

The concern about the “Japanization” of Europe and America and the rise of interest rate risk

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The Bank of Japan (BOJ) had not raised interest rates at strategic recovery points of the economy in the 1990s and 2010s and subsequently faced economic slowdown with few policy options. This has been viewed as an example of a central bank’s policy miscalculation and the term “Japanization” was coined. There are fears that Western central banks might follow the BOJ’s path with a low growth and low inflation environment, in tandem with very loose monetary policy. An accommodating monetary policy is not the only tool for driving recovery. However, it has been over-rated and other policy options such as co-ordinated fiscal policy have been largely overlooked. The so-called unconventional monetary policy would only delay the inevitable and sometimes entail unintended and or adverse effects.

Financial institutions are worried about losses related to securities trading as an adverse effect of QE

The prolonged low interest rate environment has led to decreased bank loan profitability and a challenging environment in asset management in Japan. This situation has forced financial institutions to rebalance their securities portfolio. Given that the BOJ purchased the lion’s share of the new issue Japanese Government Bonds (JGBs) from the market, financial institutions have explored new investment portfolio strategies, including increased investment in the super-long JGB. In particular, they have inclined towards foreign bond investment with higher interest yields and bond investments with longer maturities than previously held.

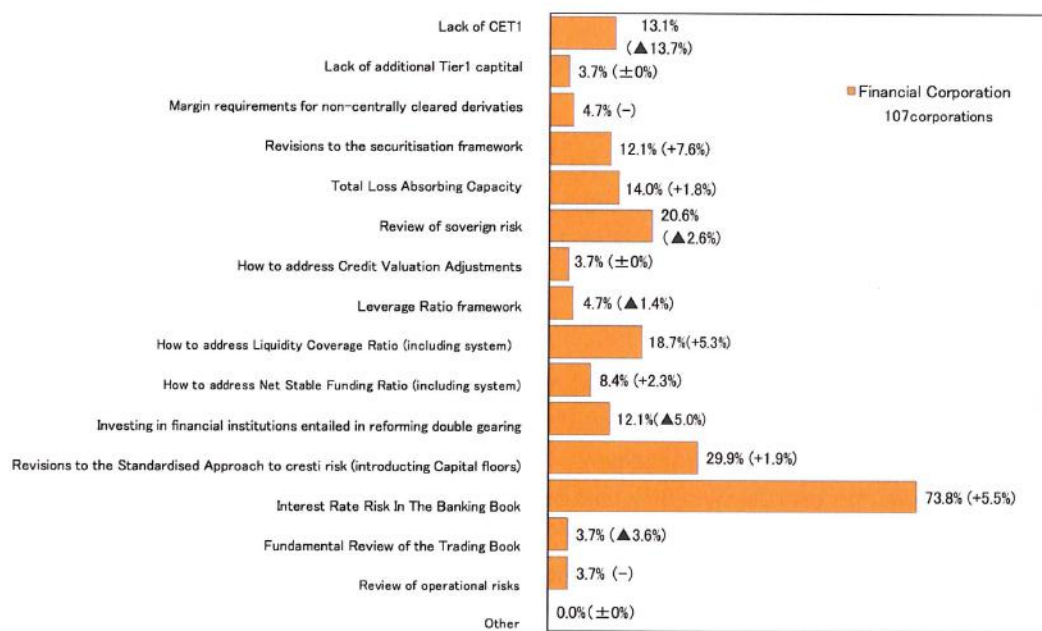
However, the Lehman shock had triggered a tightening of regulations on market-led rate setting and leverage which was designed to achieve more stringent balance-sheet regulations. This has left many Japanese banks with challenges for future business management. In addition, some regional banks have recently been endeavouring to avoid interest risks by selling long-term JGBs and refraining from re-investment in them. They appear to be worried about sudden shocks to the market environment, for instance: a rate rise coupled with monetary tightening as a BOJ exit strategy from the current quantitative easing (QE) programme.

