Urgent Political Policy Recommendation

# New Paradigm of the Japanese Financial System

Securitization, not privatization of the postal system is the key.

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- No matter how major banks are aided by public funds, no relief will be available to small and medium-sized companies.
- Japan's indirect finance system is fated to fade out amidst rebalancing and curtailment.
- The only hope lies with the postal savings not yet damaged. If privatized, the postal savings depository would be certain to go the way of the banks.
- How should we create the flow of funds from postal savings to small and medium-sized companies? There is the last-resort plan for the financial rebirth of Japan.

Small and medium-sized companies, the employers of 70% of Japan's workforce and central players in Japanese society and economy, now face dire conditions.

Many have faced sudden credit crunches and have been haunted by involuntary demands for repayment that drive them into bankruptcy. Others have financed their businesses with exorbitant interest-bearing borrowings. As they go forward, small and medium-sized companies (including ventures) should shoulder the growth of the Japanese economy instead of the large corporations (who are now slimming their operations). However, in reality, the small and medium-sized companies are more exposed to bankruptcy risk than large companies. While financial institutions bail out major companies and write off their unpaid debts to spare them further damage, without extending such considerations to small and medium-sized companies, their support and lending to them continues to diminish.

Substantial defects in the Japanese financial system can be cited as the underlying reason for this situation, and conditions worsen as monetary agencies continue their contradictions as they ignore such defects. The banks, so highly protected, are another part of the problem. Major players in the financial system are now failing to fulfill their functions. As a whole they have not been allowed to provide ample relief to small and medium-sized companies; on the contrary, strong forces are now intervening to halt any such flow of support. As the bad loans recognized at banks continue to be disposed, small and regional financial institutions and small and medium-sized companies will be irreparably harmed if the full deposit guarantee is removed. If that occurs, the Japanese economy will suffer from hardships it could never expect to overcome.

On the other hand, ¥350 trillion in savings of individuals deposited at the postal offices, one of the world largest financial institutions, have flowed almost exclusively to the public sector or special interest institutions of the government. Forces at work have very effectively curtailed the supply of these funds to small and medium-sized companies. The state in which small and medium-sized companies find themselves mirrors the substance of the problems inherent in the Japanese financial system.

In addition to eliminating these perils, the reform of the financial system must focus on the creation of a mechanism based on the market principle, in order to ensure an efficient flow of the vast private savings in the postal depository to small and medium-sized companies. By reforming the financial system reliant on large banks, and their preoccupations with scale and monopoly, the private and public financial systems of Japan would benefit from the formation of an integrated financial network and a synergetic effect likely to promote the proper functioning of a variety of financial channels concurrently and open the way to stable and market principle-based competition.

Without such substantial reform of the financial system, the financial system would not be likely to return to the primary position of serving the national economy as an engine of economic growth and employment.

This non-fulfillment of financial system reform can certainly be cited as the reason why Japan alone has been unable to rise from its protracted recession. At the beginning of 1990s, bubble economies burst all over the world. Real estate prices plummeted in major European countries and the US, and the banking systems in individual countries faced many crises. Most of major banks in Scandinavian countries were nationalized. Yet these countries disposed of their bad loans and banking system crises by the early 1990s. Subsequently they established more efficient financial systems that have been upholding overall economic growth, increasing employment, and enhancing the asset value (including equity). Japan is the only country in the developed world that failed to solve its banking problem.

Moreover, the management models for financial institutions have greatly changed and improved in many countries. Citibank, a bank that had been at the edge of failure in the early 1990s, is now among one of the most profitable banks in the world. Financial institutions centering on banks have adopted new business models with globalization

and diversification of risk management and business operations. Thanks to these new business models, many have been able to secure stable management and growth in revenue even amidst plummeting prices of IT stocks and so-called the Enron shock. The Japanese financial system has stepped aside and taken no involvement in these revolutions in financial management.

Alarmed by the failure of the Big Bang, which is incomplete and moreover outdated by about 20 years, the Japanese public has senselessly argued that the financial system is being threatened from abroad. This discussion is as absurd as the contention that the Internet and Linux do not exist.

The Japanese financial problems have rooted in micro issues, including the financial system structure and the management of financial institutions, particularly the banks. These problems will never be solved with macro-based stimulus packages introduced under fiscal and monetary policies. Excessive stimulus packages represented by the zero interest policy have resulted in the fiscal indebtedness and crises in the pension, insurance, and equity markets. A definitive solution to the financial problems should accompany the restructuring of Japan's financial system. As these problems are complicated, a consensus has yet to be obtained.

The reform of financing for small and medium-sized companies centering on the securitization I recommend hereunder may directly solve most of the critical issues of the postal business reform without any undue effort and costs.

