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Daiwa's View

October BOJ *Financial System Report*

- Warns against lower profitability at regional financial institutions, but seeks solutions via efforts to improve operating efficiency at individual firms and mergers/partnerships

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October BOJ *Financial System Report*

Warns against lower profitability at regional financial institutions, but seeks solutions via efforts to improve operating efficiency at individual firms and mergers/partnerships

On 24 October, the BOJ announced its *Financial System Report* (*FSR*). In the previous *FSR*, the BOJ raised its alert level regarding operations at financial institutions by emphasizing "downtrends in the profitability and capital adequacy ratios of regional financial institutions" amid prolonged low interest rates.

This time around, the format has changed slightly due to the change in the head of the Financial System and Bank Examination Department. However, awareness of the problem has changed little from the previous issue. This issue adds "a chapter that comprehensively examines domestic and overseas financial vulnerabilities," which shows the BOJ's intention to comprehensively grasp the vulnerabilities of the entire financial system. However, the important point is that "changes in the activities of major banks and regional financial institutions both stem from the decline in domestic deposit-taking and lending activities."

◆ **Oct 2019 *Financial System Report***

・Japan's financial system has been maintaining stability on the whole. Financial institutions generally have strong resilience in terms of both capital and liquidity with respect to tail events like the onset of the global financial crisis. However, financial institutions' profitability, particularly that of domestic deposit-taking and lending activities, has continued to decline. This seems to be not only due to the prolonged low interest rate environment but also, from a longer-term perspective, due to structural factors such as the secular decline in loan demand associated with the shrinking population and the decline in the potential growth rate.

First, regarding the financial system in Japan, the report maintains its previous judgment that it "has been maintaining stability on the whole." As for the financial cycle as well, the report says that the cycle "as a whole has shown no signs of overheating observed during the bubble period in the late 1980s," as in the previous issue. These judgments are in line with remarks by Governor Haruhiko Kuroda immediately before the *FSR* announcement.

In the words of Mr. Kuroda, a risk to the financial system under large-scale monetary easing lies in a path in which excessive financial investment and financial bubbles have large negative impact on the economy. Another path would be seen if financial institutions are reluctant to lend because interest rate spreads become very narrow as interest rates remain low for a very long time.

◆ **BOJ Governor Kuroda (18 Oct 2019)**

・When large-scale monetary easing continues for a long time, two risks to the financial system are often pointed out. The first risk is that excessive financial investment and financial bubbles may have a large negative impact on the economy. The second risk would emerge if financial institutions are reluctant to lend because interest rate spreads become very narrow as interest rates remain low for a very long time.

