



# Foreign Banks in Japan

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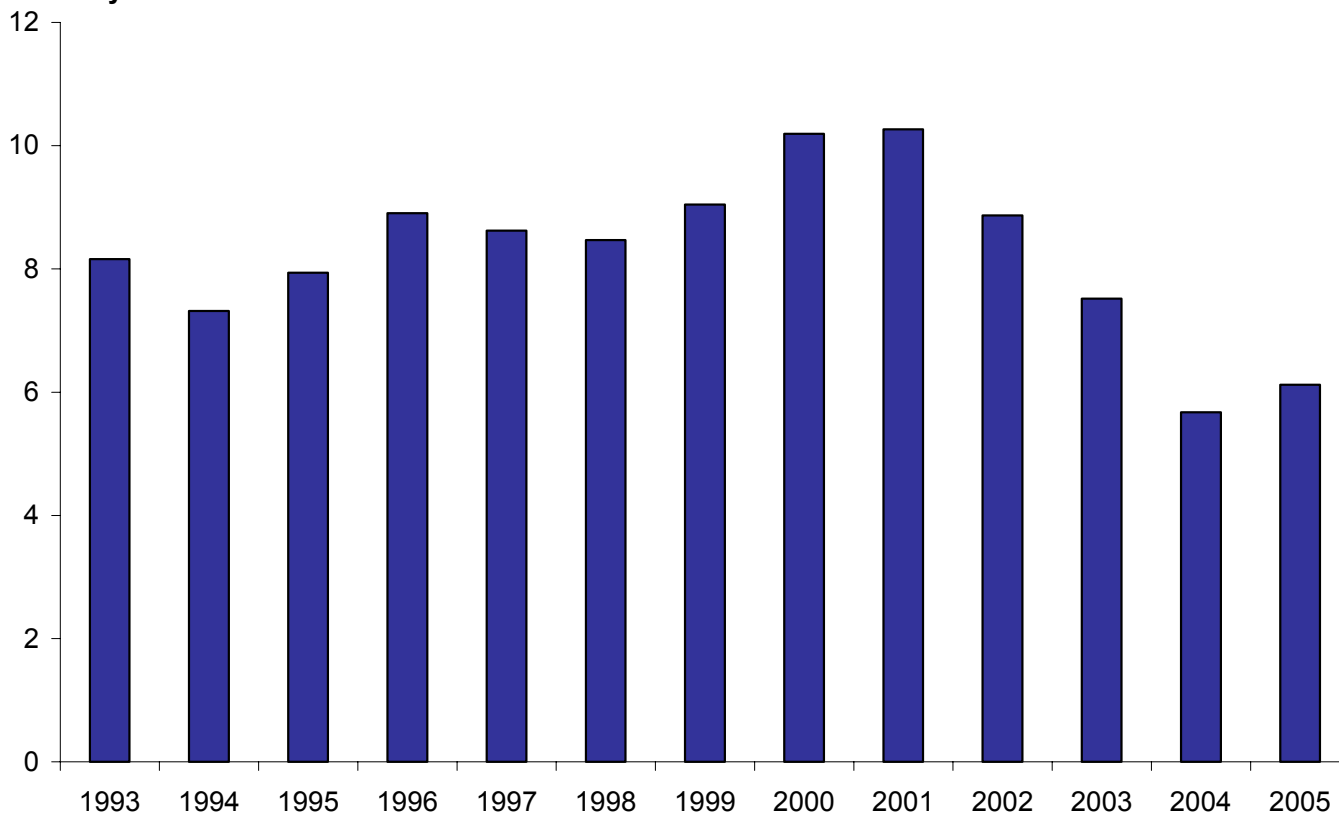
# Potential impact of foreign banks

- Increase competitiveness of domestic banking sector [Levine (1996)]
- Stimulate the underlying bank supervisory and legal framework [Claessens, Demirguc Kunt, and Huizinga (2001)]
- Increase the domestic supply of capital