Then, financial institutions in public finance and private finance will align their efforts and integrate them within a rational financial network while they are so far vertically work towards their diverse interests without any coordination among them. This will spur the evolution of a new Japanese financial system that includes both micro and macro financial policies. The determination and implementation of individual participants are certain to be tackled.

**Why do major banks reduce lending to small and medium-sized companies?**

In the wake of the financial crisis for small and medium-sized companies, the major banks have promised to expand loans to them. But the promise is false: the major banks

have consistently reduced their lending to small and medium-sized companies. For example, Mizuho Financial Group (banks with sluggish equity prices) and Resona Bank (a bank bailed out with public funds infused after it fell under thin capitalization) curtailed loan balances for small and medium-sized companies by ¥8 trillion and ¥1.8 trillion, respectively, last year alone.

This curtailment in lending has had serious effects. Specifically, the banks have demanded involuntary repayment of the outstanding loans without extending new loans. And many of the small and medium-sized companies unable to find any other access to financing than bank loans have resorted to borrowing at illegal high interest rate and driven into bankruptcy. Serious situations such as unemployment, collapse of family relations, and suicides have entailed. In 1999, the Bank of Japan started to supply high-powered money to banks substantially without limit. Unprecedented amounts have been at the banks' disposal, yet none have been lent to small and medium-sized companies. The consequence is credit contraction among them. The Bank of Japan's credit creation mechanism through banks has not totally functioned. In spite of the zero interest rate policy no economic recovery has been attained.

The Financial Services Agency's policy towards the banking sector has been void in terms of the expansion of loans to small and medium-sized companies. This policy can be viewed as the largest cause for the contraction of the entire economy.

Some major banks have certainly fallen into *de facto* bankruptcy. Why have they been able to survive? This is because the Bank of Japan has been maintaining the zero interest rate policy at the mercy of the national economy for over four years and the government has infused the fiscal budget with more than ¥10 trillion. The Financial Services Agency has not submitted to the fact. And because it intended to implement contradictory policies, it has fallen into a deadlock.

First, the Financial Services Agency demanded the acceleration of the disposal of bad loans. The disposal of bad loans results in the further lowering of capital adequacy ratio of major banks. In order to maintain the capital adequacy ratio prescribed by the BIS (Bank for International Settlements regulations applicable to international banks) and avoid falling into thin capitalization, the major banks are forced to reduce the loans accounting for the majority of their assets by the amount equivalent to the reduced capital. Thus, the banks at the verge of failure have considerably reduced their loans

outstanding by even forcible means.

In addition, the stock prices are now a fourth compared with that in the early 1990s. The situation is very different from that in the US, where the stock prices have tripled over the same time horizon. The stock price lowering has also triggered the reduction of capital adequacy ratio. In the 1980s, Japanese banks and financial authorities forced the BIS to make to alterations in its regulations: to allow management to include unrealized profit and loss on equity (difference between the purchased price recorded on the financial statements and the current market value) in its shareholders' equity. Since then, unexpected drops in stock prices have turned the unrealized profit into an unrealized loss, thus lowering the capital adequacy ratio.

When some major banks failed or fell under *de fact* thin capitalization, the Financial Services Agency argued that they were sound and left the situations as they were without injecting public funds or nationalizing the institutions. This story during the bail-out of the Resona Bank turned out to be a fiction.

Needless to introduce the cases in Scandinavian countries or South Korea, it is quite apparent that the nationalization averts the problems of capital deficiency and uncertainty over the management. On the other hand, the government forces the banks to fundamentally change the management policies and reshuffle the management to recover the funds so injected. But the Japanese financial authority has failed to fulfill the responsibility and has swollen the losses of the major banks. This increases the burdens that the national people will have to shoulder. Without the backing of an enforcing power, a vast amount of treasury funds has been slackly infused for the bailout of banks. To date, ¥12 trillion has been used to write off the bad bank loans.

As there is no enforcing power, the Industrial Revitalization Corporation of Japan has not efficiently been utilized. Against this backdrop, the Financial Services Agency has left the capital deficiency of banks as is while forcing a vast burden on the shoulders of the national people. This has induced today's deflationary economy. On top of this, the Financial Services Agency has demanded major banks to expand the loan extension to small and medium-sized companies. How can the major banks, now driven to the verge of failure by the lowered capital adequacy ratio, manage to find the large amounts of capital needed to expand retail banking (financing for small and medium-sized companies)? By our understanding, they would be forced to reduce lending to small

and medium-sized companies. This is a total contradiction.

Worse, the Financial Services Agency has now ordered small and medium-sized regional banks to recognize a part of the refinancing in the course of ordinary business (a long-term banking practice) as problem loans. Unlike listed companies, small and medium-sized companies that have no access to direct capital market including bond market have suddenly encountered cash flow difficulty. It looks as if they have been forced to repay the long-term variable rate debts. In this way, the administration of the Financial Services Agency has forcibly reduced the lending to small and medium-sized companies.

