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Daiwa's View

Preview of BOJ's *Financial System Report*

- Seeking a longer-term financial system framework that reflects structural changes to society brought by the pandemic

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Preview of BOJ's *Financial System Report*

Seeking a longer-term financial system framework that reflects structural changes to society brought by the pandemic

The BOJ will release its *Financial System Report* this week, on 22 October. It published its last such report in April, as downside risks to the economy from the pandemic were materializing. That report summarized the imminent risk of the pandemic causing the development of a negative feedback loop between the real economy and the financial sector.

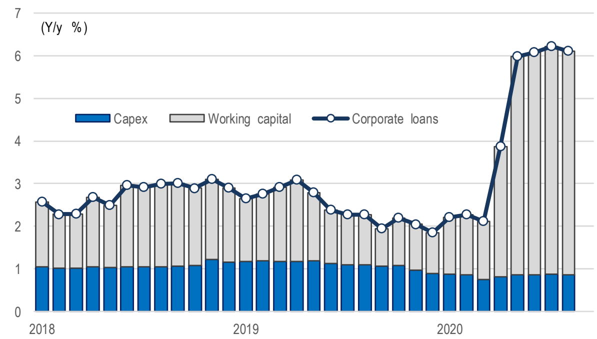
The upcoming report will probably again focus on risks to the financial system from covid-19 but may also include longer-term considerations rather than only the near-term outlook. With this in mind, we look here at domestic monetary trends since the April *Financial System Report* was released.

◆ **Summary of Opinions at Monetary Policy Meeting on 16-17 Sep 2020**

・The functioning of financial intermediation has been fulfilled appropriately, and bank lending has continued to increase on an unprecedented scale. However, market participants' assessments on financial institutions, as seen in the price-to-book ratios of banks remaining low, may reflect concern over financial system stability.

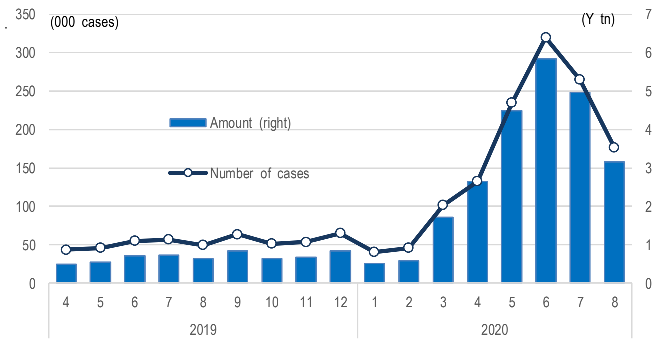
There has been a sharp increase in corporate lending by domestic financial institutions since May. As made clear by the data on loans by type, nearly all of that borrowing was based on demand for working capital, i.e., the need for cash. It is certainly the case that government support for corporate loans played a big role in enabling lenders to supply those funds at a time of significant deterioration in corporate earnings. In addition to loans from government-affiliated financial institutions, this was helped greatly by private sector financial institutions getting access to effectively interest-free unsecured loans starting in May. In fact, there was a sharp increase in the amount of guarantees approved by credit guarantee corporations.

Breakdown of Corporate Loans



Source: BOJ; compiled by Daiwa Securities.

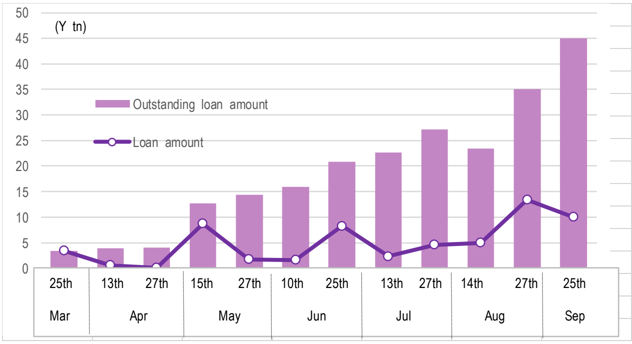
Amount/No. of Cases Approved by Japan Federation of Credit Guarantee Corporations