# Foreign bank lending in Japan has declined dramatically

## Foreign bank lending in Japan

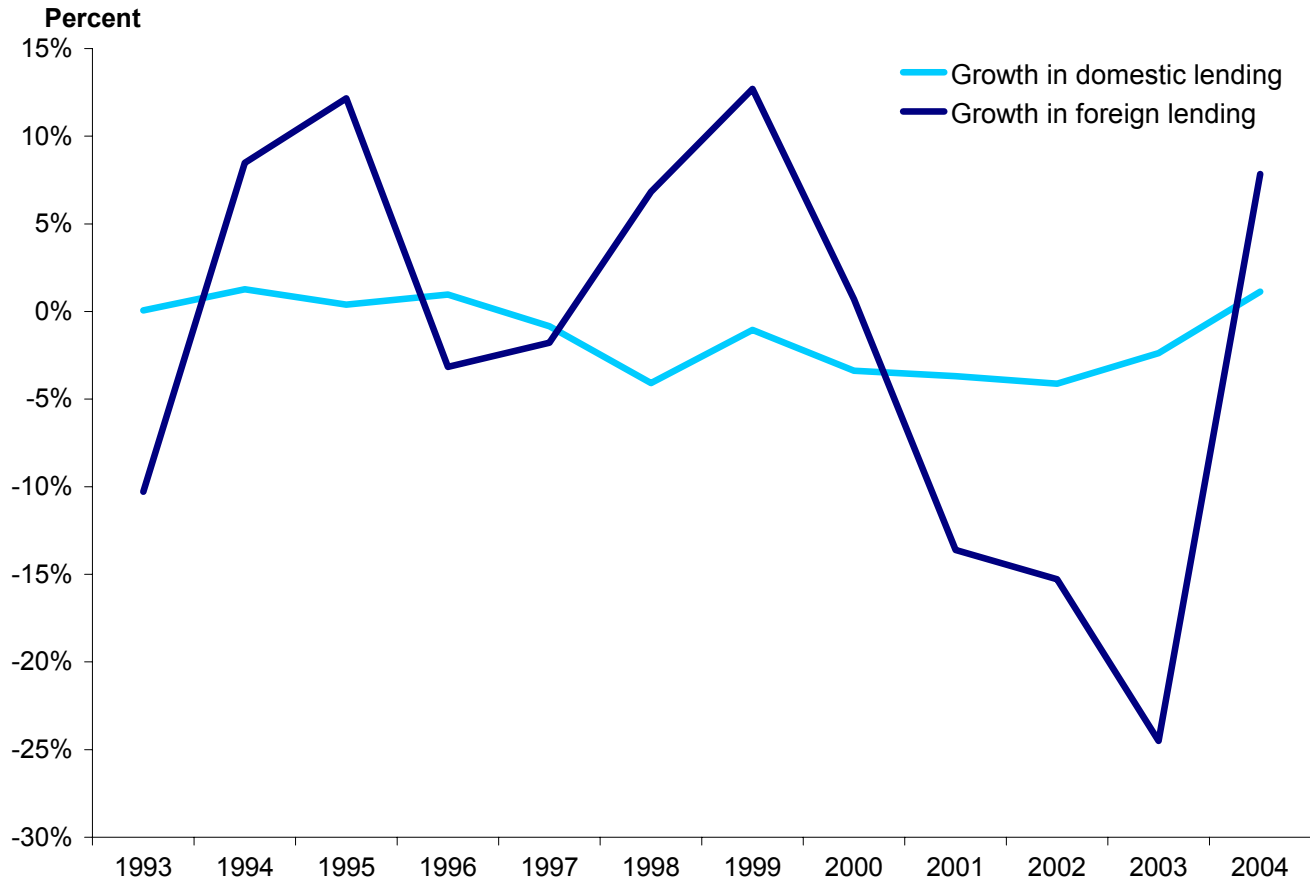
Trillion yen



Source: Bank of Japan