**Major banks cannot bail out small and medium-sized companies.**

The major banks themselves have not been equipped with the management capability to expand retail banking focusing on small and medium-sized companies. Retail banking is the core business of European and US banks (including Citibank). Most in fact expanded their retail businesses in the 1990s because businesses centering on lending to major companies and mortgage-backed lending were unable to bring in stable profits.

The situation was the same in Japan. Yet, as the Japanese banks were protected from international competition, they failed to take in the changes in such international trends. Other industries that have always been exposed to international competition may find this inconceivable. Still, the banks have adhered to the outdated course of lending to the major companies they have been supporting in the past.

Success in the retail banking business lies with a large increase in the sales channel, in addition to the increased employment of staff versatile with retail banking. Taking into account the cases of Citibank, Japanese banks may have to triple their workforces to bring in the same asset amounts. The sales channel has to be enhanced with a density similar to that of regional and small and medium-sized banks. Without question, a vast amount of capital expenditure will be required.

Of more importance is a large reshuffle of management. Unless management is versatile with retail banking, the success of the new business model will never be

attained. No change in business models has taken place. The reasons are twofold: pressure from shareholders does not operate properly amidst cross share holdings, and the government that infused the tax revenue has done little else. Most management has no knowledge of retail banking, risk management and securitization (a financial practice of converting assets which produce regular income such as outstanding loans and real estate into financial instruments which generate yield and then selling them on the market). Moreover, they cannot contrive any new investments because of lowering capital adequacy ratios. Amidst these situations, the major banks are unlikely to largely increase lending to small and medium-sized companies. At best, they will pretend to expand the retail banking by substituting it with some automated loan application examination for small unsecured loans.

### Monetary policy of the Bank of Japan failing to fulfill its primary objectives

Amidst the miserable status quo mentioned above, the macro monetary policy of the Bank of Japan has been totally incompetent. Worse still, it has been severely damaging the national economy. For the decade following the disposition of the bad loan problems by the European countries and the US, Japan maintained its interest rate at a super low level. The result has been a vast loss of private financial assets, pension funds, and insurance premium investments. The loss of interest income incurred by the entire economy of Japan is certain to stand at several hundreds trillion yen. The main cause for the failure of insurance companies and pension funds can be cited as a deficiency in revenue due to the super-low level interest rate and the equity pricing lowered to a fourth of its level during its heyday.

The Bank of Japan dared to adopt the zero interest policy in February 1999. However, despite such effort, the high-powered money supplied by the Bank of Japan to banks has stayed in the banks, and lending by the banks to small and medium-sized companies has been contracting. As long as the market relies on the major banks as a credit creation facility, the monetary policy of the Bank of Japan will fail to fulfill its objectives. No matter how the Bank of Japan effects monetary easing from the macro-economic perspective, major banks face lower capital adequacy ratios and cannot develop new business models. Conversely, they reduce lending and aggravate the deflationary spiral.

The purchase of equity and real estate by the Bank of Japan is unlikely to contribute to the credit creation in the entire financial system. Quite the reverse, it deteriorates the quality of credit since the central bank takes a large risk. Furthermore, this may distort the market in which primary long-term investors should ideally be pension funds, insurance companies, and individual investors. Investments in recently introduced collateralized debt obligations have not yet contributed to the expansion of lending to small and medium-sized companies. The funds supplied by the Bank of Japan to banks bypass the small and medium-sized companies and go directly into the purchase of Japanese government bonds. The monetary policy has disappointed both investment needs by individuals seeking instruments with favorable return and the funding needs of small and medium-sized companies seeking loans in spite of even higher interest rates.

**Further hardship anticipated for regional and small and medium-sized financial institutions**

Regional and small and medium-sized financial institutions that have played a major role in lending to small and medium-sized companies to date are expected to encounter further hardship. As they are directly affected by individual regional economies, they will be exposed to higher lending risks.

Regional and small and medium-sized financial institutions in Japan have basically adopted the same business model as major banks. They operate main offices and branches to collect deposits and hold the outstanding receivables to maturity after extending loans. Management cost and risks are higher compared with those of major banks.

In anticipation of the removal of the full deposit guarantee and in consideration of the importance placed on the rating, the deposits of small and medium-sized financial institutions may drain off to postal savings and the major banks. Also, many of them are certain to remain as micro financial institutions unable to benefit from the streamlining of operations through mergers or improvements in financial strength. In addition, the financial inspection criteria of the financial authority will be more strictly applied to them, now that they are forced to contract their lending to small and medium-sized companies. Yet few newcomers have advanced in such lending market. If the current

path is followed, the businesses of regional and small and medium-sized financial institutions, the main players for lending to small and medium-sized companies, are certain to decline, and small and medium-sized companies will face further cash flow difficulty.

