Banks during the pandemic: A Japanese perspective

Mimoza Shabani[1]

Abstract

In recent years, Japanese banks have revived their leading international role in the provision of global liquidity. Since the start of the pandemic of Covid-19, Japanese banks have increased their overseas lending at a much higher pace. This paper looks at the activities of Japanese banks, and the drivers behind such a surge by considering factors that characterize the domestic economy. It is argued that uncertainties associated with Covid-19, and government response by means of introducing numerous unconventional measures to counter adverse effects of the pandemic, have increased cash hoarding in the economy. Japanese banks have seen a surge in the deposits held, as well as a decline in loans. Data from the Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks, reveals that the demand for loans from all size firms and households has declined since mid-2020. Faced with ongoing razor-thin margins and prolonged low interest rates at home, Japanese banks have continued their overseas activities in a search for yield; and they have increased their exposure to offshore financial centres which could have potential domestic financial stability implications.

JEL Classification: E02; E41; E51; F34
Keywords: offshore cross-border claims; Japanese banks; Covid-19 pandemic

[1] Royal Docks School of Business and Law, University of East London, m.shabani@uel.ac.uk.

Introduction

The Covid-19 pandemic has not only been a global health crisis but has also had an unprecedented impact on the global economy. The economic shut down due to government restrictions being put in place in response to the pandemic has led to circumstances our economic society has never witnessed before. With businesses being shut down and workers rendered unemployed, governments had to intervene by introducing unconventional measures to circumvent the economic disruptions caused by the pandemic. The initial economic response of the Japanese government was the allocation of ¥117 trillion to support businesses, healthcare systems, and simulate consumption amongst others. It further provided employment-related support, as well as a special loan programme to support all firm sizes.

These measures were mostly deployed through the banking sector, where banks played a vital role in assisting the government in providing necessary credit to the economy. Though the banking sector has been stable and well-functioning throughout the Covid-19 crisis, there is a great concern in relation to the risk defaults given the economic crisis caused by the pandemic, the magnitude of which still remains uncertain. Such uncertainty associated with the economic outlook raises concerns about the future financial health of banks. The concern raised by policymakers is the risk that the credit provided during the pandemic could backfire on them, in the event of increased non-performing loans. This coupled with the already low profitability environment prior to the Covid crisis, and the market volatility given the uncertainty caused by the pandemic could place Japanese banks in a more vulnerable position.

This paper examines the activities that Japanese banks undertook during the pandemic. We find that the domestic market response to the Covid-19 shock has led to an increase in cash surplus held by the Japanese banking sector. The reluctance of both the household and corporate sector to invest, resulting in a high amount of cash hoarding, is also reflected in the demand for loans which remains at low levels. This market response has placed Japanese banks to continue to increase their cross-border activities in a search for yield. The findings suggest that cross-border lending increased more so during the pandemic with offshore financial centres dominating the overall positions. These results imply that the domestic government stimulus packages, including continuing quantitative easing, introduced at the onset and during the pandemic seem have not been very effective in stimulating the economy. Not only have household consumption and business investment not picked up, but in contrast, markets have been loaded with more cash leading to an outflow of funds to overseas and offshore financial markets and taking on more risk in a search for yield.

This paper is organised as follows. The next section gives an overview of the Japanese economy focusing on the Covid-19 period and the response of markets. The second section of the paper gives an overview of the activities of Japanese banks, and their exposure to offshore financial centres. The final section concludes.

Overview of the economy

The Japanese real GDP growth rate shrank around 4.5% in 2020, and it remains at lower levels than the pre-Covid period. The main contributor to the negative growth rate was a substantial decline in private consumption (Masazumi 2021). Even though the Japanese government provided ¥100,000 to every resident in the country to mitigate the impact of the pandemic, the consumption remained low and coincided with a higher level of cash hoarding. The household sector increased its holding of the cash and deposits from nearly ¥979 trillion in the first quarter of 2019 to nearly ¥1,072 trillion in the second quarter of 2021, a nearly 9.5% increase. Some 55% of the total household financial asset is held in cash and deposits, as of mid-2020. During the same time period, the demand for bank loans declined significantly as shown in Figure 1. However, the overall demand has reverted to the pre-pandemic period, although it is the demand for housing loans that drive such demand rather than consumer loans.