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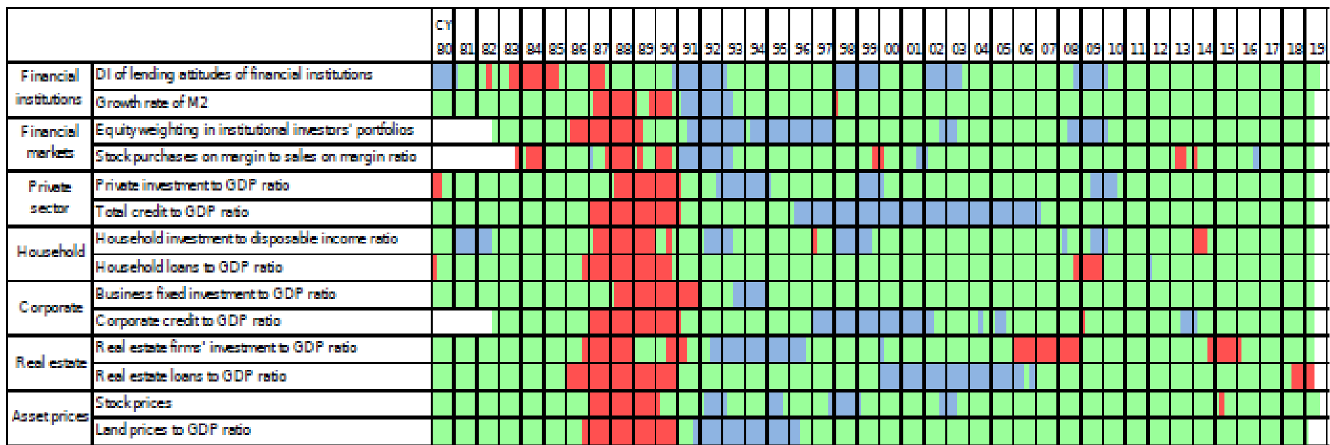
The latest *FSR* points out increased global financial connectedness through overseas lending mainly at major banks as the first risk. The report states that "financial institutions, particularly major banks, have increased overseas lending and overseas credit investment such as leveraged loans and collateralized loan obligations (CLOs)" and that they posted high growth far above the figures at US and European financial institutions. As these risks are matters of concern for overseas policymakers such as the Fed, the previous *FSR* and *BOJ Review* also touched on them. The latest *FSR* conducts a simulation analysis for the robustness of highly rated tranches of CLOs. Specifically, the report shows the recognition that AAA-rated tranches of CLOs are "reasonably robust in terms of credit risk," although "attention should be paid to, among other things, the risk of a decline in market prices, due to a downgrading of ratings" as a result of evaluation in the event of market stress similar to the global financial crisis.

In addition, regarding the domestic overheating condition in the first risk, the report made the judgment that "financial and economic activities as a whole have not shown excessive movements similar to those seen during the bubble period," by using the heat map similar to the previous issue. That said, the latest report reiterates that the signal for loans to the real estate industry, which was a focal point in the previous issue, remains red and that the total credit to GDP ratio has also been rising.

Chart: Heat Map



Source: Extracted from BOJ FSR (Oct 2019).

However, this stems from an "increase in loans to low-return borrowers" with narrow profit margins, rather than that Japan's real estate market is experiencing overheating driven by overly optimistic growth expectations as in the bubble period. This explanation was similar to that in the previous issue. The increase in loans to low-return borrowers with narrow profit margins may lead to the second risk (risk of impairment of financial intermediation function). However, as Governor Kuroda repeatedly touched on the increase in lending, the current interest rate level is consistent with the BOJ's perception that it has not reached the "reversal rate."

◆ **BOJ Governor Kuroda (31 Jul 2019)**

・Currently, I don't think the interest rate has reached the reversal rate. Major banks and regional banks are steadily increasing lending, and as indicated in *FSR*s in the past, the financial intermediation function has not been impaired at the moment due to, for example, restraints in lending caused by lower profits and capital. I don't think debate about the "reversal rate" is at all applicable.

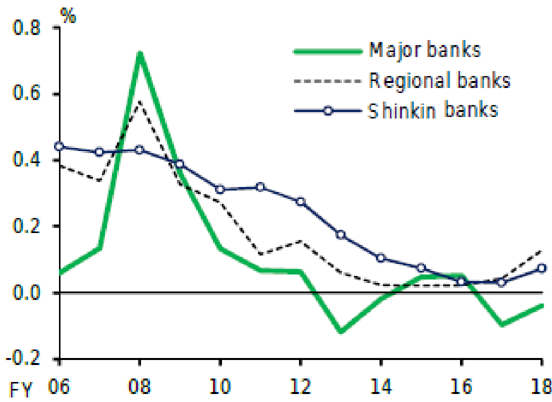
However, the latest *FSR* is also very concerned about the risk of financial institutions becoming reluctant to lend because the interest rate spread is very narrow as interest rates remain low for a long time. The focus of the latest *FSR* is on risk at regional financial institutions, which are directly affected by a decline in profitability in domestic deposit-taking and lending activities.