While lending by financial institutions to small and medium-sized companies has been tapering, public support to small and medium-sized companies through public credit guarantee by the Credit Guarantee Corporation has rapidly expanded. Unfortunately, the public credit guarantee has only a weak ability to examine loan applications and is unable to set interest rates matching the creditworthiness of borrowers. As a result, the corporation is trapped in a moral hazard and incurs vast losses to be burdened by the national people. Consequently, public finance has been proved not to serve as main player in lending for small and medium-sized companies.

Most small and medium-sized companies have no access to funding from the securities markets. The operations of securities markets have been focusing on the major corporations. The markets in which small and medium-sized companies can access financing through junk bonds (low rated bonds) and securitization have not yet fully matured.

### Fatal defect of mono-line financial system

As often misunderstood, the nature of bad loan problems in Japan is basically different form those that took place in the US in the 1990s when the real estate bubble burst. At the center of the bad loan problems in the US at that time were regional small savings and loan associations (S&L) that extended credit to commercial estate investments and failed. This bad loan problem was solved through the liquidation of the savings and loan associations by the Resolution Trust Corporation (RTC), a US governmental agency, after it sold the assets of the savings and loan associations. The deficiency not covered by the sales was recouped with treasury funds. The RTC liquidated three-fourths of the savings and loan associations within the two-year period up to 1993. The bad loans incurred by US major banks such as Citibank were relatively small, and the banks themselves managed to solve the problem.

In this manner, almost all the bad loan problems in the US were solved by the end of

1993. From that point, the US financial system entered into the era of stiff competition and large-scale innovation.

In the US financial industries, enhanced efficiency through securitization and IT technologies has diversified and lowered the risk exposures inherent in loan business, as well as the cost of loan businesses. Newcomers have actively advanced into the market. The increase in lending for mortgage loans and small and medium-sized companies through the vast securitization market and secondary markets for loans has supported the firm growth of the entire economy.

With the US equity price hikes throughout the 1990s, the entire economy ascended to the world's strongest position by leveraging the revolutions in the IT and service industries in spite of the bad loan problems. To insulate the economy from the bad loan problems of the banks, the US developed plural lines in its financial system and a mechanism to ward off the adverse effects of the bad loans. As a result, a sound financial system was obtained. Even the bankruptcy of Enron, the largest failure in history, had had little impact on the financial system.

The current status quo of the Japanese financial system resembles the great crisis that took place in the U.S. before World War II. Without plural lines in the financial system or a mechanism to ward off adverse effects of bad loans, the U.S. banks expanded their business into commercial property and equity transactions. When the stock prices plummeted, the finance, real estate, and other industries failed, leading the collapse of the entire economy. When the banks, the main players in the financial sector, finally melt down in Japan, the entire economy will be contaminated, as if from the radioactivity of a broken nuclear reactor. Without a doubt, the current Japanese financial system resembles the US financial crisis prior to the World War II.

Learning from the miserable experience of its great financial crises, the US has developed a strong financial framework by segregating banking and securities businesses, prohibiting banks from holding stocks and real estate, creating a deposit insurance system, creating a public market for securitization (including commodities), creating a securities administration that places the highest priority on the protection of investors, and establishing the Securities and Exchange Commission. Certainly, with the guidance of the US after World War II, Japan has segregated its banking and securities businesses. Yet the mono-line financial system operated centering on major

banks was left unchanged. As a result, the major banks are still located at the hub connecting corporations, insurance companies, pension funds, securities firms, and realtors with cross holding of shares.

Contrary to the case in the US, no public markets for securitization have existed, and the securities markets operating in Japan have failed to gain public confidence or approach anything close to maturity. Once a major bank fails, crises in land prices, pension funds, and insurance premium management will all take place at once. Under this scenario, traditional financial policies will have no positive effects. Quite the reverse, they will very likely bring about adverse side effects. The financial system has not been equipped with the power to recover autonomously. Notwithstanding this situation, the Japanese economy has been sustained. Why? Because the deposit insurance system has prescribed the government's obligation to protect depositors (not banks) and the government has protected the banks by transferring their burdens onto the shoulders of the national people. The true collapse of the economy is certain to arrive when Japan is entangled with twin deficits, namely, a fiscal deficit and deficit in its international balance of payments incurred when its external surplus to recoup its vast fiscal deficit dwindles to nothing. Unless situations change, Japan will surely follow this catastrophic path.

**The financial system can be saved not through privatization of post offices, but securitization.**

During the financial system reform in the 1990s, the period of the so-called Big Bang, no one sought to tamper with the roles of the postal savings and postal insurance deposits—huge reserves of money together approaching ¥350 trillion. Most of the postal savings are still applied to investments in government or municipal bonds or lending to public sector entities such as local governments and special interest institutions of the government. Very little has flowed to private companies. Defects of the financial system and failed steering of financial institutions and administration have dried up the lending source for small and medium-sized companies. The national economy has been exhausted, and on the back of this, there has been a large vacuum in the financial system. The advancement of private companies into the postal business dominated the discussion in the privatization of postal services. No one discussed the actual role of the post office, which has been viewed as one of the world's largest financial institutions.

