even if they had detected the problem at an early stage, would it have been possible to prevent the problem from growing with monetary tightening? Mr. Allan Greenspan wrote: “Even if the Fed were to decide there was a stock bubble and we wanted to let the air out of it, would we be able to? ... I was reasonably certain that seeking to defuse a mounting bubble with incremental tightening, as many had recommended, would be counterproductive. ... I decided that the best the Fed could do would be to stay with our central goal of stabilizing product and services prices.”⁸ I expect that there will be more than a few plausible arguments that monetary policy and prudential supervision could do something to prevent a bubble and its bursting. It will be interesting to see how the discussion continues and plays out.

From the viewpoint of designing a regulatory framework, it would be constructive not to seek a correct answer that will hold for many years but to ensure that our regulatory structure evolves along with the financial industry so as to better achieve the three objectives of financial stability, customer protection and market integrity. In this regard, the recent experiences of the bubbles might suggest that we need to have a better understanding of and an insight into the financial innovations taking place in the financial markets where a wider range of financial firms inter-

act. Central banks often have better access to and more hands-on knowledge on the financial markets than other safety-net players, but the recent record of their performance in detecting a future threat has not been particularly encouraging. As the UK and the US are considering additional or new prudential responsibility of the central bank, the prudential role of a central bank might be the focus of a discussion on the distribution of responsibility among the safety-net players.

The Japanese financial system is currently relatively stable, but this is no time for complacency. Rather, for Japanese safety-net players, it is time for an “unprejudiced” review of the way they work, which is indeed the most difficult challenge ahead.

⁷ Henry M. Paulson, the Secretary of Treasury of the US, said in his remarks of March 2008 of “Optimal Model” in “Blueprint,” “A major advantage of this structure is its timelessness and its flexibility.”

⁸ Pages 200 and 201 of his recent book “The Age of Turbulence” (The Penguin Press).