Daiwa Institute of Research Ltd. has been conducting research on alternative investment trends in Japan since 2005. This research assesses the impact of the implementation of the Basel III regulations, inter alia. Regarding Basel III, the respondents are asked to identify the most concerning aspects of the full implementation of Basel III. In FY2018 the most common response was Interest Rate Risk in the Banking Book (IRRBB), accounting for 73.8% of the respondents and 5.5ppt up from the previous year. The main concern in this regard is how the rise in importance or increased significance of interest rate risk affects the balance sheet of respondents. The question was introduced in FY2014 and the proportion citing IRRBB as the most concerning aspect compared to other issues has increased markedly. In FY2014, it was 7.7% then 27.5% in FY2015, 31.4% in FY2016 and jumping to 68.3% in FY2017.

It can be assumed that this last sharp rise was triggered by the Japanese regulatory authority’s publication of a proposed revision of interest rate risk monitoring methods in 2017. This publication was designed to reflect

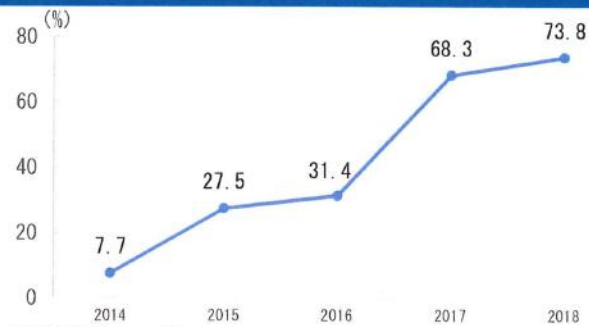
the BCBS final report and the recent interest rate environment. The regulatory authority indicated that domestic commercial banks such as regional banks and Shinkin banks would also be subject to monitoring from March 2019 and this move has undoubtedly contributed to that significant increase as well. When asked to identify which investment product they are concerned about following the introduction of IRRBB, the most common answer is “JGB”, accounting for 58.7% of all respondents. Many financial institutions (44.2%) also cited “mutual funds” where inherent and idiosyncratic risk is difficult to model. Pillar 2 of Basel 2 had required all banks not to exceed interest rate risk above 20% of total capital. If they exceed this requirement Japan’s FCA rates them as “outlier banks” since Basel 2, was implemented in 2007. However, in 2019 the number of financial institutions identified as outlier banks with interest rate risk ratios of more than 40% increased by 5.7%, signaling that other sources of profitable investment opportunities are drying up and this may have forced the outlier banks to turn to long-term fixed interest rate risks.

Graph What is your concern about Basel III?



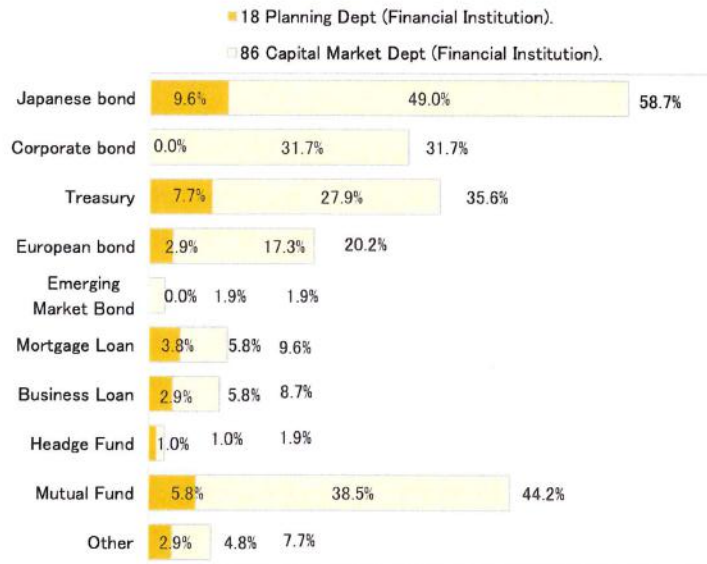
Source: DIR alternative survey (2019) Yasuo Sugeno

