"The Disposal of Non-Performing Loans and Its Potential Influence"

Study Project on the Potential Influence of Balance-Sheet Adjustments,
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Executive summary[1]

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One of the underlying causes of Japan's prolonged economic stagnation is the non-performing or bad loan problem. Some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This has delayed structural reform and prevented the financial intermediary system from functioning properly. In its Emergency Economic Package of April 2001, the Japanese government declared that it would resolve both the non-performing bank loan problem and the excess borrower debt problem at the same time. It also emphasized the need to eliminate bad loans completely.[2]

Having stated that it will resolutely carry out structural reform, it still remains for the Koizumi Cabinet to win the confidence of the market and the trust of the nation as it implements its policies. Moreover, in taking this drastic step to eliminate bad loans, the Cabinet must consider the impact of such a step on the macroeconomic level, because the balance sheet adjustment could have a series of deflationary effects, such as increasing the number of bankruptcies and the level of unemployment.

This Study Project estimates the level of unemployment that could result if bad loans – defined currently as loans that major banks have made to firms that have already gone bankrupt or are in danger of going bankrupt – are eliminated from their balance sheets. It concludes that between 390 and 600 thousand employees may lose their present jobs, and that between 130 and 190 thousand may be left unemployed if these loans are written off within the next two years.

This estimate was calculated based on all currently available information, including industry specifics and the financial data of firms that have already gone bankrupt, but it should be noted that new bad loans are not included; macro knock-on effects are not considered; and the estimate is highly dependent on past statistics. In addition, the Cabinet may take measures to minimize the deflationary effect of bad loan disposal by reducing its impact on employment.

In addition, the following issues must be noted with regard to writing off bad loans:

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1 Note: This is a translation of a Japanese-language document and as such may not accurately reflect the contents of the original.

2 In addition, a Major Policy Direction, *Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management*, which was approved by the cabinet on June 26, 2001, considers the final resolution of bad loans to be the first step toward revitalizing the Japanese economy and proposes adopting additional measures as necessary.

- Risk management skills: The existence of bad loans is not a problem in itself as bad loans are inevitable when banks provide firms with credit. The main issue here is whether Japanese financial institutions have practiced adequate risk management. It cannot be denied that banks have been slow to develop adequate risk management policies. Not all loans to Japanese industries or companies have become non-performing; only some companies in certain industries, notably construction, real estate, retail and service, are seriously in debt. If the market mechanisms already in place had functioned effectively, those companies would have been eliminated at the microeconomic level and the industrial structure would have changed at the macroeconomic level. Thus, the financial intermediary system would have accelerated the changes in industry structure by transferring money from low productivity to high productivity sectors. The fact that loans continue to go bad today seems to indicate that financial institutions practice insufficient risk management and that their market discipline is weak.

- Dynamism: The elimination of bad loans should be seen as a dynamic issue that changes with the economy. Thus, the problems of the current Japanese financial system fall into three main areas:

  1) Japanese financial institutions have not adjusted their risk management policies to match industry structure changes.

     When an industry structure changes drastically, opportunities open up for new businesses and projects while old formats can risk losing their profit bases. Under these circumstances, conventional risk evaluation, i.e., dealing with borrowers on an individual basis, is not likely to identify the real risks. It may be necessary, therefore, to change the current lending system that centers on company loans to a system that bases lending decisions on the profitability of individual business units and projects.

  2) Corporate governance is weak.

     Loans continue to go bad, and this would suggest that in the area of risk management Japanese financial institutions, which rely on official "Financial Inspection Manuals" issued by the Financial Services Agency (FSA), still follow the "me-too strategy" that was prevalent in the convoy system era. In the past, weak corporate governance has caused the market to distrust financial institutions. To rebuild market confidence, banks must demonstrate their total commitment to the elimination of bad loans in their management statements and disclose information accordingly.

  3) Information on real estate prices, which is needed to evaluate the financial risks involved in lending when real estate is used as collateral, is insufficient.

     As the bad loan problem was in part caused by the sharp decline in land prices resulting from the bursting of the bubble economy,

financial institutions should reexamine their evaluation scheme for real estate collateral and try to evaluate it even more rigorously than prescribed by the FSA manuals. Also, the government must facilitate the appropriate disclosure of information on real estate transaction prices, so that financial institutions can address the risks that may arise from the sale of real estate used as collateral.

- Government as a market enhancer: The government should enhance the market when the financial system is moving from bilateral to market-based finance. Not only should it deal with the final resolution of bad loans, but after examining the overall financial and structural adjustment implications, it should also develop a transition program and implement it appropriately and responsibly. The government's role as a market enhancer requires it to create a system that will mobilize the related branches of government, and reinforce research.

Following the collapse of the bubble economy, many stakeholders, including banks, corporations, and the government, made efforts to reconstruct companies, industries and the economy as a whole. It could be argued, however, that these efforts were "backward-looking" and did nothing to remedy the current situation. What is needed now is to push forward and implement change through structural reform while enhancing growth prospects. Government policy should support "forward-looking" initiatives and win back both market confidence and the nation's trust.

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