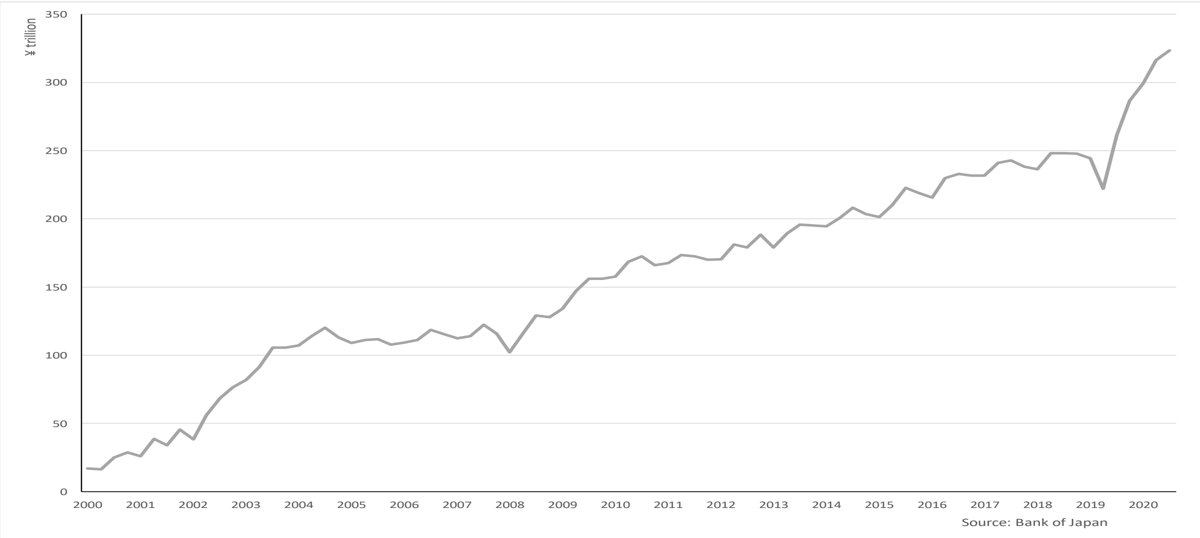
Figure 1: The demand for loans from households and firms, in percentage point

Source: Bank of Japan, Senior Loan officer opinion survey on bank lending practices at large Japanese banks

The non-financial corporate sector has also increased its cash holding during the pandemic, amounting to ¥329 trillion as of the second quarter of 2021. The share of cash holding to total non-financial corporations' financial assets accounts for around 25% in the post-pandemic period. The increase in cash hoarding by Japanese businesses reflects the uncertainty of the economic outlook whereby they respond by halting investment. While Japanese firms have increased their cash holding, the demand for loans during the pandemic has also increased, as shown in Figure 1. The surge in demand for bank loans highlights the impact of the lockdown measures during the pandemic on businesses. The consequences of which resulted in all size firms relying on some form of borrowing to survive the crisis. Data for the Senior Loan officer opinion survey on bank lending shows that whilst all size firm increased their demand for loans, it was the small firms that had much more need for bank credit, increasing their demand by 54 percentage points in the third quarter of 2020. The concern in such a fall in demand for bank credit is that the Japanese firms remain reluctant to invest, and hence the demand for bank loans remains low, the latest data for 2021 shows.

The developments in both the household and corporate sector during the Covid-19 pandemic has resulted in Japanese banks holding a significant amount of cash surplus. Figure 3.2 shows Japanese banks' surplus, which represents the difference between cash and deposit, and total loans made by domestic licensed banks, which has sharply increased since mid-2019. Over the last few years, Japanese banks have struggled with achieving high returns from their domestic activities. A negative interest rate environment which has characterised the Japanese market since 2016 resulting in a flattening of the yield curve[2], coupled with effects of the pandemic, has further deteriorated the profitability of banks.