# Foreign bank lending has been more volatile than domestic bank lending during Japan's slump

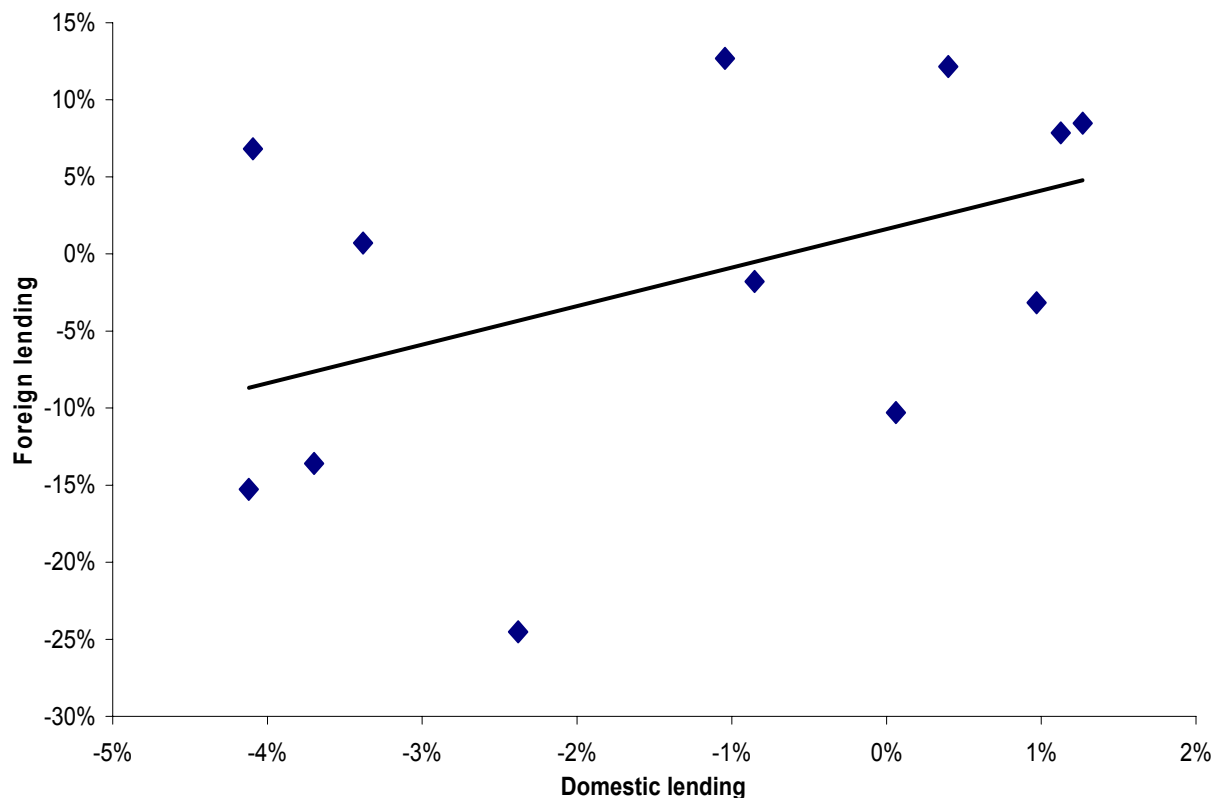
## Annual Bank lending Growth 1993-2004 (%)



