

The 11th DICJ Round Table keynote speech
March 12, 2019 (at Sheraton Miyako Hotel Tokyo)
Summary of the Speech of the Commissioner of the JFSA

It is my great pleasure to be with you this morning on the occasion of the 11th DICJ Round Table, hosted by the Deposit Insurance Corporation of Japan.

Today, I would like to talk about Japan's experience with failure resolution, efforts by the Financial Services Agency of Japan, the JFSA to ensure the stability of the financial system and exert a financial intermediary function as well as a change in the role of financial administration, including a review of the failure resolution system from the past to the present day.

Japan's experience with failure resolution and the history of its failure resolution system

Please take a look at **page 3**. This slide shows a summary of the events of financial administration in Japan since the 1980s.

When economic bubbles emerged and expanded in the 1980s, many Japanese financial institutions grew aggressive in arranging real estate loans and expanded the credit facility per customer, while their credit risk management was insufficient as they placed excessive focus on profit growth.

Such financial institutions were saddled with massive non-performing loans through the bursting of the bubble in the 1990s. Since then, they had to spend significant energy on resolving these problems over a long period of time, and Japan encountered the bankruptcy of a financial institution for the first time since World War II.

After that time, in response to the rising number of failures of financial institutions, it was decided in 1996 to protect the entire amount of customer deposits until the end of March 2001, considering the possibility of failures of financial institutions that required the intensive disposal of non-performing loans.

The next year, in 1997, the first case of a default occurred in the Call Market, causing major disruption in the Interbank Market. Affected by such development, the Hokkaido Takushoku Bank, one of the major banks in Japan, went bankrupt, and recognition of the financial crisis spread rapidly. Credit uncertainty rose and bank runs were triggered at multiple financial institutions.

[Page 5] In response to such a situation, the next year, in February 1998, the Emergency Economic Stabilization Act was enacted as a special measure at the time of crisis with serious concern over the credit order and the economy. The Act is intended to stave off a credit crunch by increasing the capital of financial institutions using public funds. In March, around 1,800 billion yen in funds was provided to 21 financial institutions including major banks.

Even after that, however, the financial system continued to be unstable.

For this reason, the Japanese government, reviewed drastic measures in cooperation with the ruling party. On the other hand, the opposition party also respectively developed its own measures. In the beginning, the parties were in fierce conflict, but they discussed policies together when they witnessed the deterioration of the operations of the Long-term Credit Bank of Japan, one of the major banks in Japan at that time. This led to the development of the Financial Reconstruction Act, which addresses failure resolution, as well as the Act on the Early Strengthening of Financial Function, which enables the use of public funds to increase the capital of financial institutions. The latter act replaced the Emergency Economic Stabilization Act.

Prior to the implementation of the Financial Reconstruction Act, the former management team of a failed financial institution would continue its business operations until a receiving financial institution was determined. It was necessary to develop a way to find a receiving financial institution upon careful examination of the assets from a more objective perspective, as other Japanese financial institutions were also facing deterioration of their business operations as the Non-Performing Loan problem grew increasingly severe.

[Page 6] The “Financial Administrator System” was set up under the Financial Reconstruction Act. The financial administrator appointed by the commissioner of the JFSA will oversee a failed financial institution, and carefully examine the details of the assets of the failed entity while continuing operations such as deposit and lending transactions. It was made possible to find a receiving financial institution in that way.

With the establishment of the “Bridge Bank System,” it was also made possible to temporarily transfer the operations of a failed financial institution to a bridge bank, if it is not possible to promptly find a financial institution that could take over the operations of the failed financial institution. In that way, the bridge bank could find the ultimate receiving financial institution.

In addition, the “Special Public Management System” was also developed. In this system, the DICJ acquires the shares of a failed financial institution by temporarily nationalizing

the failed entity, and the new management team appointed by the commissioner of the JFSA manages and operates the failed entity in the case that systemic risk exists. The Long-term Credit Bank of Japan that I mentioned earlier went under in October 1998, and the Nippon Credit Bank in December 1998. The Special Public Management System was adopted for the failure resolution of these two banks. The details are shown on **pages 7 and 8**.

Other than the above, 42 failure resolutions took place under the Financial Reconstruction Act.

A total of 8,600 billion yen in funds was injected into 32 financial institutions to increase their capital in accordance with the Early Strengthening Act.

The purpose of these systems was to restore trust in Japan's financial system as soon as possible, and its implementation was for a limited period until the end of March 2001. In May 2000, however, the Deposit Insurance Law was revised in view of many failures occurred in 1999, and the capacity for prompt response in the case of failure of a financial institution in the future. The Deposit Insurance Law incorporated what was set out in the Financial Reconstruction Act and the Early Strengthening Act, converting them into permanent systems. The details of the revised Deposit Insurance Law are described on **pages 9 and 10**. Please look at them in your own time.