This is nonsense.

No privatization without any philosophy should be effected. If the privatization proceeds under the current conditions, a great confusion will be caused in the financial system. At worst, the treasury accounts and economy will both fail.

With the postal services privatized, post offices will compete with banks for collecting savings. If so, the very suppression of private financial institutions will take place. With larger employment in this division, the post offices are certain to start their lending businesses all over Japan. The cost of postal offices, which have so far been the lowest-cost of the financial institutions in Japan, will jump sharply. Will they be able to manage lending businesses as even the banks have failed? Undoubtedly some of their lending is fated to become bad loans. When the ratio of the bad loans grows sharply, the privatized post offices will face the risk of failure.

The failure of post offices with funds of ¥350 trillion and over 24,000 bases all over Japan would impact the national life and treasuries far more than the failure of individual banks. Currently they are not privately operated, and the management of funds at post offices is limited to lending to the government or investments in highly secure securities. As post offices themselves are not allowed to extend loans, they do not have any bad loans like banks. They only lend the funds to the government, purchase government bonds or high-rated securities, and entrust equity investments with investment advisors. For a vast amount of money, several hundred staff alone could manage the businesses.

The increase of flow of funds to the private sector from post offices can be attained through their purchases of highly secure securities issued by the private sector. The fund will flow to small and medium-sized companies that cannot issue securities using the mechanism of securitization I will describe later. The supply of large amount of funds to the private sector in a secure manner and based on a market principle by post offices without adding any costs can best be achieved by a broadly defined securitization, i.e., diverting the entire investment into the public sector to investments in highly safe securities issued by the private sector. Further increase in the fund supply to small and medium-sized companies requires narrowly defined securitization where loans to small and medium-sized companies are pooled and securitized and the funds are invested in safe and investment grade securities with high ratings.

Often post offices are cited as the largest cause for losses incurred by special public institutions. Yet, that is because the financial authority borrows most of post office savings and lends part of them to special public institutions so that the primary responsibility lies with the financial authority. When major banks fail one after another, there are few bad loans in relation to the savings at post offices. This is only a relief of the Japanese financial system. Why are there few bad loans? Because post offices are strictly defined as public entities.

There is some argument suppressing savings at post offices noting that post offices are a cause for hardship in the management of private banks. This is also out of mark. Banks rapidly grew to the world top class in terms of revenue and size in the 1980s and weakened in the 1990s. This can never be attributed to the post offices.

If three core businesses of postal offices are forced to be privatized, the ability of the post offices to provide services to every corner of Japan as a single integrated entity is certain to be lost as such ability is attained thanks to the integration of three core businesses. In particular, important infrastructure in remote areas will be lost.

The equal competition theory that all the financial institutions must be private institutions has no meaning. Private and government-related financial institutions have different roles. In the US, the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC), all government-related institutions, have provided $3.1 trillion (approximately ¥370 trillion) funds through a securitization market larger than the treasury market. This function can never be attained by individual financial institutions. Since the Meiji era, Japan has been collecting the world's largest savings from individuals in its post offices, leveraging the credibility of the state. Now it is urgently required to utilize the savings for the national economy instead of destroying the history and assets of post offices.

A far better option than privatization is to maintain Japan Post as is and solve the problems inherent in the post offices. It should pay taxes and deposit insurance premium and enhance IR (investors' relation) activities without taking an involvement in politics. Free advancement by private companies into the door-to-door courier services should be completely permitted. Enhanced efficiency of personnel management

and businesses should be attained. A merit system should be introduced. On the back of it, a mechanism should be created whereby the funds collected from the national people through the securitization facility are supplied with market discipline to small and medium-sized companies on a stable and large-volume basis via private financial institutions, including regional and small and medium-sized financial institutions. Then, in addition to the mono-line private financing centering on banks, another conduit for fund flow to the private sector from post offices would be available. The chain effect of the financial system can be averted and all the participants in the financial system may benefit from the enhanced efficiency.

**Nature of lending for small and medium-sized companies and profit potential**

There are substantial reasons why small and medium-sized companies have not been supplied with sufficient funds in the Japanese financial system. First, lending to small and medium-sized companies is small in volume when it is made on an individual basis, and the credit quality varies among such companies. In collecting information necessary for investments, efficiency is low, resulting high risks. A large amount of funds is not likely to flow directly to individual small and medium-sized companies. Second, since the financial system is not equipped with a mechanism to understand the risk exposure of small and medium-sized companies, it does not adequately diversify and reduce risks further. Third, there is no principal financial entity in the financial system that aggregates individual loans to small and medium-sized companies or reduces risks pursuant to the diversification of risks and the law of large numbers (the larger the number of samples, the more accurate the probability). In addition, there is no mechanism by which financial entities of different types and sizes such as post offices, major banks, government-related financial institutions for small and medium-sized companies, the Bank of Japan, and regional and small and medium-sized financial institutions can play their appropriate roles. In particular, the absence of lending to small and medium-sized companies from postal savings is a problem.