Source: Bank of Japan

# Foreign and domestic lending growth rates are positively correlated

Foreign and Domestic Bank Lending growth rates



Source: Bank of Japan

# Volatility of Foreign and Domestic Lending (1993-2005)

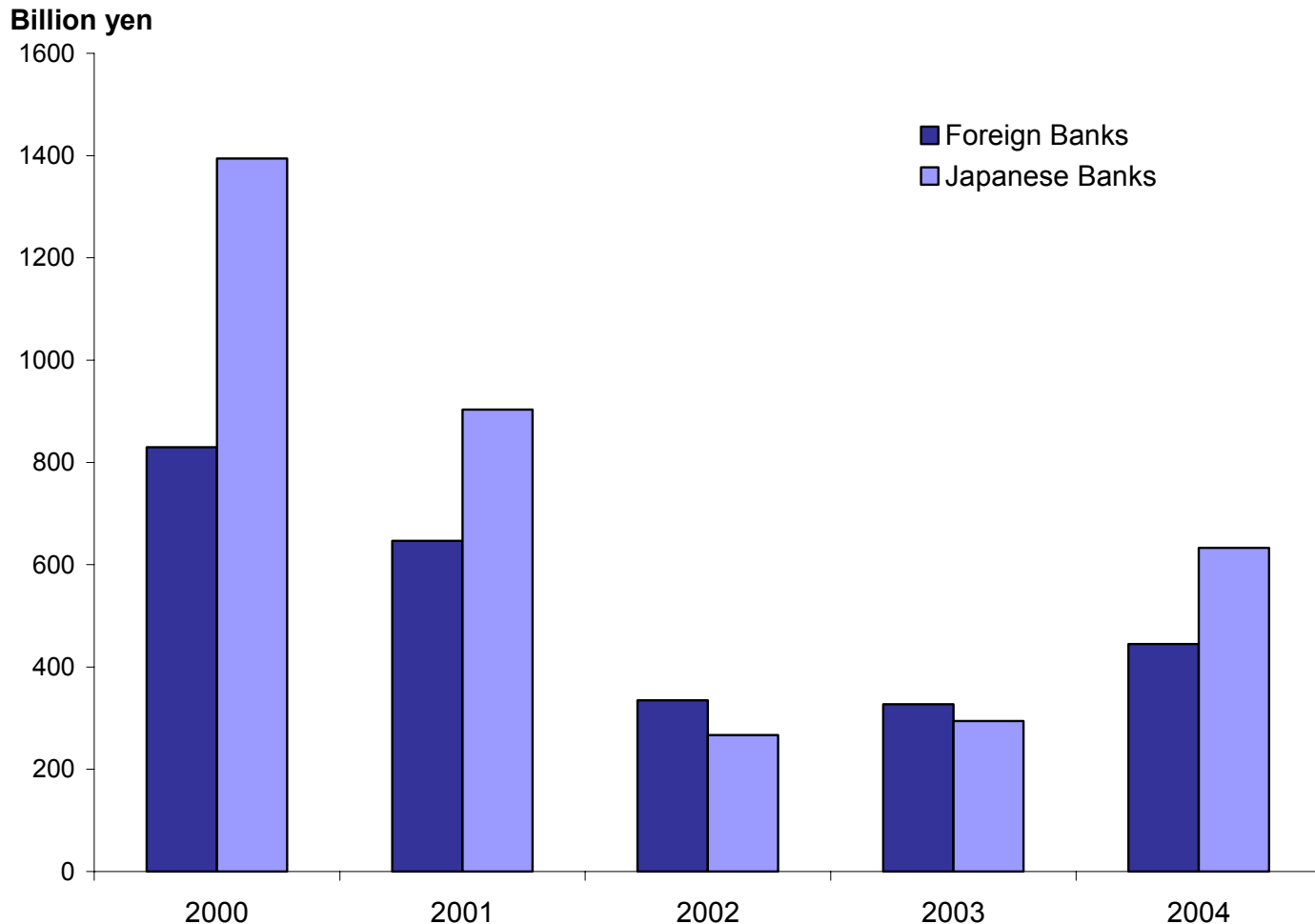
(100 billion yen)

	<b><u>Standard Deviation</u></b>	<b><u>Sharpe Ratio (<math>\mu/\sigma</math>)</u></b>
<i>Foreign Lending</i>	14.8	5.73
<i>Domestic Lending</i>	29.9	15.12
<i>Foreign + Domestic</i>	30.5	15.1
<i>Correlation Coefficient</i>	0.4	