In particular, "an increase in credit costs" was pointed as a major situational change since the previous issue. Six months ago, the report said that credit costs are still at a low level but posted an upturn as a whole. However, the latest report clearly shows a sense of

caution—"credit cost ratios have recently started to rise, ... although levels have remained low" and "their upturn ... warrants close attention, given that regional financial institutions' profitability is currently declining." In particular, the BOJ pointed out that "the offsetting effects that have supported the financial institutions' declining core profitability have become less powerful," alongside the decline in room for locking in gains on securities.

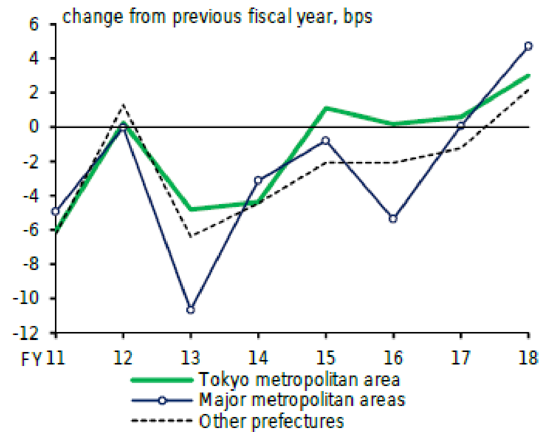
Chart: Credit Cost Ratios

Chart V-1-3: Credit cost ratios by type of bank



Source: Extracted from BOJ FSR (Oct 2019).

Chart V-1-4: Credit cost ratios by region

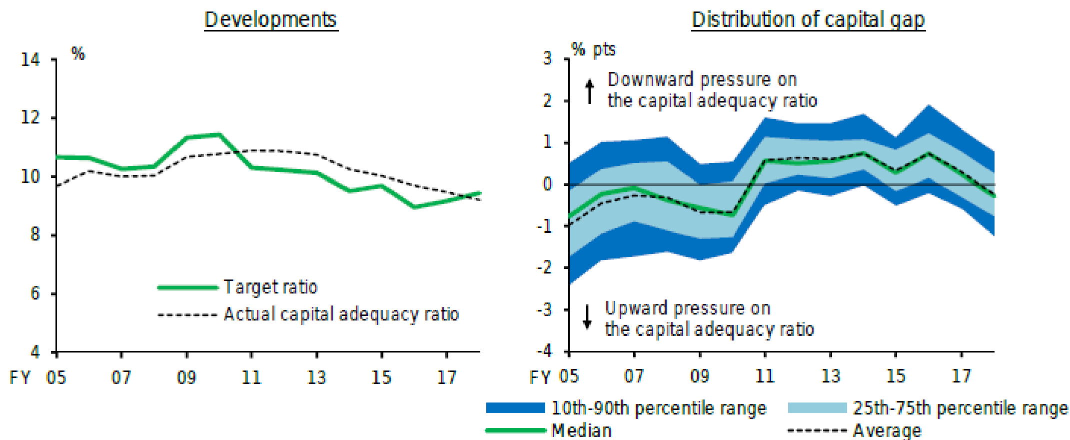


Source: Extracted from BOJ FSR (Oct 2019).

In addition to the increase in credit costs, the above-mentioned "loans to low-return borrowers" have been increasing. In such a situation, the profit level at regional financial institutions is not enough relative to expanded risk assets, and therefore the capital adequacy ratio and stress resilience have been declining moderately. In particular, the latest *FSR* estimates the capital adequacy ratio, which is used by financial institutions as a yardstick of their business stability (target capital adequacy ratio), and shows an increase in the number of banks whose actual ratio is lower than the target.

Here, the report expresses the interpretation that financial institutions have raised the target capital adequacy ratio due to the decline in unrealized gains on securities that have been used as a capital buffer. However, according to the empirical analysis in the report, the fact that the actual ratio is lower than the target ratio serves as a factor to restrain lending. In other words, if this situation continues, capital constraints in the banking sector would tighten. We can say that this implies a risk of hitting a "reversal rate," in which the financial intermediation function is impaired.