Figure 2: Cash surplus of the Japanese banking sector



Notes: The cash surplus represents the difference between total loans, and cash and deposits held by Japanese domestic licensed banks

Offshore banking activity

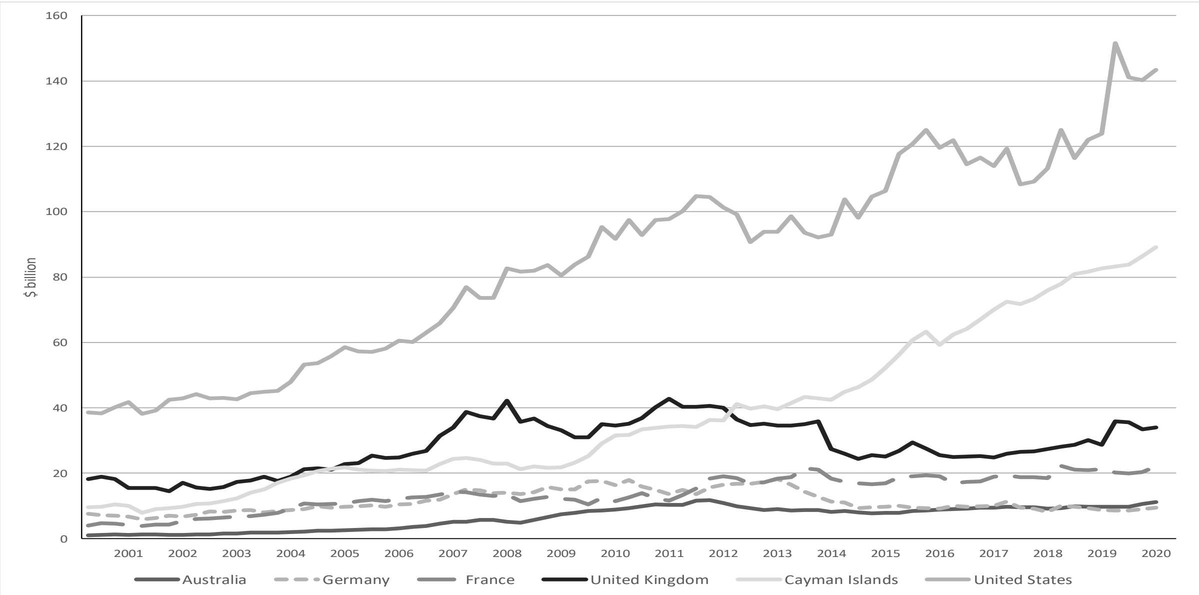
During the last few years, Japanese banks have actively engaged in overseas markets and have played a key role in the provision of global liquidity. However, whilst the trend of overseas lending by Japanese banks has been increasing since mid-2009, the increase during the pandemic has been more so by nearly 9%. Indeed, Japanese banks cross-border lending increased from $4.63 trillion at the end of 2019 to more than $5 trillion at the end of 2020.

Figure 3 shows the cross-border lending of Japanese banks to selected countries. As can be observed, Japanese banks are highly exposed to the US banking sector, with cross-border claims reaching $1.43 trillion as of the end of 2020. Cayman Island, an offshore financial centre, is the second most exposed country, with cross-border claims steadily

[2] In an attempt to achieve the 2% inflation rate target in 2016 the Bank of Japan introduced the "quantitative and qualitative monetary easing (QQE) with negative interest rate. The increase in money supply through purchasing long-term Japanese movement bonds policy resulted in the flattening of the yields curve. In response to this, Japanese banks reduced their holding of government bonds (Yoshino et al 2017).

increasing from just over $200 billion in 2009 to nearly $900 billion by 2020. Overall, the cross-border lending trend reflects the Covid-19 pandemic crisis which was spread globally by mid-2019, and hence lending slightly fell during that period. However, such reduction was not homogenous across countries. That is, whilst overseas lending to other countries such as US and UK slightly declined in 2019, lending to the Cayman Islands seems to have not been affected by Covid-19. Figure 3 shows that lending to the offshore centre continued to increase, representing an increase of nearly 8% from 2019 to 2020.

