

## *Global Crisis Testing Financial Strength of Banks and Life Insurance Firms*

*Fukao Mitsuhiro*

*President, Japan Center for Economic Research*

- Conditions may warrant further support, with focus on risk management
- Review role of government financial institutions
- Credit may dry up as banks face tighter capital adequacy standards

The sub-prime loan debacle which emerged in the United States in 2007 developed into a global financial crisis following the collapse of Lehman Brothers in September of 2008. One after another, large European and American financial institutions found themselves in difficulties, with financial institutions rapidly losing confidence in the viability of counterparties. As a result, financial markets around the world ceased functioning, with credit worldwide drying up.

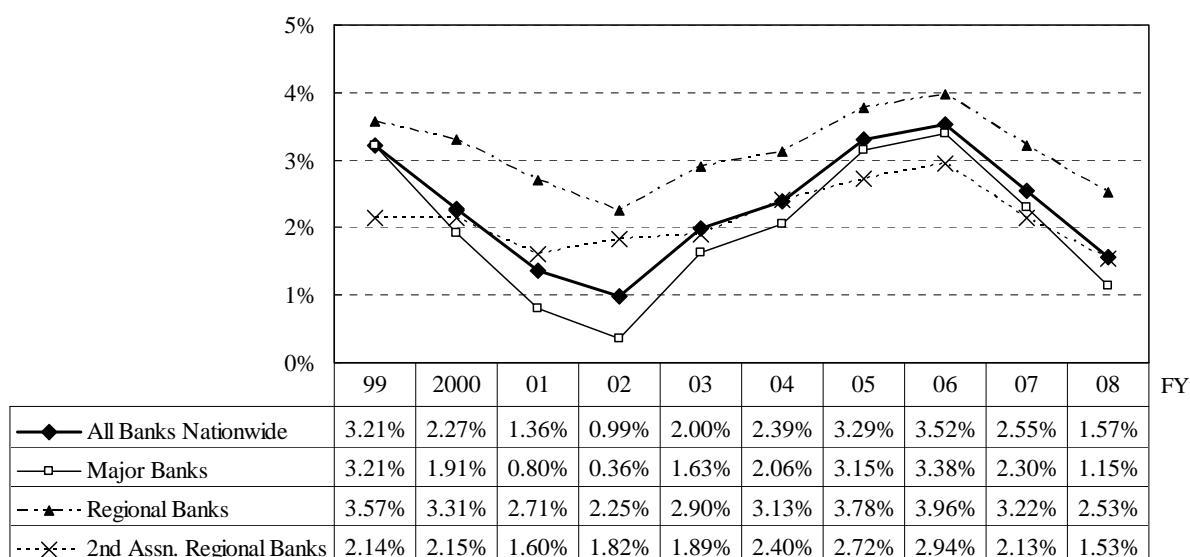
Although calm has gradually been restored to financial markets around the world, the strength of the recovery in the real economy has been weak, meaning that vigilance regarding macroeconomic trends remains necessary. In Japan, financial institutions such as banks and life insurance companies risk seeing the fact that their financial positions deteriorate further. Our present report will therefore focus on these issues.

A look at financial results in the banking sector for the year ended March, 2009 shows an incipient deterioration in both earnings and the capital base of banks. Owing to the decline in the stock market, the value of shares held by banks has fallen sharply, and banks have written off huge losses as a result. Due also to the global economic slowdown and the strong yen, Japanese exports, which had been fuelling the economy in the last few years, have fallen sharply, undermining the performance of business firms. Banks are also facing mounting losses on bad loans. Although the mountain of impaired loan assets accumulated by banks in the second half of the 1990s had been declining in recent years and remained low over the past few, it began to expand again at the start of the present 2009 fiscal year (April 2009 - March 2010). If the poor business conditions resulting from the financial crisis drag on, bad loans could once again pressure banks' finances.

The accompanying table shows the financial health of the banking sector based on real capital adequacy ratios by type of institution. Ratios for all banks nationwide have been improving since bottoming out at the end of FY2002. However, due mainly to the sharp decline in stock prices since the spring of 2007, they began worsening again in FY2007. They deteriorated even further in FY2008 and are now approaching a level not seen since FY2001, during the financial crisis. A look at the banking sector overall shows that bad debt write-offs in FY2007 and FY2008 could be accommodated within the scope of earnings, but some banks which have experienced rising bad debts are in such a position that they need to be monitored. There are also some banks whose real capital adequacy ratios have turned negative.

With a view to preventing a recurrence of the financial crisis, authorities have been prone to tighten regulations. In order to strengthen the capital adequacy of banks both qualitatively and quantitatively as economic conditions recovered, the Basel Committee on Banking Supervision raised the banks' capital adequacy ratios required subject to international standards to higher than 8 percent. The Committee is also considering the adoption of narrowly defined core capital criteria, with regulations expected to be adopted in 2012. This could be expected to have a major impact, perhaps making it necessary for some Japanese financial institutions to boost their capital by issuing common stocks. It is possible that stricter capital adequacy criteria could lead to a tightening of credit, so any move to do so should be carried out carefully.

**Bank Real Capital Adequacy Ratios by Sector**



Note: Real capital adequacy ratio = [(unconsolidated (core capital) + (unrealized gain/loss on equity holdings and derivatives) - (deferred income taxes) - (reserve shortfall)] / total assets

Deteriorating economic conditions are having an impact on government-related financial institutions. Japan Finance Corporation has been increasing its safety-net loans made at below-market interest rates and its insurance underwriting for credit guarantees. Meanwhile, the Development Bank of Japan has stepped up loans related to crisis management activities and its buying of commercial paper. These trends show that, as private-sector banks become more cautious in their lending posture, government-linked financial institutions are assuming a proportionally greater role. DBJ was privatized in October of last year, with plans for the government to sell off all its shareholdings within five to seven years. But with its operations as a government-related financial institution expanding, full privatization seems even farther away.