Source: Bank of Japan

# Correlation is positive in bond activity as well

## Samurai bonds from Foreign banks vs. from Japanese banks



Source: International Financing Review



# Evidence of link between bond underwriting and lending

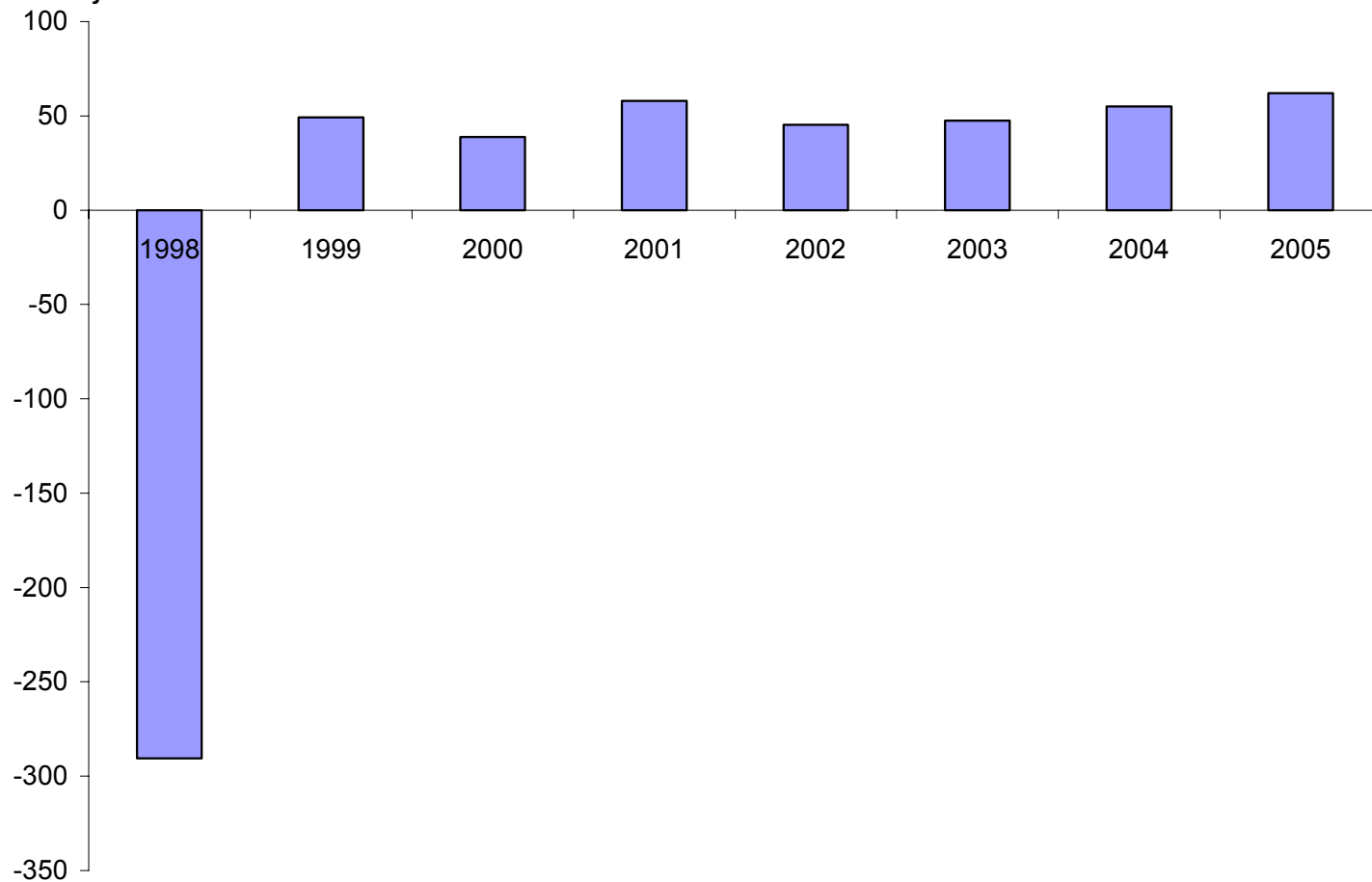
- Drucker and Puri (2005): Both underwriters and issuers benefit from concurrent underwriting and lending relationship
  - Informational economies of scope
  - Reduces both underwriting fees and lending spreads
  - Lenders engender long-term relationships
- Disproportionate underwriting activity by foreign banks leaves them well-placed to capitalize on these economies