Figure 3 Japanese banks' outstanding cross-border claims to selected countries



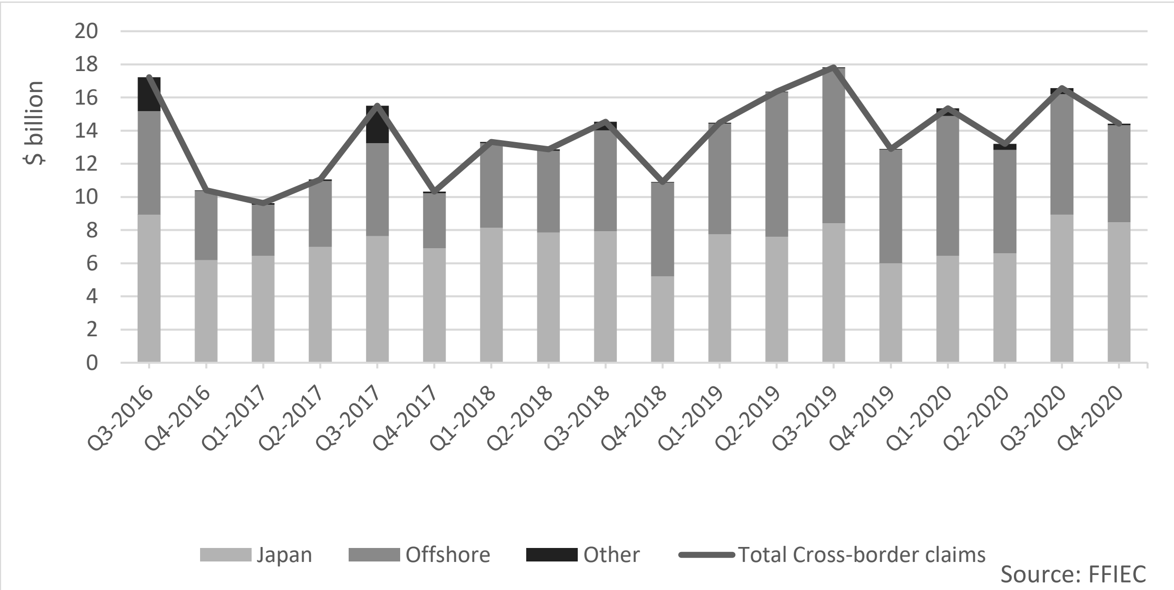
Source: BIS Locational Banking Statistics

Cross-border activities take place both via the headquarter of banks, in this case Japan, and by means of banks operating in host countries via their associated established subsidiaries and/or foreign branches. Japanese banks are not only exposed to the US by just cross-border lending via the headquarter but also, they are present in the country by means of operating via their subsidiaries and/or foreign branches. The Federal Financial Institutions Examination Council (FFIEC) publishes data on all banks operating in the US market and their cross-border claims. Figure 4 shows the total cross-border claims of Japanese banks located in the US. As can be seen, the claims to offshore financial centres, including the Cayman Islands as well as to their homeland Japanese banks dominate the share of the total cross border lending of Japanese banks located in the US.

Aldasoro et al (2019) document that Japanese banks increased their asset dollar holdings by 88% in the decade post-2007 crisis. Therefore, the cross-border position between

Japanese banks could indicate the existence of a channel of US dollar transmission between the affiliates located in the host country (US) and home country (Japan). Because data on the counterparty details are not available, the cross-border claims could also reflect the activities of the internal capital market vis-à-vis their parent banks headquartered in Japan as well as the activities in the interbank market vis-à-vis other banks located in Japan.

Figure 4 Cross-border claims of Japanese banks located in US



Notes: Total cross-border claims represent cross border claims outstanding of Japanese banks located in the US. Japanese banks consist of Mizuho, Sumitomo and MUFG banks. Cross border claims to Offshore represents claims to those centres that IMF classifies as offshore financial centres. Mizuho's cross border claims to offshore consist mainly of claims to the Cayman Islands and UK. MUFG mainly lends to the Cayman Islands whilst Sumitomo bank to the UK.

Japanese banks have also increased their holding of overseas securities, and more so their holdings of risky financial securities, such as collateralized loans obligation (CLOs), which are securitized financial products backed by leveraged loans (Review Bank of Japan 2020). The observed exposure of Japanese banks to the Cayman Islands may reflect the holding of securities such as CLOs (Aldasoro et al 2020) which are mainly issued by special purpose vehicles (SPV). This suggestion is driven by the fact that Japanese banks have large cross-border claims against non-bank financial institutions located in offshore financial centres.

