Risk Management & Bank Governance

Shuichi Uemura
Bank of Japan
Content

1. Collapse of real estate bubble and non-performing loans problems of Japanese banks in the 1990s

2. The current financial crisis

3. Risk management & governance of Japanese banks assessed from on/off-site monitoring of the Bank of Japan

4. Way forward
1. Collapse of real estate bubble and non-performing loans problems of Japanese banks in the 1990s

(1) Collapse of real estate bubble in the 1990s

Through 1990s---
Tokyo Stock price index 40% decline
Commercial land prices 43% decline

(2) NPLs of Japanese banks

The NPL ratio in the peak time 9.0%
Credit cost from 1992 to 2005 97 trillion yen
Capital injection from 1998 to 2003 12 trillion yen
Factors deteriorated the crisis in the Japan’s case

- Increased bank lending into real estate related sectors
- Long lasting monetary easing
- Financial deregulations
- Lack of mark-to-market practice on land price valuation
- Delay in introducing crisis management framework & formal capital injection procedures
- **Weak discipline of bank business**
Changes in the early 2000s

- Establishment of FSA independent from the MOF
- Safety net & pay-off regime clarifying the principles of self-responsibility
- Higher importance attached on risk management in on-site examinations and off-site monitoring
- Disclosures requirement of important financial figures including NPL ratios
2. Impacts of the current crisis on Japanese banks

Severe impacts in 2008 FY

- Limited losses from sub-prime loan related assets
- But, 8 of 12 major banks and 55 of 108 regional banks reported deficit

This was due to…..
1) high credit costs owing to deteriorated business conditions
2) losses from securities investments due to the market turmoil
Quick recovery in 2009 FY

- Various *policy measures*, pick up in *macroeconomic conditions*, & *recovery* of financial markets

- Current bubble did not originate in Japan

- Well *diversified* loan portfolio (especially for major banks)

- Peer monitoring among market participants contributed to sound risk management
3. Risk management & governance of Japanese banks assessed from on/off-site monitoring of the Bank of Japan

Bank of Japan is not the official regulator, but it conducts...

Both off-site monitoring and on-site examination

... according to the contracts with banks based on the Bank of Japan Law (article 44)
Challenges for Major banks

Risk of “too big to manage”

- Building a global–wide risk management framework
- IT system infrastructure
Challenges for Regional banks

- Economic capital based risk management practice
- Corporate governance
- Human capital in risk management
Common Challenges for both major banks & regional banks

- How to motivate bank executives to appropriately conduct risk management
- Not over-rely on single econometric tool such as the VaR

“Comprehensive approach”
- Based on various information complement to each other

“Dynamic approach”
- Level of risk management is flexibly adjusted according to market circumstances

Corporate governance plays a key role in implementing comprehensive and dynamic risk management

- The current crisis provided a “wake-up call” for bank executives to revisit the importance of liquidity risk management
4. Way forward
--- suggestions for supervisory authorities ---

Supervisory authorities should......

- Stress the importance of risk management
- **Strengthen** further on-site examination and off-site monitoring
- Enshrine disclosure and market discipline
Supervisory authorities should stress the importance of risk management

- Should actively promote financial literacy for risk management
  - BOJ established the Center for Advanced Financial Technology (July 2005)

- Should encourage market innovation in risk management techniques and tools
  - e.g. Behavioral finance and econophysics
Supervisory authorities should strengthen further on-site examination and off-site monitoring

- Linkage with "macro-prudential" policy
- Communications with bank executives
- On-site examinations with "forward-looking" perspectives
- Encourage bank executives to apply effective PDCA cycle
Supervisory authorities should enshrine disclosure & market discipline

- Regulations and supervision are not sufficient to impose effective discipline to bank management
- Stakeholders should be able to understand banks’ risk appetite and risk management through disclosure
Thank you for your kind attention