Life insurance companies hold large amounts of equities in the context of their asset management operations, and the decline in equity prices since the 1990s has caused their unrealized losses to balloon, adversely affecting their financial positions. Although just one small life insurance firm called Yamato Life has recently collapsed, the others have been drawing on accumulated retained earnings in a bid to survive the present crisis. Although stability has returned to financial markets more than a year after the Lehman shock, life insurers have learned a lesson from the debacle and are once again mindful of the need to review their risk management system.

Two indicators used to assess the financial health of a life insurance company are the real excess liability standards and the solvency margin ratio. We have pointed to problems with the publicly available data on these ratios and computed our own values adjusted as necessary. Our adjusted solvency margins for fiscal 2008 (April 2008 - March 2009) are presented in the accompanying table. Life insurance companies with their solvency margins of 250% do not face regulatory intervention under U.S. risk based capital (RBC) criteria and are deemed to have adequate leeway to meet their obligations. The margin of one company falls short of this level in the case of Adjusted Solvency Margins Criteria (2), and with five falling short of the margin in the case of Adjusted Solvency Margins Criteria (3). It is clear that the recent financial crisis has significantly hurt the financial position of each company.

#### Adjusted Solvency Margins of Nine Major Life Insurers (FY2008, %)

|              | Nippon | Dai-Ichi | Meiji<br>Yasuda | Sumitomo | Mitsui | Taiyo | Daido | Asahi | Fukoku  |
|--------------|--------|----------|-----------------|----------|--------|-------|-------|-------|---------|
| Public Data  | 904.4  | 768.1    | 1,098.7         | 837.2    | 602.0  | 866.4 | 823.4 | 583.1 | 1,008.4 |
| Adjusted (1) | 470.7  | 405.8    | 527.6           | 494.6    | 414.7  | 436.5 | 521.9 | 287.0 | 494.0   |
| Adjusted (2) | 378.2  | 297.6    | 418.5           | 355.6    | 357.5  | 289.2 | 323.6 | 203.0 | 374.4   |
| Adjusted (3) | 378.2  | 243.5    | 397.1           | 236.0    | 197.0  | 244.4 | 323.6 | 112.7 | 333.5   |

Note: Definitions: (1) Data revised to reflect a higher risk weighting we deem necessary for equities, foreign currency-denominated assets and real estate; (2) Same as definition (1) and subtracting deferred income taxes, etc., from equity capital; (3) Same as definition (2) and deducting subordinated debt.

These institutions are able to meet their obligations thanks to reserves for subordinated obligations supplementing equity capital and policy reserves to ensure safety. Thus although we don't believe they are about to become insolvent, their difficult financial status should be evident from these figures.

In this way, banks and life insurers have undeniably weakened, and the enervation of the financial sector has cast a shadow over the real economy. If stock prices should turn down again and economic conditions otherwise deteriorate further, there may be talk about another crisis in the finances of weakened banks. If that happens, debate would turn to the pros and cons of government support to avoid systemic risk.

The financial crisis which began with the Lehman shock of September 2008 brought into relief a number of problems inherent in the global financial system. These include the instability of the U.S. dollar, the top-heavy debt-equity ratio of investment banks and some other major financial institutions, the questionable reliability of rating agencies, and the fragility of the Euro-zone. The financial crisis has brought a global recession, affecting the real economy and causing massive unemployment in a number of countries.

Around the world, governments and central banks acted decisively, greatly expanding fiscal spending and slashing interest rates while flooding markets with liquidity. And government-linked financial institutions guaranteed debts while expanding lending to the private sector. As a result, financial markets gradually began to settle down. Even so, stock prices of financial institutions around the world remain far lower than they were before the crisis, showing that investors still believe deterioration in the real economy could further undermine their performance.

In the financial crisis affecting Japan from 1997, the mounting losses of financial institutions hurt the real economy, and that in turn hurt the performance of those institutions in a vicious cycle. The government sought to resolve the problem by providing liquidity to institutions, but they were unable to regain stability until the real economy began to recover around 2003.

Discussions have begun in countries around the world regarding a new financial system with limits on compensation in the financial industry and tighter equity capital requirements for banks. At the Pittsburg G-20 summit meeting held in September of 2009, member representatives adopted a statement calling for the design and implementation by the end of 2012 of international rules aimed at improving the size and quality of bank capital as well as immediate implementation of tighter rules governing the compensation of directors and employees of financial institutions. They also moved toward tightening regulations on rating agencies which, among other things, would result in

further disclosure of rating methods.

Even as they consider measures to prevent a recurrence of the financial crisis, central banks around the world have begun searching for the right time to unwind the unorthodox measures taken thus far, but with present conditions giving no indication of a clear recovery in the real economy, they have little choice but to proceed at a slow pace toward policy normalization.

By providing credit in the context of a larger economic package, Japan's government-related financial institutions have played an important role in shoring up the economy. Their roles have greatly increased in the context of the emergency measures taken to address the global financial crisis, but governments will need at the same time to continue reviewing policy with a view to shifting much of that role back to private sector financial institutions.

(The original Japanese article appeared in the October 28, 2009 issue of the Nihon Keizai Shimbun.)

Copyright © 2009 JCER

---

**Japan Center for Economic Research (JCER)**  
Nikkei Bldg. 11F 1-3-7 Otemachi, Chiyoda-ku, Tokyo 100-8066, Japan  
Phone:81-3-6256-7756 / FAX:81-3-6256-7927