Source: Japan Federation of Credit Guarantee Corporations; compiled by Daiwa Securities

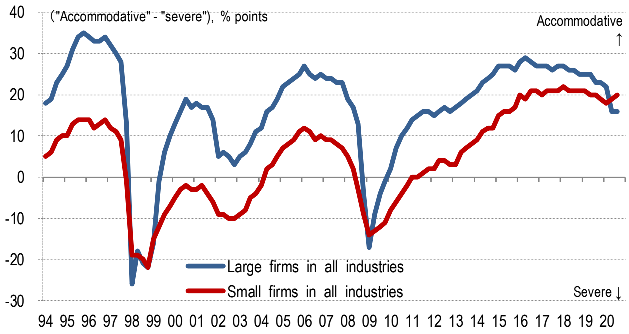
Additionally, through its Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus, the BOJ proactively provided funding support to private sector lenders, and these low-cost funding operations encouraged financial institutions to supply credit to corporations. This combined with the government's measures to loosen credit kept deterioration in the banks' lending attitude to a minimum.

Outstanding Loan Amount and Loan Amount Under Special Funds-Supplying Operations to Facilitate Financing in Response to Novel Coronavirus



Source: BOJ; compiled by Daiwa Securities.

BOJ Tankan: DI on Lending Attitude of Financial Institutions



Source: BOJ; compiled by Daiwa Securities

Meanwhile, there has also been significant growth in deposits since May, and various subsidies to businesses, including the above-noted funding support and the program for sustaining businesses, wound up accumulating in corporate deposit accounts.

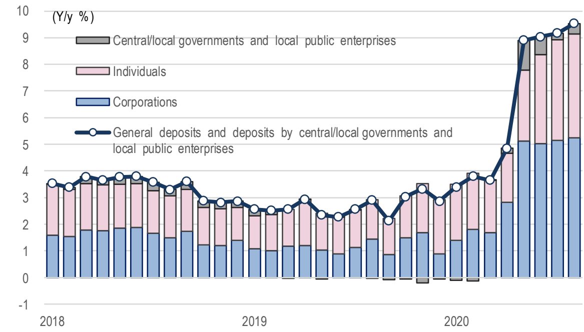
Additionally, the increase in deposits owned by individuals was fueled not only by the per-person cash subsidy of Y100,000 paid out to each individual but also by various government subsidies given to business operators, some of which wound up in the deposit accounts of the single proprietors of those businesses.

Because growth in deposits outpaced growth in lending, the deposit-loan gap at both the city banks and regional banks widened substantially. Although that gap is still in a widening trend, it is widening at a slower pace. We expect this growth in individual deposits to slow, given that 96.8% of the cash subsidies had already been paid out as of end-July, and 98.3% as of end-August[1]. Note that this accumulation of funds that were meant to be spent in deposit (savings) accounts is a consequence of households' sensitivity to uncertainty over their future incomes and could be taken as evidence of their hesitancy to consume.

◆ **Summary of Opinions at Monetary Policy Meeting on 16-17 Sep 2020**

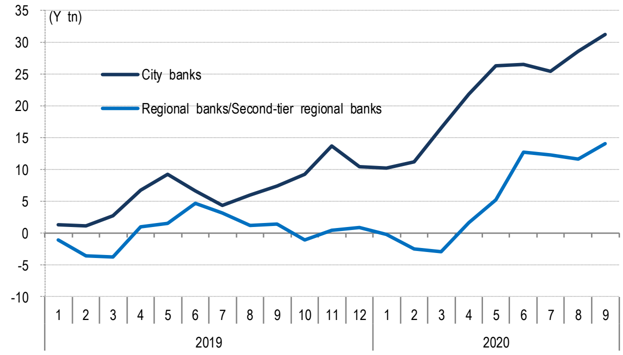
・Due to COVID-19, the risk of an unexpected future decline in income has been recognized. There is concern that this may further raise households' propensity to save and that downward pressure on consumption may be exerted accordingly.

Breakdown of General Deposits and Deposits by Central/local Governments and Local Public Enterprises



Source: BOJ; compiled by Daiwa Securities.