Graph The trend on the concern over IRRBB (2014-2018)



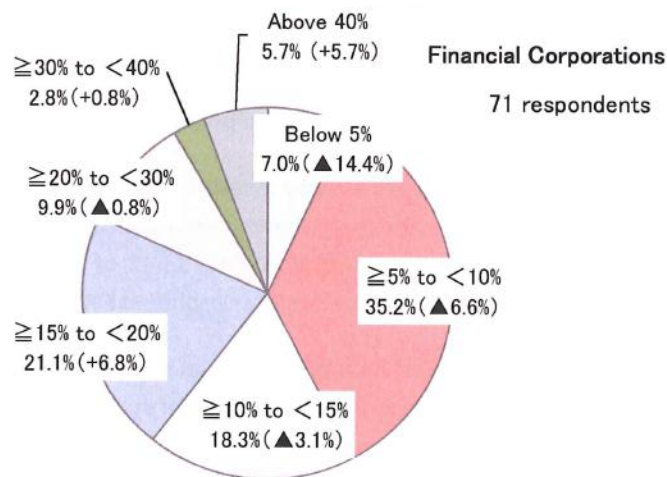
Source: DIR alternative survey (2019) Yasuo Sugeno (FY)

Graph Which investment products are you concerned about following the introduction of IRRBB?



Source: DIR alternative survey (2019) Yasuo Sugeno

Graph Outlier ratio (FY2018)



Source: DIR alternative survey (2019) Yasuo Sugeno

There still is concern about the interest-rate risks on loans

Additionally, when asked to identify which asset class they were worried about following the implementation of IRRBB, some regional banks cited “long-term fixed-rate mortgages” and “loans to local public authorities”.

Currently, the drivers for the expansion of loans at Japanese banks are mortgages with low profit margins, and loans to local public authorities. Despite the low profit margins, mortgages remain a steady source of revenue for Japanese banks as they are collateral-backed and the risk of their becoming bad debts is low. Securing mortgage contracts, however low the interest rate, would mean securing a main bank account which, in turn, provides opportunities to generate income continuously by cross-selling etc. Having said that, due to negative interest rates, the number of long-term fixed-rate mortgages has been increasing leading to greater interest-rate risk within balance sheets than previously. The substantial monetary easing being implemented by the BOJ could cause more competition between banks for securing mortgage contracts. The prolonged ultra-low interest-rate policy environment has triggered interest-rate competition between banks for ultra-low fixed interest rate business and deviation from lending-rate standards has persisted. However low the lending rate is, the potential for continuous income generation by cross-selling etc has led to increased interest-rate risk since loans are approved, regardless of their profitability.

Against the background of strong demand for loan expansions from SMEs and long-term fixed mortgages (10 years or longer) with low interest-rate margins, the number of loans approved by the Credit Guarantee Association has been increasing. This has created the situation where specific risks such as interest-rate risk and liquidity risk are amplified. Lending rates in Japan are low by international standards and this makes it increasingly difficult for Japanese financial institutions to respond to the strengthening of risk management while securing their profitability. Furthermore, Japan lags behind other nations in the marketization of credit risk and removing risk assets from balance sheets is not so easy. Therefore, for Japanese financial institutions to manage risk, achieving higher profitability and meeting capital adequacy ratios by improving the investment efficiency of the asset with interest-rate risks and liquidity risks would be a basic coping mechanism. Whether they could maintain the required standards for “current profit or loss” and “capital adequacy ratio”, which are critical for financial institutions, would be their challenge of management.

Return to alternative investments caused by the prolonged policy of ultra-low interest rates

Concurrently, Japanese financial institutions are actively investing in alternative products such as REITs and structured loans in order to compensate for the sluggish net core business profit. According to the above-mentioned survey by Daiwa Institute of Research Ltd., in FY2018, 93.4% of the respondents were investing in REITs whose dividends were converted into net core business profit. In FY2009, it was around 60%.

