Reform of Bank Regulation and its Application to Japan

Joint Statement by a sub-group of the Shadow Financial Regulatory Committees
of Europe, Japan, and the U.S.

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I.

Contrary to government claims, the Japanese financial sector remains fragile. A continuation of current policies will increase the cost to Japanese taxpayers. The stock market clearly reflects continued deep skepticism over the sector's health. Banks are dangerously undercapitalized. Current deposit insurance premiums are grossly insufficient. Lending margins are far too low to cover the post-bubble default risk. The government exacerbates these problems by subjecting private banks to subsidized competition from state institutions, e.g. the postal savings system and Japan Housing Finance Corporation, while pressuring them to increase lending to small and medium-sized enterprises at below market interest rates.

The reported capital of the Japanese banking system is 35 trillion yen, which is overstated by 8.2 trillion yen of deferred tax assets, and includes 7.5 trillion yen of injected government capital which banks are committed to repay. This capital base pales in comparison with unreserved problem loans amounting to about 52 trillion yen. We also note that banks have already lost 66 trillion yen (13% of GDP) since 1992.

Massive cross-shareholdings among financial institutions, and between the financial and nonfinancial sectors, compound the risks to stability. Banks' corporate shareholdings have recently amounted to almost twice their private capital. Furthermore, banks and life insurance companies have effectively swapped enormous sums of subordinated debt, inflating their regulatory capital while exposing each to the fragility of the other.

II.

In the U.S. and Europe, the situation looks sounder at present. This does not mean that only Japan needs reform of regulation and supervision. As the Shadow Financial Regulatory Committees have argued in the past, control of bank risks and crisis prevention are deficient everywhere. In particular, it is important to agree on a common set of principles to enhance the role of market discipline as a supplement supervisory discipline.

While government-sponsored deposit insurance helps to ensure stability in the short run, it reduces private incentives to maintain adequate capital in the long run. Insured depositors have less incentive to monitor banks' activities or to discipline banks because some or all of their deposits are protected from loss. In turn, protected banks face strong incentives to allow their capital ratios to fall and their portfolio risk to rise. Deposit insurance also increases the banking system's tolerance for incompetent or dishonest bankers, who unwittingly increase risk or operate their banks in self-serving ways.

Sound policy requires the right blend of regulation, supervision, and market discipline to provide incentives for commercial banks to avoid excessive risk and to protect taxpayers, who ultimately stand behind the government funds that insure deposits in these institutions.

We therefore urge the adoption of the following set of independent -- but mutually reinforcing -- recommendations:

- Capital should be measured so that it substantially reflects market values and should be disclosed promptly at regular intervals.
- Banks should maintain a level of capital that is sufficient to absorb almost all losses.
- Bank regulators should utilize a system of prompt corrective action and rules for timely resolution.
- Banking authorities should enhance market discipline, both on banks and themselves, by requiring large banks to issue credibly uninsured subordinated debt.

With an appropriate closure rule and schedule of sanctions, subordinated debt discourages excessive bank risk taking, especially at capital-impaired banks. In particular, the market signals provided by the price and yield of subordinated debt not only discipline banks, but also discipline bank regulators by discouraging them from engaging in regulatory forbearance. Requiring a market in bank debt creates incentives for banks to disclose information. In addition, subordinated debt also can serve as a basis for pricing risk-based deposit insurance premiums.

III.

In view of the above general principles, we believe the Japanese financial system requires the following policy initiatives.

Resolution of weak financial institutions

First and foremost, rapid resolution of insolvent financial institutions is a prerequisite for a healthy financial system. To identify insolvent institutions, a more aggressive write-off of bad loans is required. The resolution of Long-Term Credit Bank of Japan and Nippon Credit Bank raises concerns because no due diligence was carried out before their sale to private investors. Therefore, a blanket government guarantee of the loan portfolio had to be provided by the Deposit Insurance Corporation (DIC). In the future, the blanket guarantee should be replaced by an explicit loss-sharing arrangement between the DIC and the buyers.

Capital Standards and Prompt Corrective Action

Strict application of prompt corrective action to banks and life insurance companies is necessary. Solvent but undercapitalized banks should be forced to raise equity capital from the private market. Successive failures of life insurance companies that had relatively high reported solvency margins indicate that a strengthening of solvency margin requirements is necessary.

In order to put the Japanese financial system on a sound base, it is imperative to remove the effective double-gearing among financial institutions. Banks should be forbidden to hold any instruments counted as capital of insurance companies. The government should remove the DIC protection of subordinated debt. Furthermore, borrowers should be prohibited from buying the subordinated debt of their lenders.

Deposit Insurance

After the recapitalization of the banks, the government should eliminate the protection of bank non-deposit liabilities and limit protection of deposits to 10 million yen per customer. Risk-adjusted deposit insurance premiums should be introduced promptly. The postal savings and life insurance systems represent a huge competitive distortion in the Japanese financial markets, and should be privatized at the earliest possible time. In the short-term, the postal savings system should be subject to taxation, deposit insurance premiums and reserve requirements.

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