In 2003, Resona Bank, which had the 6th largest assets in Japan, received public funds to strengthen its capital, and Ashikaga Bank, which boasted an around 50% market share in Tochigi Prefecture, was nationalized in accordance with the revised Deposit Insurance Law. The courses of responses to deal with the respective crisis are described on **pages 11 and 12**.

In addition to handling these systems and a series of failure resolutions, the JFSA created the "Financial Reconstruction Program," which was aimed at halving the Non-Performing Loan Ratios of major banks by the end of March 2005. To achieve this goal, the JFSA implemented strict inspection and supervision including special inspection to implement the strict assessment of assets. The ratio of non-performing loans dropped to 2.9% at the end of March 2005 from 8.4% at the end of March 2002.

In April 2005, as the Non-Performing Loan Problem subsided, the protection of deposits returned to that for fixed amounts other than non-interest-bearing deposits for payment and settlement purposes, following several extensions of the 100%-protection-of-deposits scheme introduced in 1996. Since then, only one case of failure resolution occurred in 2010, which is described on **pages 13 and 14**.

[Page 4] Since the 1990s, Japan has experienced 182 failures of financial institutions, most of which occurred from the latter half of the 1990s to the first half of the 2000s. Around 900 deposit-taking financial institutions in 1996 fell to around 600 in 2005, after a series of failures and mergers for survival. From just this statistic, I think you can understand the magnitude of the impact of the crisis at that time.

By experiencing the crisis, we recognized again how important it was to ensure a failure resolution system and the soundness of financial institutions. Japan's active participation in the international discussion on financial regulation after the Lehman Shock, which I will talk about next, was based on the lessons that we had learned.

Global efforts and Japan's response in view of the Lehman Shock

Next, I would like to talk about the global efforts and Japan's response after the Lehman Shock.

As I discussed earlier, it was the mid-2000s when we saw the end of the Non-Performing Loan Problem. Until then, we had been working on improving the soundness of the entire financial sector in Japan, in addition to dealing with the failed financial institutions. One of the examples of the JFSA's efforts was that we started the domestic implementation process of Basel II agreed upon in 2004 at the end of March 2007, in accordance with the agreed-upon schedule.

Japanese financial institutions had not focused so much on financial businesses that pursued high-leverage or short-term profits, or the securitization business, in contrast to Western investment banks at that time. This was because Japanese financial institutions prioritized the disposal of non-performing loans. As a result, Japan's financial system at the time of the Lehman Shock in 2008 was relatively stable compared with those of Western countries.

Nevertheless, the turmoil in the global financial markets caused Japan's real economy to worsen through a stagnant global economy, and also had a huge impact on Japan's financial sector, including extreme volatility in the foreign exchange markets and stock markets.

The G20 started discussions on global financial regulatory reform to prevent the recurrence of a financial crisis.

[Page 16] The course of those discussions is shown here. In 2008, the first G20 Summit was held in Washington, D.C. Since then, financial regulatory reform including Basel III has

been pushed forward, and now, 10 years since the global financial crisis, most of the items under the global financial regulatory reform, which were designed to prevent the recurrence of such a crisis, were finalized.

I will not go into the details of these global discussions, as many of you may be already aware of them. However, I would like to point out that Japan, as a member of the G20, actively took part in the discussions and implemented the agreed-upon criteria in Japan in steps.

[Page 19] With respect to Basel III, agreements have been made in steps since 2010, and Japan started phased implementations from the end of March 2013.

[Page 20] Also, Japan rolled out a framework for the orderly resolution of financial institutions in the form of a revision to the Deposit Insurance Law in June 2013. It was agreed upon at the 2011 G20 Cannes Summit in accordance with the lessons of the Lehman Shock that the impact of the failure of a systemically important financial institution is propagated through financial markets, and may have a dire impact on the real economy.

The trigger condition for this system is specified as the time when it is deemed necessary to initiate the system to avoid major disruption to the markets. It is applicable to the entire financial services industry including financial holding companies, not only limited to deposit-taking financial institutions.

[Page 21] The 2015 Antalya Summit confirmed the completion of the tasks including the finalization of TLAC. TLAC was agreed upon as a measure to deal with the issue of “Too big to fail,” and its purpose was to enable smooth failure resolution while avoiding the burden on taxpayers.

[Page 22] The JFSA announced policies for developing a framework of TLAC rules twice in 2016 and 2018, and is now working on revisions of the administrative notices. Next, starting from the end of March 2019, TLAC regulations will be applied to Japan’s three mega banking groups. From 2021, four financial services groups, including Nomura Holdings, are scheduled to be placed under the scope of the TLAC regulations.

The JFSA would like to firmly coordinate with the relevant international authorities and the DICJ, in order to make this new framework effective.

