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*Japan's Banking "Crisis"*

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**Abstract.** The Japanese economy is burdened by an overhand of nonperforming bank loans that are officially recognized to total \$367.5 billion but could exceed a trillion dollars if all problem loans are taken into account and economic conditions worsen significantly. The United States and Japan have initiated a Financial Dialogue led by the U.S. Treasury to discuss various financial issues - including the bad loan problem - and the Bush Administration has said it would assist Japan in pursuing its economic reforms in any way it can.

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# CRS Report for Congress

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## Japan's Banking "Crisis"

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### Summary

The Japanese economy is burdened by an overhang of nonperforming bank loans that are officially recognized to total \$367.5 billion but could exceed a trillion dollars if all problem loans are taken into account and economic conditions worsen significantly. These bad loans have weakened Japan's already sluggish economy, undermined the strength of the yen, and are exacerbating the slowdown in Asia's economies. In recent years, Japan has averted a replay of the crisis conditions that accompanied earlier failures of financial institutions, but the problem is immense, and restoring health to the balance sheets of Japanese banks remains a top economic policy concern both in Tokyo and in international financial circles. After nearly a decade of repeated attempts to resolve the problem, the current Koizumi government has set a new deadline for banks to write off the worst of the loans within three years even if this causes as many as 200,000 lost jobs and numerous bankruptcies. The United States and Japan have initiated a Financial Dialogue led by the U.S. Treasury to discuss various financial issues – including the bad loan problem – and the Bush Administration has said it would assist Japan in pursuing its economic reforms in any way it can.

The nonperforming loans held by Japan's banking sector total at least \$367.5 billion despite a decade of government programs to strengthen its banks and private efforts to clean up the mess. This mammoth challenge facing Japan's financial sector is of interest to the United States because this huge debt problem weakens Japan's economic performance, is dragging down other neighboring economies in Asia, undermines the strength of the yen, and affects the financial flows between the United States and Japan. It also can affect American trade and investments in Japan. In addition, as the second largest economy in the world, Japan's economic weakness, along with the slowing economy of the United States, are key to the export performance and stability of many export-dependent countries in Asia. The overhang of bad loans also contributes to weakness in Japan's capital markets and a shortage of capital. Despite Bank of Japan interest rates of less than 1%, small- and medium-sized businesses in Japan face relatively high interest charges and a reluctance on the part of banks to lend them funds. Japanese banks also have been reducing their lending in international markets, particularly in Southeast Asia. Tokyo recognizes that the country is in danger of becoming a second- or third-rate power if it does not restore health to its economy – beginning with the banking sector.

As of March 2001, deposit taking financial institutions in Japan held an official total of ¥43.4 trillion (\$367.5 billion) in nonperforming loans (up from ¥42.4 trillion in March 2000). (See Appendix.) Of the ¥43.4 trillion, banks held ¥32.5 trillion, and cooperatives held ¥10.9 trillion. The nonperforming loans were categorized as those to borrowers in legal bankruptcy (¥4.9 trillion), loans in arrears six months or more (¥24.0 trillion), loans in arrears three to six months (¥0.8 trillion), and restructured loans (¥13.8 trillion).<sup>1</sup> The nonperforming loans account for 6.9% of total loans (5.7% for major banks). These official figures, however, are thought to be understated. If one includes problem loans that might go sour if the economy goes into recession, the total could be as high as ¥140.9 trillion (\$1.13 trillion).<sup>2</sup> Also, only about 30% of the bank loans to firms that recently have gone bankrupt had been listed as nonperforming.

For most Japanese banks, only extensive government efforts and financing of bank recapitalization packages have kept them from bankruptcy or severe punishment by stock and lending markets. Even with government intervention, Fitch (an international rating agency) rates the intrinsic strength of individual Japanese banks as D or D/E (the bottom of the scale), although Fitch gives ratings mostly of A or A- on long-term debt for major Japanese banks. This is based on the theory that the banks' long-term debt instruments are of relatively higher quality because the Japanese government would intervene to support them if necessary.<sup>3</sup> The poor condition of Japanese banks did cause a "crisis" in 1997-98 when they had to pay a premium of as much as 0.7 percentage points over international bank borrowing rates to compensate lenders for their increased risk.