Change in Deposit-loan Gap from End-2018



Source: BOJ; compiled by Daiwa Securities

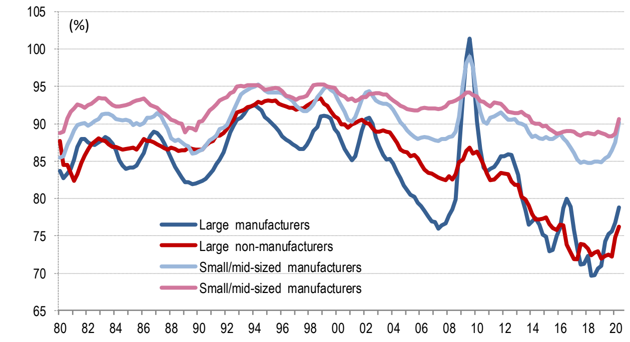
[1] With about 80% of the budget for the subsidy program for sustaining businesses having been paid out as of end-August, there is a possibility of further growth in deposits as this subsidy program continues.

It was the industries that rely on face-to-face contact, particularly smaller businesses in the nonmanufacturing sector, that were hit hardest by this crisis. Because these companies, in addition to having weak financial positions with high fixed costs and high profit breakeven points, are more reliant on bank credit than large companies are, the large-scale funding support from the government and the BOJ has clearly played an outsized role. The worst of the pandemic may be over, but with the economy recovering at a tepid pace, this support should continue to provide an important safety net.

Although this funding support has enabled companies to escape crisis, the loans will eventually have to be paid back, and the expansion of their balance sheets enabled by their access to effectively zero-interest loans will inevitably create a financial burden that hampers management of the business. Furthermore, unlike large companies, business investment by SMEs depends greatly on their own financial leeway (debt and cash flow), and therefore any borrowing to fund day-to-day operations will have a major impact on the macroeconomy by suppressing (lowering the potential growth rate of) their business investment.

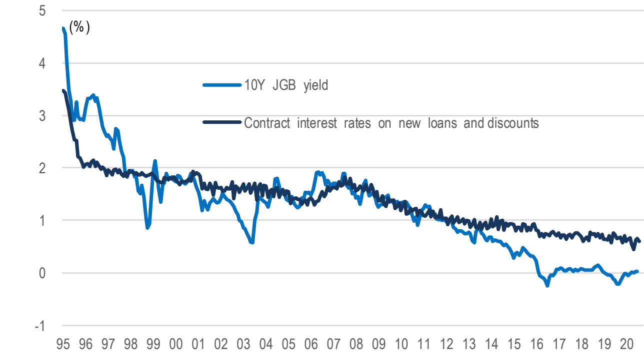
It is worth noting that this can affect the financial system over the longer term. The covid-19 crisis has occurred at a time when bank lending rates are in a secular declining trend because of declines in the potential growth rate brought by demographics and sustained accommodative monetary policy from the BOJ.

Breakeven Point Ratio



Source: MOF; compiled by Daiwa Securities.
Note: 4-quarter backward moving average.

Contract Interest Rates on Loans and Discounts, 10Y JGB Yield



Source: BOJ; compiled by Daiwa Securities

In other words, making use of the effectively interest-free unsecured loan programs described above has the effect of rapidly expanding loans outstanding, and depending on the region, the relatively low rate of interest obtainable in these lending programs may put downward pressure on loan rates[2]. In fact, the media has reported an overheated market for interest-free loans[3], and the BOJ's Summary of Opinions included comments alluding to the risk of that occurring.