This hints at the activities Japanese banks undertake via the affiliates located in offshore financial centres. The activities of global banks in offshore financial centres are driven mainly by the tax haven status that accompanies them. However, Coppola et al (2020) also reveal the intermediary role offshore centres play in international capital markets, whereby the parent of global banks (firms) invest and/or raise finance (borrow or lend) via the established shell companies in offshore banking centres. Therefore, the cross-border claims of Japanese banks to offshore financial centres, mainly the Cayman Islands, could hinder the true position of banks, which can have implications for financial stability.

Such implications may stem from obscuring both country risk, as well as investment security risk. Meaning when offshore financial centres serve as a bridge for Japanese banks to channel funds to other counties by means of purchasing or lending, the direct risk assessment could be undermined. In other words, whilst official statistics record cross-border claims to the Cayman Islands, for example, a risk exposure analysis will consider only such direct exposure i.e., Cayman Island country-related factors. However, in a situation in which a Japanese bank would lend to its established affiliate located in the Cayman Islands with the purpose to purchase or lend to other institutions located in another location, the true risk is not captured by the observed cross-border banking claims. Furthermore, the investments - the purchase of various financial products for example - conducted via the foreign subsidiaries located in offshore financial centres also hinder the level of risk banks undertake[3].

Conclusion

The Covid-19 pandemic has wreaked havoc across the globe, impacting not only the healthcare systems but also the global economy. The Japanese economy has been no exception, leading to the government taking on further unconventional measures to support the economy. The quantitative easing already in place, and the various stimulus packages provided, have resulted in an increase in the cash holding of both the household sector and the corporate sector. This on the other hand has resulted in the Japanese banking sector being flooded with more cash. Whilst at a first stance this implies that the banking sector is highly liquid, hence lowering the possibility of insolvency, the fall in demand for credit in the economy posits profitability challenges. With razor-thin margins in the domestic markets, and more liquidity available, Japanese banks have further expanded their overseas activities; in particular their exposure to offshore financial centres, i.e. the Cayman Islands. This on the other hand could imply a threat posed to financial stability in continuing to take risky

[3] Even though foreign subsidiaries are separate legal entities, parent banks are positively related to the risk exposure of their foreign affiliates and hence they can bear the risk of their own subsidiaries (see Anginer et al., 2017)

activities in overseas markets, such as holdings a large share of the global CLOs. Furthermore, these holdings together with other activities undertaken vis-a-vis their established affiliate in offshore financial centres obscure their true risk exposure to markets and products. The activities in offshore financial centres could also hinder the effectiveness of the banking regulation[4] currently in place with far-reaching implications for domestic banking stability.

References

Anginer, D., E. Cerutti, M. S.M. Peria, (2017), Foreign bank subsidiaries' default risk during the global crisis: What factors help insulate affiliates from their parents? *Journal of Financial Intermediation* 29, 19-31.

Aldasoro, I., W. Huang., and E. Kemp., (2020), Cross-border links between banks and non-bank financial institutions, *BIS Quarterly Review*, September 2020.

Aldasoro, I., T. Ehlers., E Eren., (2019), Global banks, dollar funding and regulation, Monetary and Economic Departement, *BIS Working Paper* No 708.

Bank of Japan Review, (2020), Developments in overseas credit investment and lending by Japanese financial institutions: An overview based on the joint survey by the Bank of Japan and the Financial Services Agency, *Financial System and Bank Examination Department of the Bank of Japan Supervision Bureau of the Financial Services Agency*, June 2020. Coppola,

A., Maggiori, M., Neiman, B., Schreger, J., 2020. Redrawing the Map of Global Capital Flows: The Role of Cross-Border Financing and Tax Havens. SSRN Journal. https://doi.org/10.2139/ssrn.3751686

Masazumi, W., (2021), Japan's Economy and Monetary Policy, Speech at a Meeting with Local Leaders in Hiroshima, available on: https://www.boj.or.jp/en/announcements/press/koen_2021/ko210901a.htm/

Yoshino, N., F. Taghizadeh-Hesary, H. Miyamoto, 2017, The effectiveness of Japan's negative interest rate policy, Asian Development Bank Institute, Working Papers Series No. 652, January 2017.

[4] Basel III supplementary leverage ratio measure requires large banks to fund themselves with equity worth at least 5% of their total assets.