The new Koizumi administration has announced its intention to restructure the Japanese economy and to resolve the nonperforming loan problem. The United States and Japan also have been engaged in what is called the U.S.-Japan Economic Partnership for Growth, launched by President Bush and Prime Minister Koizumi at a Camp David summit on June 30, 2001. This Economic Partnership includes a Financial Dialogue which is to serve as a forum for the U.S. Department of the Treasury and Japan's Ministry of Finance and Financial Services Agency to exchange information and views on a range of key financial issues, including nonperforming loans of Japanese banks.<sup>4</sup> In June 2001, U.S. Federal Reserve Chairman Alan Greenspan reportedly urged Japan to immediately embark on the task of disposing of bad loans in the banking sector.<sup>5</sup>

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<sup>1</sup> Japan. Financial Services Agency. Non Performing Loans of All Deposit-taking Financial Institutions (as of the end of March 2001). August 2, 2001.

<sup>2</sup> *Japan Digest*, August 3, 2001. P. 2.

<sup>3</sup> These are not debt ratings but rather an assessment of the intrinsic strength of each bank assuming no governmental or other external support. See: Fitch IBCA on Internet at [<http://www.fitchratings.com/corporate/index.cfm>].

<sup>4</sup> U.S. Trade Representative. Fact Sheet. The U.S.-Japan Economic Partnership for Growth. June 30, 2001.

<sup>5</sup> Urakama, Kenji. US Federal Reserve Chief urges Japan to Clear Bad Loans Immediately. Kyodo News Service. June 1, 2001.

In June 2001, the Koizumi government declared that banks must dispose of loans to bankrupt and near-bankrupt borrowers within two years and remove newly emerging nonperforming loans within three years of such classification – even at the cost of 100,000 to 200,000 jobs in troubled companies.<sup>6</sup> Given Prime Minister Koizumi's popularity rating of over 80%, he may succeed in pushing through reforms that heretofore have been stymied by powerful interest groups. The program is being criticized by some as being too limited, while entrenched financial interests are attempting to reduce its scope. A problem is that the Prime Minister also is attempting to curtail deficit spending which could slow the economy so much that new bad loans will appear and banks will be unable to generate the profits needed to finance the bad loan write-offs. A counter risk is that if drastic action is not taken now, the situation will only worsen.

## Background

The genesis of Japan's problem with nonperforming loans can be traced to two structural factors. The first is the burst of Japan's so-called economic bubble in 1989. During the latter half of the 1980s, Japan's monetary authorities flooded the market with liquidity (money) in order to enable businesses to cope with the rising value of the yen. Businesses did invest in new capital equipment to become more competitive in international markets, but the excess liquidity also found its way into speculation in Japan's stock market, in real estate ventures, and in foreign investments. At that time, the market value of both land and equities was rising so fast that investors and speculators could hardly miss. The larger mistake for them was not to borrow and invest and consequently not be positioned to reap the returns from rising markets. Banks considered most loans with real estate as collateral as being unquestionably secure.

When Japan's economic bubble burst in 1989 causing stock and land prices to fall, the value of collateral underlying many loans dropped below the value of their loan principal. Commercial real estate ventures, especially office buildings, also became unprofitable as rents fell. As the economy slowed, companies also faced excess capacity and inventories and lower profits. As more and more loans turned sour, more and more of the underlying real estate had to be sold at "bargain" prices. This only drove land values further down – particularly for commercial real estate in the major urban areas.

As shown in Figure 1, Japan's Nikkei stock market average peaked in 1989 at 40,000 and subsequently has dropped by more than half to roughly 12,000 in August 2001. Unrealized capital gains on holdings of stock by major banks which stood at ¥49.1 trillion (\$355 billion) in 1989<sup>7</sup> has dropped to approximately ¥5 trillion (\$42 billion) in 2001. For some weaker banks, stock holdings have resulted in capital losses. Commercial land values in the six major metropolitan areas peaked in 1991 and by 2000 had fallen by 80%. The value of residential and industrial land (which are combined with commercial to form the All Urban land price index) fell by less, but still declined by nearly 20%.