Chart: Target and Actual Capital Adequacy Ratios (regional banks)

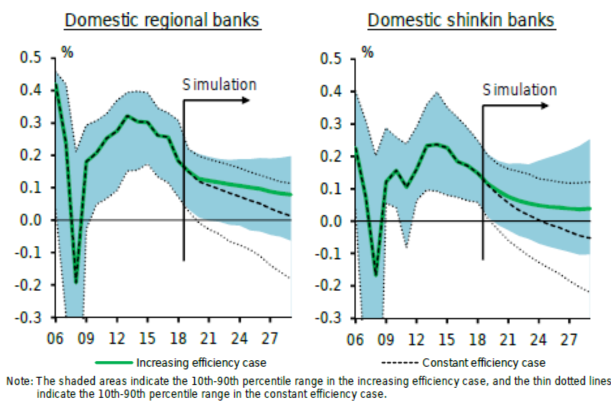


Note: 1. Covers regional banks. The left-hand chart shows the simple average of these banks. Estimated by the BOJ.
Source: Extracted from BOJ FSR (Oct 2019).

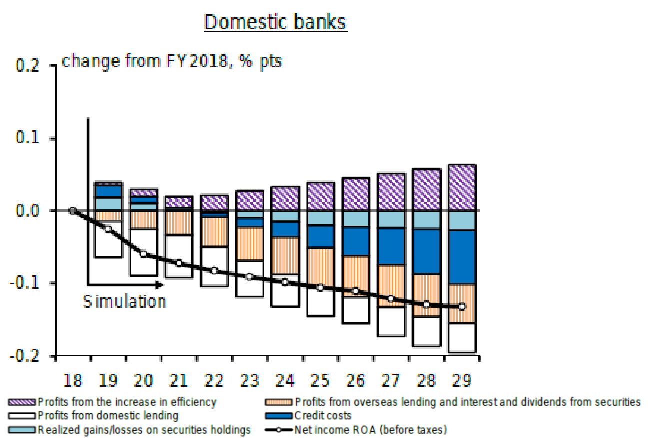
However, the latest *FSR* points out measures to improve operating efficiency at individual financial institutions as a solution for this type of risk. In fact, the report shows that many regional financial institutions are conducting measures to improve operating efficiency (such as cost reduction) at an accelerated pace. In addition, as in the previous *FSR*, a medium- to long-term simulation (macro stress test) was conducted. This time around, the scenario included the impact of measures to improve operating efficiency (such as cost cuts and increases in net non-interest income) on future earnings.

The result is that, as in the previous issue, even in the baseline scenario without a shock, lending margins continue to face structural tightening pressure mainly in domestic operations in the weaker loan demand case. Therefore, downward pressure continues on capital adequacy ratios at banks under domestic regulation. However, the report says that "wide-ranging efforts by financial institutions to improve operating efficiency such as through overhead cost savings and increases in net non-interest income will significantly enhance their future financial soundness and stress resilience."

Chart: Net Income ROA (medium- to long-term baseline scenario)



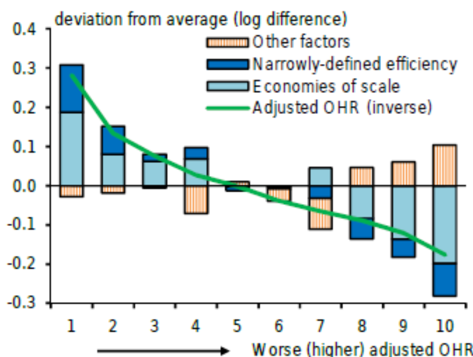
Source: Extracted from BOJ FSR (Oct 2019).



Source: Extracted from BOJ FSR (Oct 2019).

The report also states that "there are considerable differences in operating efficiency especially among regional financial institutions." The quantitative analysis shows that "economies of scale" is the most influential factor. This appears to be proposing that "mergers and partnerships among financial institutions and alliances with firms in other business areas" are effective options for improving operating efficiency, not limited to measures at individual institutions alone.