It is true that the lending to small and medium-sized companies has a high risk on an individual basis, but when looking at the lending as a whole, it is more profitable than lending to large companies. This is because abundant funds are likely to flow to small and medium-sized companies if the financial system structure is adequate. Taking up all the small and medium-sized companies as one sector, the law of large numbers

would operate properly. In this situation, as lenders can perceive the profitability, one large condition for expanding lending to small and medium-sized companies would be fulfilled. When the law of large numbers applies to the lending to small and medium-sized companies, if the risk and return are distributed among public and private financial institutions according to the functions and preferences of various investors, then private financial assets will generate high return against risks and be distributed to the lending to small and medium-sized companies with enhanced market efficiency. This is certain to contribute to the recovery of the economy.

Now, please allow me to propose a new system for the purpose. The main part of the proposal is the mechanism of securitization of pooled loans extended to small and medium-sized companies. The securitization is characterized by standardized risk classification, risk reduction through aggregation, a pass-through feature of risk and return (setting return matching the risk), and flexibility of design such as credit enhancement. These characteristics can contribute to the new organized system design.

**Mechanism of securitization as a breakthrough**

The financial institutions located at the center of the design of securitization are government-related financial institutions such as The Shoko Chukin Bank, the Japan Finance Corporation for Small Business, the National Life Finance Corporation, or major financial institutions versatile with lending to small and medium-sized companies such as the Shinkin Central Bank and other central banks for a certain category of financial institutions (hereinafter collectively “major loan purchasing financial institutions”). The securitization-related businesses such as establishment of the framework for guarantee and credit enhancement in the securitization business must be implemented. The government-related financial institutions in the US took initiative for the businesses in the 1930s, whereas in Japan they have been set to be the main work of the Government Housing Loan Corporation. This business can be viewed as the insurance of loan extension, and high profitability has been ensured in the US.

Related government agencies such as the Small and Medium Enterprise Agency and Financial Services Agency will support necessary changes in laws and regulations. Major loan purchasing financial institutions will set forth the criteria for purchasing loans extended by regional and small and medium-sized financial institutions to small

and medium-sized companies based on data, including the past loan application examination criteria and bad loan rate. Of course they will implement such role in tandem with regional and small and medium-sized financial institutions. Nationwide standardization of loans is important and the form of private placement can be perceived. The important point here is that unlike conventional public guarantees for small and medium-sized companies, the purchasing criteria must be set forth in light of loans to sound small and medium-sized companies.

Then regional and small and medium-sized financial institutions sell the loan receivables at the price according to the risk criteria and interest rate matching the risk. Then, major loan purchasing financial institutions pool loans as standardized as possible in terms of period and amount from all over Japan and originate a large portfolio. In such a situation, the Bank of Japan creates credit by extending loans for the purchase by major loan purchasing financial institutions when necessary.

After the sales, regional and small and medium-sized financial institutions will monitor the borrowers and recover the loans as servicers (entity for managing securitized assets and collecting loan receivables), and receive fees according to the collection performance. Furthermore, regional and small and medium-sized financial institutions may enhance the incentives and profitability by holding a tranche of the securitized loan receivables. Extending consideration to the inter-region or inter-industry diversification, major loan purchasing financial institutions purchase loan receivables from regional and small and medium-sized financial institutions all over Japan, create portfolios with risk diversified as a whole, and categorize the portfolios into different securities according to the risk return demand level of investors, period, and investment parameter. For example, the major loan purchasing financial institutions develop highly rated securities with credit enhancement by senior or subordinated structure (one security is divided into a low risk, low return preference tranche and a high risk and high return subordinated or equity tranche) and guarantee for investors who are only permitted to buy investment grade securities like postal savings. In turn they will sell subordinated or equity tranche to long-term investors who prefer high risk and high return. After the sales of loans, such securitized loans can be a good investment product for regional and small and medium-sized financial institutions as they understand the nature of such securitized loans. Compared to holding the loans as is by regional and small and medium-sized financial institutions, the interest expenses are lower and smaller investment funds suffice. Funds for investing in the pooled and securitized middle risk

and middle return loan receivables may be formed.

The first effect of such facility is that return can be maintained while reducing risks as public financial institutions standardize and pool lending to small and medium-sized companies that have a higher risk on an individual basis. Further, through the securitization, such huge loan portfolios can be divided in various securities with different risks and return, and the liquidity can be enhanced. Then they can be provided to different types of investors. Eventually, a flow mechanism of a vast amount of funds to small and medium-sized companies can be established.