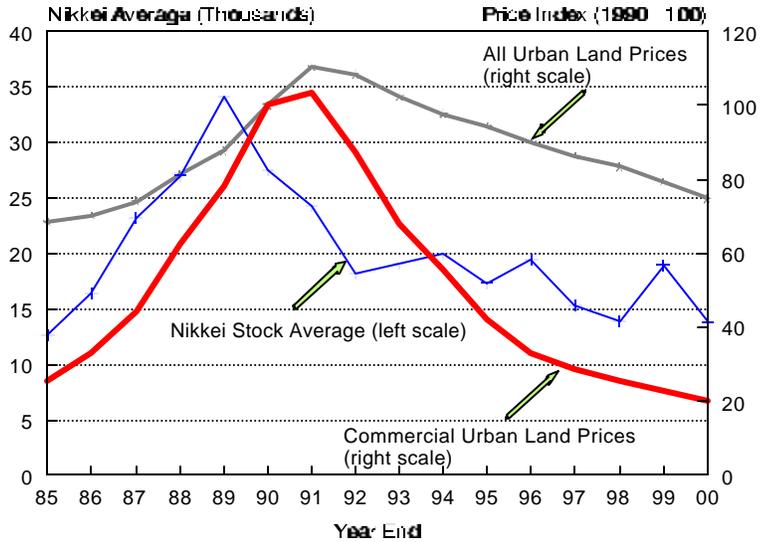
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<sup>6</sup> Dvorak, Phred and Peter Landers. Japan Weighs Stiff Measures for Economy. *The Wall Street Journal*, June 22, 2001. P. A11.

<sup>7</sup> J.P. Morgan Securities Asia. Japan's Bank Problem is About to See Policy Action. Economic Research Note. March 2, 2001.

The second cause of the bad loan problem has been the structure of Japan's capital markets. During most of the post-World War II period, Japan's banking system provided a mechanism to transfer savings from the household sector to the business sector. The system favored business investment and household saving while it discouraged household consumption and consumer debt.

**Figure 1. Japan's Nikkei Stock Market Average and Prices for All Urban and Commercial Urban Land, 1985-2000**



Source: Bank of Japan. *Financial and Economic Statistics Monthly*.

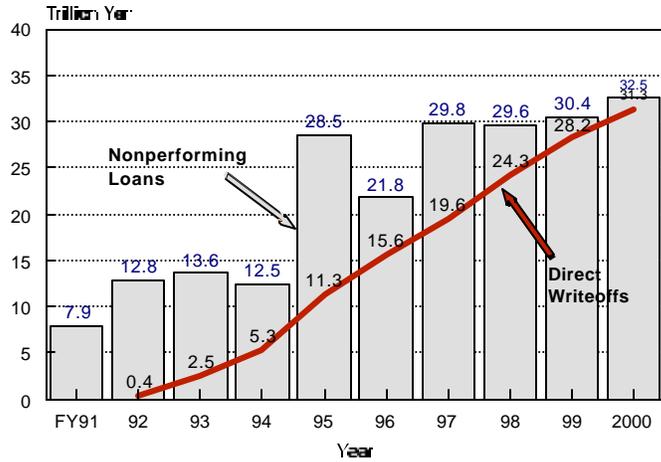
Banks also operated under a “convoy” system in which the government oversaw and intervened extensively to ensure not only that banks followed its official policy line but that stronger banks helped weaker banks in order to keep the convoy of domestic banks moving along together. One result of this system was that banks tended to lend on a “relational” rather than purely economic basis (crony capitalism). Also an implicit government guarantee of deposits in the banking convoy created a moral hazard that encouraged lending to borrowers who might have been considered substandard by more independent credit evaluators. The moral hazard stems from the government guarantee of deposits which tended to foster risky lending behavior by banks which then exacerbated the problem of bad loans the government guarantee was to have alleviated.

Over the 1990s, the Japanese government announced various programs and measures to resolve the problem of nonperforming bank loans. This included ¥1.8 trillion (\$13.75 billion) in public funds injected into 21 major banks in 1998 and ¥7.5 trillion (\$62.5 billion) in public funds that included ¥5.6 trillion (\$46.7 billion) allocated to be transferred to the top tier of Japanese banks through the sale in 1999 of new preferred bank shares to a government-run organization.<sup>8</sup> The government has the option of converting these preferred shares – which convey a priority claim on dividend payments but no voting rights – into common stock after certain periods of time. The government can convert the preferred shares to common stock if a bank misses its dividend payments. The government furthermore has replenished funds in its woefully undercapitalized deposit insurance fund and nationalized two banks before selling them to private investors (the defunct Long-Term Credit Bank of Japan was bought from the government by the New York-based Ripplewood Holdings). For much of the 1990s,

<sup>8</sup> For details, see: Choy, Jon. *Banks Go Hat In Hand to Tokyo. JEI Report*, March 19, 1999.

however, the hope of the government was that if it could keep banks operating, their profits from operations and capital gains from equity holdings could fund the write-offs of bad loans. Despite billions of dollars in write-offs, however, nonperforming loans are appearing as fast as they are being disposed of. Between FY1992 and FY2000, Japan's banks had written off a cumulative total of ¥31.3 trillion (approximately \$275 billion) in bad loans, but new ones have appeared so fast that the total for bad loans keeps increasing. (See Figure 2.)