◆ Summary of Opinions at Monetary Policy Meeting on 14-15 Jul 2020

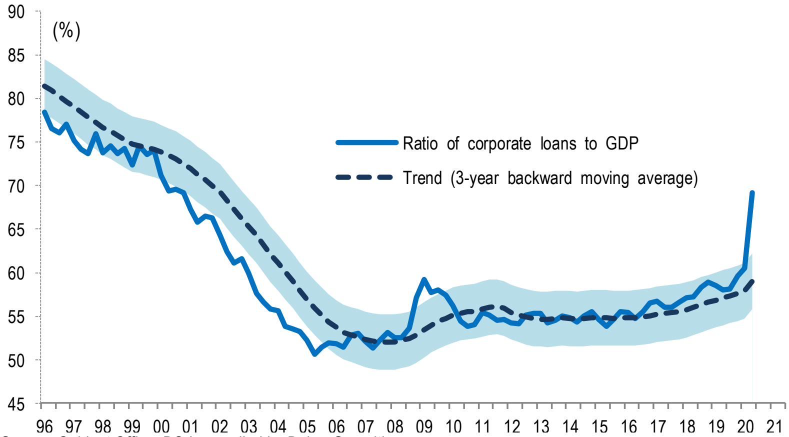
・Effectively interest-free loans are being provided to small and medium-sized firms through private financial institutions in response to COVID-19 based on the government's economic measures. Such loans will have significant positive effects since they serve as support for firms that have difficulties in raising funds. On the other hand, even after the impact of COVID-19 subsides, such loans might put downward pressure on spreads on the ordinary loans that will be made.

It is true that the BOJ is alleviating the side effects on the banks from its coronavirus funds-supplying operations by paying the 0.1% IOER on the usable portion of banks reserve accounts and a 0% rate on the macro add-on balance, which is double the usable portion. Nevertheless, if the sectors and companies hit hard by the pandemic are indefinitely kept on life support with this funding assistance despite their not having any hope of a future

[2] The detailed data on new loan rates by originator show that since the pandemic began, loan rates have been flat at city banks and regional banks but have declined substantially at *Shinkin* banks.
[3] See *Interest-free loans, overheating at the regional banks, national interest rate burden from covid-19 measures, norm setting and crossing borders: FSA survey* (in Japanese) in the 4 August 2020 edition of *Nikkei*.

earnings recovery, there is a risk that a shock of some kind would greatly increase credit costs and windup damaging the financial system's credit mediation function.

Ratio of Corporate Loans to GDP



Source: Cabinet Office, BOJ; compiled by Daiwa Securities.
Note: Shaded range shows root mean square of diversion from trend.

To ensure these companies and industries can adapt to the post-covid new normal, there is a need to push for changes in business models and industry structure. In other words, financial support probably needs to be directed more toward companies that use riskier capital. The FSA's Financial System Council is now studying an easing of the restrictions on banks taking equity stakes in companies (currently maxed at 5% of voting rights for banks and 15% for bank holding companies). The new Suga administration's desire to restructure SMEs and the regional banks needs to be thought of in this context.

◆ Summary of Opinions at Monetary Policy Meeting on 16-17 Sep 2020

・It is necessary for the time being to focus on conducting monetary policy with a view to supporting financing, mainly of firms, and maintaining stability in financial markets. However, from a medium- to long-term perspective, while the government and firms make efforts to push forward with structural reforms and growth strategies, it is also important to encourage firms' growth, mainly through financial institutions' expertise in examining the creditworthiness of firms and through the market mechanism, so that the potential growth rate will rise accordingly.

An urgent issue now facing Japan's policymakers is figuring out how to prevent corporate liquidity pressures from morphing into insolvencies (as the IMF put it in its October 2020 *Global Financial Stability Report)*. However, in the upcoming *Financial System Report*, we will be looking for, in addition to the answer to that question, a longer-term assessment of the financial system that reflects the significant structural changes to society brought by the pandemic, as well as for hints on the future direction of monetary policy.

◆ Summary of Opinions at Monetary Policy Meeting on 16-17 Sep 2020

・The Bank should maintain the current stance of monetary policy and carefully examine the positive effects and side effects. In order to achieve the price stability target, it is essential, mainly for small and medium-sized firms, to implement reforms to raise productivity beyond cutting their costs. The Bank should support reforms in the private sector while thoroughly analyzing and assessing the efforts by the government and the private sector, as well as taking account of consequent insights in conducting monetary policy as necessary.

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[Standard & Poor's]

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[Moody's]

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February 2020

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2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

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5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison's total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

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- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
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