Second, the management cost and risks of regional and small and medium-sized financial institutions can be reduced and their management efficiency can be improved. They will not be affected by the withdrawal of deposits by investors fearing the removal of full deposit guarantee, and further, they will be able to use the proceeds from the sales of loans for other lending, thus bringing about credit creation on a micro basis.

Furthermore, if they place the securitization at the core of their businesses, they may save the management resources that have been allotted to the efforts for collecting deposits and turn the saved management resources to their lending businesses. This is certain to help strengthen their financial conditions. New advancement into the market can more easily be attained. If stiff competition takes place between newcomer financial institutions and regional and small and medium-sized financial institutions with enhanced management conditions, the supply of funds to small and medium-sized companies can largely be improved, thereby helping to revive the Japanese economy.

The third effect is a renewed effectiveness of financial policies. Fund supply to major loan purchasing financial institutions by the Bank of Japan will ultimately expand lending to small and medium-sized companies by expanding credit.

The fourth effect is the facilitated disposal of bad debts. As the impact of the disposal of bad debts on small and medium-sized companies lessens, the disposal of bad loans can be further facilitated by the major banks. But without the resolve to recognize the deficiency in shareholder's equity and a basic change in management policies, the bank issues in Japan will not come to an end.

Fifth, if the mechanism for this securitization is established, private financial

institutions may utilize the mechanism. This would achieve the plural lines in the financial system and risk diversification, thereby stabilizing the financial system.

Post offices can also benefit from these very much. They can invest in high rating securities developed from the securitization of pooled loans to small and medium-sized companies. This would ensure that the vast amount of private savings deposited at post offices would safely flow to the small and medium-sized company sector. Under such a chain of events, no reorganization of Japan Post would be required. The investment department of the Japan Post could be sufficiently operated with a small increase in the number of staff members. With these changes made, the postal businesses could be reformed to improve the economy in the cheapest possible manner.

### Application of US securitization approach

The principles and mechanism mentioned so far are derived by applying the securitization in the US. As described previously, the government-related agencies in the US do not extend loans, but purchase loan portfolios (pools) that meet the standards from regional and small and medium-sized financial institutions nationwide. As they purchase large portfolios, the risks reduce as a whole. Then they categorize the portfolios they have purchased into senior or subordinated securities, i.e., low risk/low return securities or high risk/high return securities. Low risk/low return securities represent high-investment-grade securities eligible for investments by investors all over the world, including Japanese investors.

Under such a mechanism, the US government-related financial agencies would not function as competitors with regional and small and medium-sized financial institutions in terms of lending. Rather, they would serve as aggressive fund providers. As the latter is relieved from the cost for deposit collecting and risk arising from holding loan receivables, they may concentrate their principal efforts on the lending and collection business. Given that the giant loan portfolios would be able to reduce their risks while maintaining high yields (because of the law of large numbers at work), they could generate higher yields for the same ratings after the securitization. This, in turn, would increase investor demands. Likewise, larger funds would go into circulation and be lent out at cheaper costs. The US adopted the securitization mechanism in the 1930s following the great financial crisis and succeeded in developing plural lines of the

financial system.