**Figure 2. Total and Cumulative Direct Writeoffs of Nonperforming Loans for Japan's Banks FY1991-2000**



Note: Bankrupt loans, Past due loans, & (from 1995) Restructured loans.  
 Source: Japan, Financial Services Agency

In response to the banking problem and in line with the general liberalization of Japan's financial markets, Tokyo also has been deregulating its financial sector. In what the government has termed its Big Bang, various reforms have been announced that are aimed at making Japan's financial markets more efficient, transparent, global, and fair. In addition to new standards, products, supervision, and reporting requirements, the government lifted the half-century-old ban on holding companies. These banking sector changes along with the bad-loan problem have induced a wave of mergers among Japanese banks.

On August 15, 2001, the Bank of Japan announced that it intended to pump more money into the economy by implementing a monetary policy aimed at fighting deflation by increasing cash balances at banks and by buying more government bonds. This may slow the decline in Japan's asset prices and help banks deal with their bad loans.

### U.S. Policy Options

The policy options for the United States with respect to Japan's banking problem are limited considering the broad implications of the situation for U.S. economic and financial interests. Congress has held hearings on the banking problems and economic conditions in Japan. Under the Clinton Administration, the United States pressed Japan to pursue stronger actions to recapitalize banks and to resolve the problem, but the Bush Administration appears to have opted merely to express U.S. support for whatever policies Japan adopts. During a July 2001 visit to Japan, Secretary of State Colin Powell stated that the U.S. stood ready to assist in any way it could to help Prime Minister Koizumi in his efforts to reform the Japanese economy and to clean up the Japanese banking sector. He also stated that a "vibrant Japanese

economy is a key to America’s prosperity and to Asia’s growth.’<sup>9</sup> The Financial Dialogue led by the U.S. Treasury on the U.S. side provides a forum for the two countries to exchange information and views on Japan’s banking problem and other issues. It also is in the interest of the United States to ensure that Japan pursues solutions to its banking woes that provide the widest access to Japan’s financial services sector to U.S. investors, exporters, and corporations.

Currently, the financial situation in Japan bears close watching. A significant change in certain indicators could portend a worsening of the problem and possible need for counteractions on the U.S. side. These indicators include a large fall of values on Japan’s stock market and in real estate markets, a sudden jump in the rate of bankruptcies – particularly of financial institutions – a reappearance of the “Japan premium” in international borrowing, or any failure by Japanese banks to meet their capital adequacy ratios.<sup>10</sup> A true banking crisis characterized by multiple bank failures and a run on deposits seems unlikely at this time. However, as Japanese banks cope with sluggish economic conditions and write off more nonperforming loans while attempting to cut costs and integrate operations with other banks as a result of mergers, they face particularly difficult and precarious times.

**Appendix. Nonperforming (Risk Management) Loans of Japanese Deposit-Taking Financial Institutions**

(As of March 2001)

	Non-performing Loans				Total Loans	Loan Loss Reserves
	Total	Bankrupt	Past Due	Restructured		
City Banks	12,895	952	8,104	3,838	238,945	4,852
Long-term Credit Banks	3,167	536	1,091	1,539	31,756	1,185
Trust Banks	3,219	295	1,633	1,291	42,887	902
Major Banks	19,218	1,783	10,829	6,668	313,588	6,939
Regional Banks	13,234	1,547	7,634	4,054	180,601	4,616
All Banks	32,515	3,330	18,464	10,721	494,189	11,555
Cooperatives	10,934	1,568	6,319	3,047	132,268	3,719
Total	43,448	4,897	24,782	13,769	626,457	15,274

Source: Japan. Financial Services Agency.

<sup>9</sup> Powell, Colin L. Press Briefing with U.S. Ambassador to Japan Howard Baker, American Embassy, Tokyo, Japan. July 24, 2001.

<sup>10</sup> Japanese banks currently meet the 8% capital-output ratio required for international banks, but the depressed stock market and new reporting requirements may cause some weaker banks to report capital losses on their stock holdings.