Efforts by the JFSA in the Era of Transition

Lastly, let me introduce the reform of the monitoring methodology, which we are currently working on.

[Page 24] Twenty years ago, when the Financial Services Agency was established, we were pushing forward financial administration with a focus on the following: “Ex-post regulatory / supervisory policy with emphasis on rules,” “inspection focused on the assessment of individual assets,” and “thorough checking of compliance.” This is because it was considered an urgent task to regain trust in the financial system and restore the soundness of financial institutions at the time when we witnessed a worsening the Non-Performing Loan Problem, failing financial institutions, and incidents of compliance breaches.

As a result, the Non-Performing Loan Problem subsided in the mid-2000s. Also, financial institutions have developed a compliance structure, and minimum customer protection has been ensured. On the other hand, a variety of adverse effects have been created along with the changes of the times, as a result of continuing the same inspection and supervisory method mechanically while maintaining the same policy.

[Page 25] There are three main types of specific adverse effects. The first type of adverse effect is “focus on the form.” This means that when providing loans, lenders place emphasis on collateral and guarantees rather than the details of the business operations of the borrowers. This also means that they focus on securing evidence, which ensure that they comply with the rules, rather than providing services aligned to customer needs. The second type is “focus on the past.” This means that the lenders focus on the health of the balance sheet, which is the result of operations in the past rather than the sustainability of business in the future. This also means that they concentrate on discussions of compliance breach in the past rather than responding to the changing needs of customers. The third type is “focus on the elements.” This means that lenders concentrate on the assessment of individual assets rather than discussing truly important risks of the overall business operation of financial institutions. This also means that they neglect to examine the root causes of problems or to discuss the required measures, while blaming individual cases on breach of compliance.

In June 2018, the JFSA put together the basic concept and procedures of new inspection and supervision, which address the adverse effects, extend the view of financial administration from “form, past, and parts” to “substance, future, and whole,” and make more effective contribution to achieving the ultimate objective of financial administration.

[Page 26] The ultimate objective of financial administration is maximizing contribution to national welfare.

It is essential to ensure the well-balanced achievement of the respective elements of: (1) the stability of the financial system and the exertion of the financial intermediary function; (2) customers protection and convenience for users; and (3) the integrity and transparency of markets, and the activity of markets, in order to achieve the ultimate objective of maximization of national welfare through the sustainable growth of corporations and the economy and stable asset formation.

For example, although the stability of the financial system is quite an important objective, if we pursued this objective as if it were the only ultimate objective, financial institutions would become excessively averse to taking risks, and the financial intermediary function would not work fully, which might thereby stave off the sustainable growth of the economy and corporations. As a result, it may even hinder the stability of the financial system. It is desirable to achieve both the stability of the financial system and the exertion of the financial intermediary function while striking a favorable balance and achieving a virtuous cycle between them.

[Page 27] This demonstrates our environment and evolving challenges, and the changes in the tools and approaches for desired inspection and supervision.

Financial institutions are under an environment of continuing low-interest rates globally, the decline and aging of the population in Japan, diversifying customer needs, and accelerating changes in the types and location of risks. Against such a background, financial institutions are required to realize a sustainable and diverse business model and endeavor to take a forward-looking stance in dealing with risks while responding to changing risks.

To promote these changes, the JFSA decided to change its approach to focus on dialogue with financial institutions in pursuit of best practices based on the actual status of financial institutions, in addition to the mere verification of whether they meet the minimum-standards. As a part of such efforts, and also as a tool for self-assessment by financial institutions, we have set up a benchmark that can be used by financial institutions to assess progress in their financial intermediary efforts as well as challenges. Furthermore, we are promoting the use of soft laws such as Corporate Governance Code.

We are also working on reform of the organizational culture and governance in order to constantly enhance the quality of financial administration. For our specific efforts, please refer to **pages 28 and 29**.

In conclusion

Let me conclude. Japan's Non-Performing Loan Problem and the turmoil of the global economy after the Lehman Shock constitute historical lessons that indicate the magnitude of the impact of the failure of a financial institution on the entire economy.

I would like you to look over **pages 30 to 33** in your own time. Although Japan's financial system is generally stable and robust at the moment, the profitability of financial institutions is on a declining trend, and some of the regional banks are facing challenges in the sustainability of business models and risk-taking in securities investments.

The JFSA is currently promoting efforts to resolve issues at an early stage. It is important for the financial regulatory bodies of respective countries including ourselves to develop a safety net at normal times to prepare for a financial crisis and to ensure forward-looking monitoring, so that we can prompt financial institutions to make improvements at an early stage against future risks so as not to trigger a financial crisis.

The JFSA would like to push forward with our efforts to realize the ultimate objective of financial administration, and the maximization of national welfare from such perspectives.

Thank you for listening.