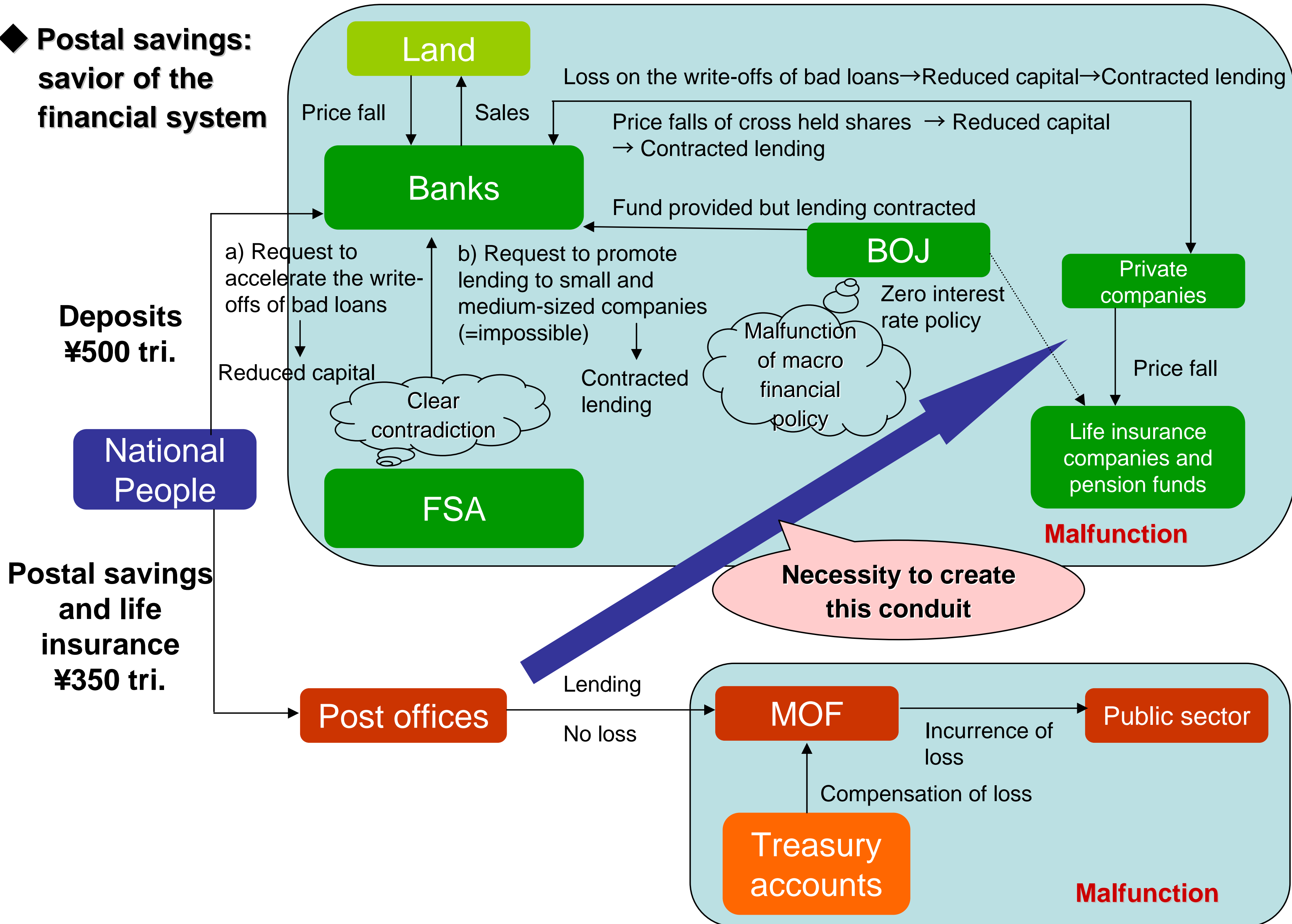
Japan is mostly urged to apply a securitization mechanism under which a vast amount of private deposits of the national people, including the postal savings, would to be lent out appropriately and in large amounts to small and medium-sized companies (companies that urgently need the loans in today's recessive economy). Fortunately the loan amounts to individual small and medium-sized companies are far smaller than those for major companies. With adequate lending criteria set, the law of large numbers starts to work and reduced risks and higher return can expected to be stably maintained.

The major loan purchasing financial institutions can function as institutions with high goals and capabilities akin to those of the US-government-related financial institutions. We wager that competent staff members have been working at many such institutions with rich management resources. Also, their bad loan problems are far smaller than those of the major banks. If we think of the securitization as a good business opportunity, we should support it as part of Japan's financial system from the national economic perspective.

### Challenges to success

The materialization of the effects brought about by the securitization is contingent on various factors. First relates to the fairness and transparency of information. The market will not develop without any accurate information on risks and restrictions. Both financial authorities and market participants will have to be involved in order to ensure the fairness and transparency. The second factor is the need to reform the individual entities involved in the securitization in order to satisfy the requirements of this new business, while the participants involved in the securitization, especially regional and small and medium-sized financial institutions and major loan purchasing financial institutions, agree on common standardization and risk pricing. This is easy to say, but difficult to implement. One effective method would be to create a catalyst to promote the new business model by backing up quality newcomer advancement into the securitization market. Second, the mobility and fostering of human resources should be promoted to bring up more individuals who could be involved in a new financial system and promote it. Lastly, legislators, financial administration and financial system

participants must clearly understand why the current financial system has not been functioning properly, and act on their understanding by cooperating in the development of plural lines of the financial system, including public financing, risk diversification, securitization and enhanced liquidity. This would be crucial to ensure the stability of the financial system and enhance the growth of the economy.


◆ Postal savings: savior of the financial system
Land
Price fall
Sales
Loss on the write-offs of bad loans→Reduced capital→Contracted lending
Price falls of cross held shares → Reduced capital
→ Contracted lending
Banks
Fund provided but lending contracted
BOJ
a) Request to accelerate the write-offs of bad loans
Reduced capital
b) Request to promote lending to small and medium-sized companies (=impossible)
Contracted lending
Zero interest rate policy
Malfunction of macro financial policy
Private companies
Price fall
Life insurance companies and pension funds
Malfunction
Deposits ¥500 tri.
National People
Clear contradiction
FSA
Necessity to create this conduit
Postal savings and life insurance ¥350 tri.
Post offices
Lending
No loss
MOF
Public sector
Incurrence of loss
Compensation of loss
Treasury accounts
Malfunction

◆ **Mechanism for securitization**