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Lessons Learned from Japan's NPL Experience

Ladies and gentlemen, today I would like to discuss the lessons to be learned from Japan's NPL problems: first, the disposal of existing NPLs; and second, implementing measures to prevent the creation of new NPLs.

The first lesson is that underestimation and procrastination of the problem will inevitably occur. This will gradually magnify the problem.

In the late 80s, Japanese companies over invested while banks lent aggressively. Faced with shrinking demand starting in 1990, companies ended up with excessive infrastructure and staff, and NPLs at banks ballooned.

However, the idea of injecting public funds into banks lacked support since it was believed the economy would recover sooner or later. Public funds were injected into banks six years after the bubble burst when the problem had already become more serious. The amount injected was 700 billion yen. Seven years later, banks collapsed one after the other, by which time the Deposit Insurance Corporation of Japan had provided nearly 40 trillion yen to banks in financial assistance and capital injections.

One of the reasons the NPL problem was underestimated and put off was because neither bank managers, the regulatory authorities nor politicians wanted to be held accountable. Put another way, people who should have been tackling the problem lacked the incentive to do so.

The banking sector often argued that NPL growth was the result of the economic downturn, and that the banks were not to be blamed. To the contrary, however, recent research has suggested that NPLs could cause macroeconomic disorganization. Companies could become increasingly wary of making transactions with companies facing loan repayment problems and this shrinks economic transactions as a whole. The underestimation of NPLs also leads to all sorts of conjecture, which could cause sudden stock price and currency speculation and have a negative impact on economic activities.

What can be learned from these experiences is the importance of fully recognizing NPLs. To grasp the full extent of the problem, first, NPLs must be accurately defined. In Japan's case, it was not until March 1998 that standards similar to those used by the SEC in the US were adopted.

Clear definitions are ineffective unless the loans are accurately evaluated using those definitions. To ensure this, three things must be strictly conducted: first, governance at banks, second, reviews by auditors and, third, inspections by financial authorities.

In Japan there has been insufficient strictness in the relationships among banks, auditors and the regulatory authorities. Although they were aware of the seriousness of the problem, they may have decided to deal with it themselves in stages.

However, people will find out without much delay that the government is concealing something. In Japan's case, between 2001 and 2002 overseas officials also began to voice their suspicions over Japan's handling of its NPLs. Faced with this, at the end of September 2002 Prime Minister Koizumi appointed Mr. Takenaka to be the minister in charge of financial affairs and started a program for financial revitalization. Under this program governance at banks, reviews by auditors and inspections by the authorities were all made stricter than ever before.

When the extent of the NPL problem is fully understood the next task is to deal with it rapidly.

Mr. Takenaka and his team mapped out a course to deal with it in one blow. In implementing this policy, however, care was needed to avoid chaotic situations such as a bank run, numerous corporate bankruptcies and a surge in unemployment.

Some believed that depositors who incurred losses were responsible themselves for making deposits at troubled banks, that the companies unable to repay their loans should be left to go bankrupt and that resources should be directed towards healthy companies. However, there is the issue of asymmetry of information, for example, small depositors cannot fully grasp the state of the bank's financial health. Also, disclosure by banks was inadequate. As such, Japan went along with the policy of dealing with its problem financial institutions while offering full government guarantees on deposits. And more recently, disclosure at financial institutions has been strengthened too.

Some also believed that the basic principle of the market economy is that companies unable to return loans go bankrupt. But, there is also the problem of the fallacy of composition: a mass collapse of companies at the same time will have a negative effect and worsen the economic situation. So, in order to carry out the bold measures to dispose of NPLs, it is essential to implement simultaneously an appropriate package of economic measures, including necessary safety nets.

It should be noted that rather than simply liquidate various problem companies, there are numerous examples that should be restored to life. Recently Japan has revised its bankruptcy system, created a structure to accelerate the pace of corporate revival as well established public institutions to promote corporate revival.

However, such economic policies and measures to support corporate revival should be implemented in order to lessen the side effects of the drastic disposal of NPLs once the true extent of the problem has been grasped. Such measures should not be introduced on their own if NPLs are not dealt with in a decisive manner. Put another way, different policy methods must be assigned to different policy objectives. It would be difficult to achieve the dual policy goals of maintaining employment levels and resolving the NPL issue through economic measures alone.

So far, I have talked about dealing with existing NPLs. It goes without saying, however, that this alone will not solve the situation. Even after the problem is dealt with, if the underlying cause is not resolved it will only give rise to further NPLs in the future. Therefore, the source must be dealt with.

Japan focused on two approaches. First, reform of the banking system, and second, the activation of the securities markets. Let's first take a look at banking system reforms. An ideal way to manage lending risk would be to first assess the risk and then set borrowing conditions to cover this risk as well as retain sufficient capital. Alternatively, by using methods such as sales or securitization of loans, syndicate loans and credit derivatives, risks can be allocated to other parties, thereby reducing the bank's exposure.

The efforts of bank managers themselves and appropriate inspections and supervisions by the authorities are indispensable to shifting banks' behavior in this direction. In Japan, a list of six criteria to review banks is being introduced: capital adequacy levels, asset quality, management, earnings, liquidity and sensitivity to market risks. In the past, asset quality has been greatly emphasized, but recently the trend is to focus on management as a starting point. To ensure solid management, there must be pressure from the financial authorities, but additional pressure from shareholders and the market is also important.

Another measure that will help prevent the reoccurrence of NPLs is the activation of the securities markets. As the Japanese economy relied too heavily on banks, overall economic risk became concentrated on banks' balance sheets. However, because banks receive deposits with a guarantee on the payment of interest and principal and play an important role in the settlement system, over-concentration of risk at banks is a problem. In addition to borrowing from banks, companies should be encouraged to issue shares and bonds to raise capital. Those securities could then be purchased by individual and institutional investors who can assume the risk. In Japan, the revitalization of the securities markets has become a national policy through which we are trying to prevent the recurrence of NPLs.

Ladies and gentlemen, this concludes my discussion on the lessons to be learned from the way Japan has approached its NPL problem over the last 15 years.

Thank you very much for your attention.