Chart: Decomposition of Adjusted OHR of Regional Banks



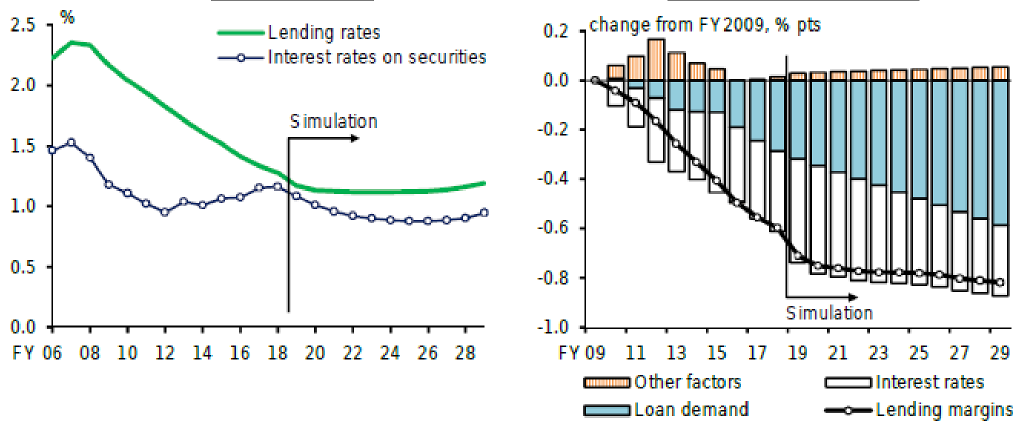
Note: Regional banks are sorted in ascending order by adjusted OHR, and divided into ten groups on the horizontal axis. Other factors include error terms.
Source: BOJ.

Source: Extracted from BOJ FSR (Oct 2019).

As mentioned above, the latest *FSR*, similar to the previous one, warns against the risk of impairment of the financial intermediation function caused by lower profitability and capital adequacy ratios at regional financial institutions. At the same time, it seems to be seeking solutions in the micro-economic system such as in-house efforts at individual financial institutions and industrial policy. That said, from the viewpoint of monetary policy, the report shows that the current interest rate level has not hit the reversal rate, although there is a risk that the rate would fall below the reversal rate if the capital adequacy ratios at financial institutions continue to decline.

Comparing the previous and latest medium- to long-term profit simulations, the report says that "yields on securities will decline even from a somewhat longer-term perspective, since long-term interest rates remain low, reflecting the fact that yield curves both at home and abroad are currently flattening." Although the BOJ cannot fight off flattening pressure via a decline in global neutral interest rates and term premium, a steeper yield curve is desirable from the viewpoint of financial institutions' operations.

Chart: Interest Rates on Securities and Lending Rates in Increasing Efficiency Case (medium- to long-term baseline scenario)



Note: "Other factors" in the right-hand chart includes a nonperforming loan factor and estimation errors.

Source: Extracted from BOJ FSR (Oct 2019).

Lastly, the latest *FSR* points out "an increase in credit costs" as a cause of the decline in profitability of financial institutions, as mentioned above. It then states that "given that credit costs have already started to increase under the current business conditions, financial institutions need to become even more aware of the possible effects on credit costs associated with the materialization of downside risks to the economy amid the increased uncertainty about overseas economies."

However, the role of paying attention to the "materialization of downside risks" and preventing them from occurring is the job of policy authorities. Of course, such policy judgments are beyond the role given to the *FSR*. It is Mr. Kuroda himself who must make decisions by thoroughly weighing policy benefits and costs after considering the latest *FSR*.

◆ BOJ Governor Kuroda (24 Sep 2019)

・If the low interest rate environment is prolonged further, it will become necessary to pay closer attention to the costs of policy measures, including the impact on the functioning of financial intermediation and market functioning. Thus, the Bank recognizes that there remains an important challenge to consider what is required to further enhance the sustainability of policy measures.

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May 2018

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