Given the nature of the long-term liability of Japanese financial institutions, prior to the 2008-2012 financial crisis triggered by the Lehman shock, Japanese financial institutions risk-modelling made little or no allowance for liquidity stress testing on their securities investments. Indeed, a sudden nose-dive in market liquidity of a retained asset had not been considered as a factor. While asset illiquidity brings a source of revenue and some measure of illiquidity can be tolerated when investing in private equity and real estate, the systemic collapse of liquidity in asset classes had not been modelled. However, if there had been a more comprehensive understanding of the specifics of the individual products, measures would have been taken to offset and provide against any illiquidity crisis. In particular, the lack of understanding of the loan claims which backed Collateralized Debt Obligation (CDO) and Collateralized Loan Obligation (CLO) led to the unexpected plunge of many of those products due to the sudden collapse of liquidity at the point of sale. Consequently, Japanese financial institutions have been investing less and less in CDOs/CLOs during

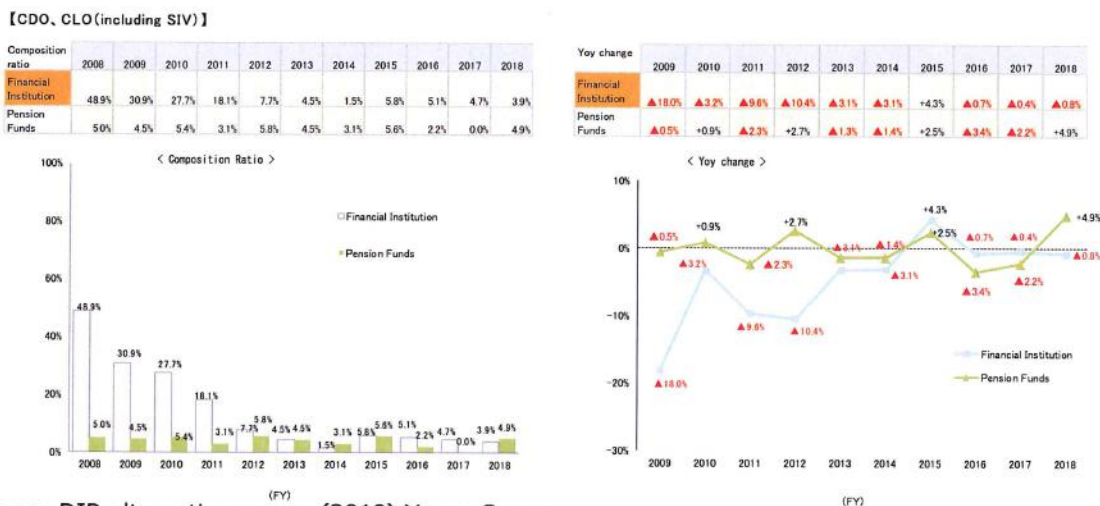
the last decade. According to the survey by Daiwa Institute of Research Ltd., the percentage of respondents who are investing in CDOs/CLOs fell from 30.9% in FY2008 to 3.9% in FY2018. This tendency is particularly notable in regional financial institutions and it contrasts with the mega-banks and major life and non-life insurance companies. These last institutions have re-started investing actively in securitized products and in FY2018 they expanded such investments. In addition, some Japanese pension funds are also investing in these products and in FY2018 4.9% of the respondents confirmed that they are investing in the CDO/CLO class. Prolonged ultra-low interest rates have driven Japanese banks to cover their net core business profit with such securities investment. The strengthening of regulations on interest rate risk has discouraged them from investing in JGBs and it appears that they have had to rely on alternative investments such as property investment.

Graph 2008-2018 REIT investments



Source: DIR alternative survey (2019) Yasuo Sugeno

Graph 2008-2018 CDO • CLO investments



Source: DIR alternative survey (2019) Yasuo Sugeno