# Shinsei profits have grown steadily ...

## Shinsei net business profits

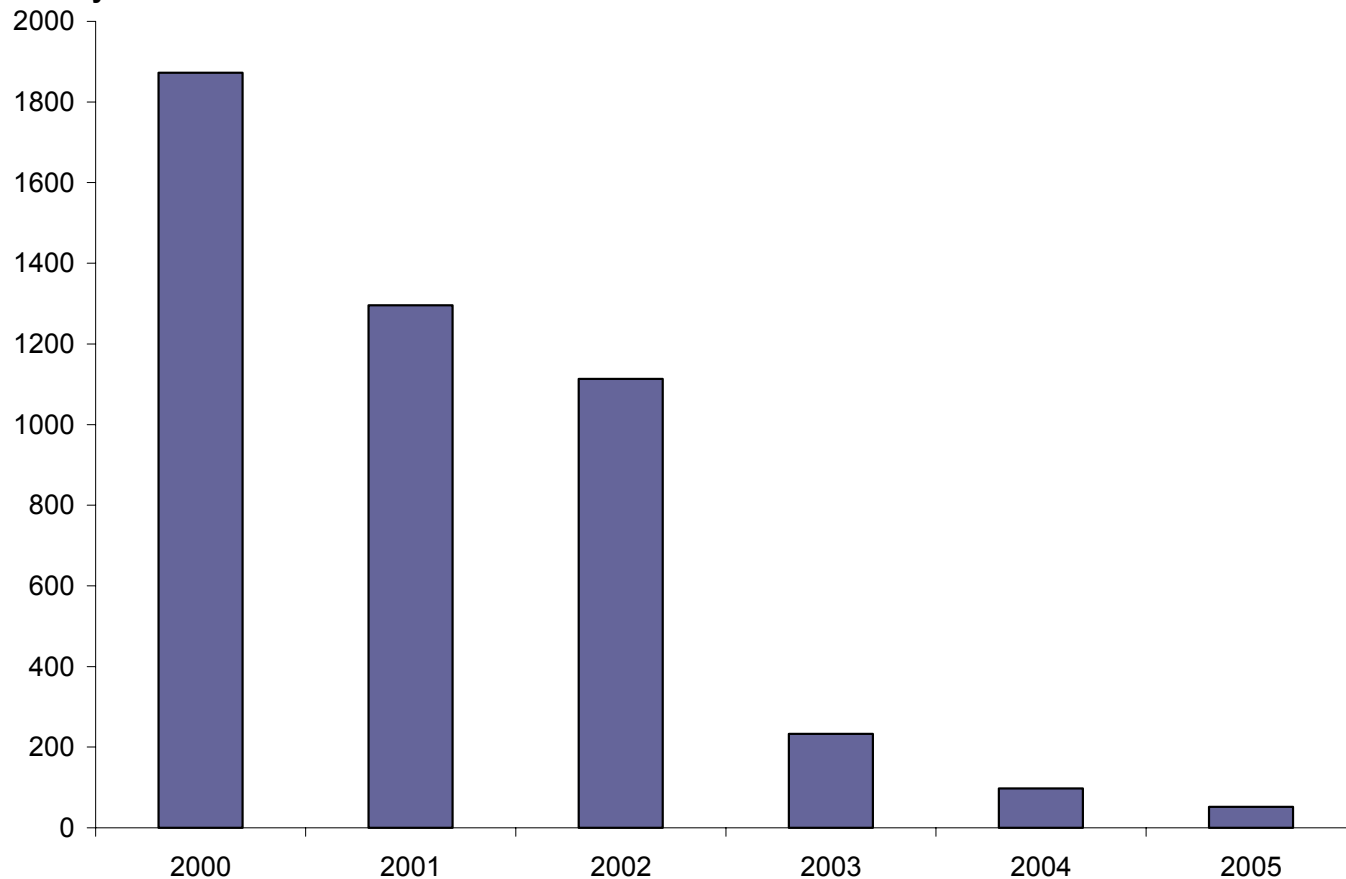
Billions yen



... and it has moved quickly to clean its balance sheet

### Shinsei outstanding NPLs

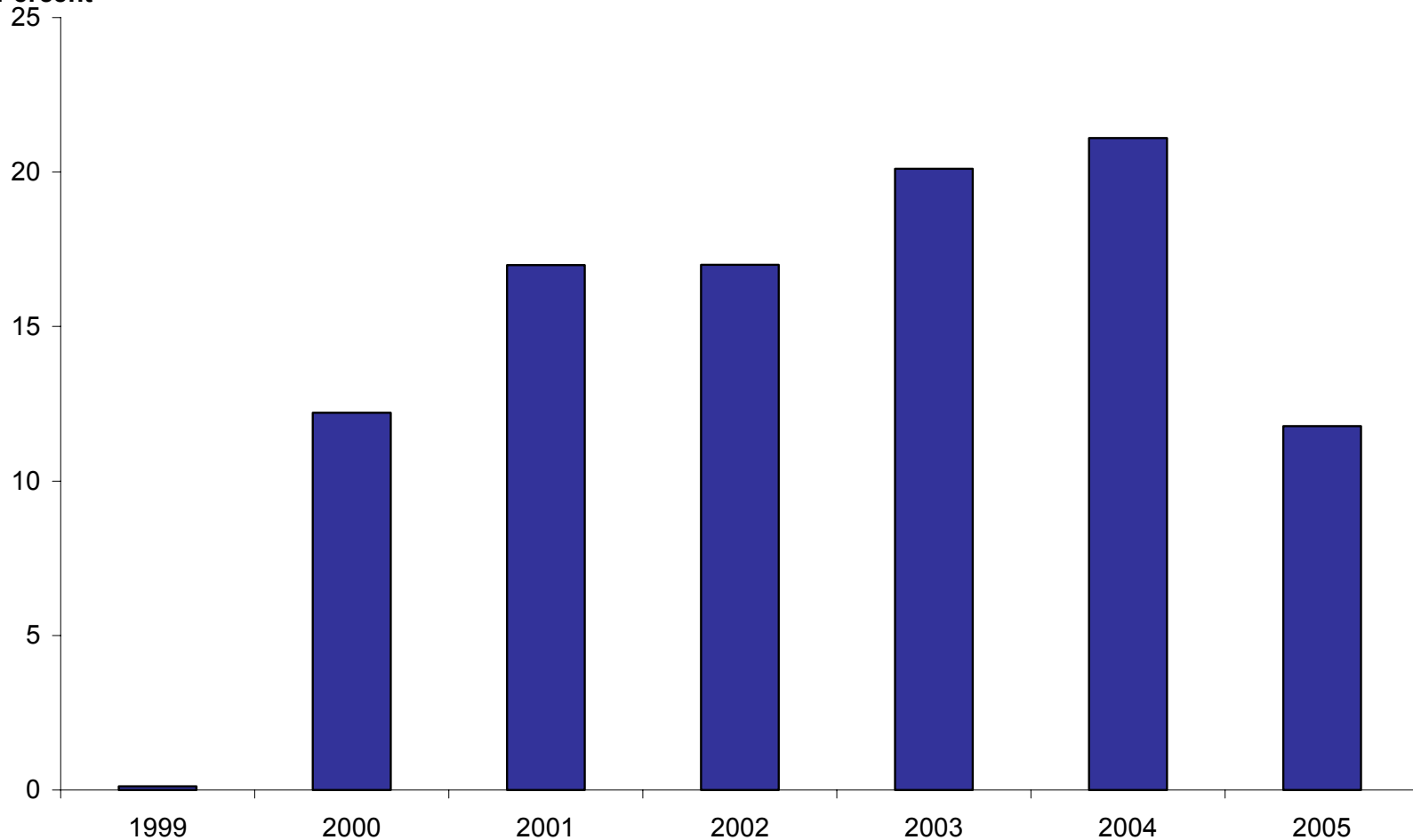
Billions yen



# Its capital position has improved as well

## Shinsei capital ratios

Percent





# Issues going forward

- End of quantitative easing
  - Increased nominal rates may raise monopoly potential
  - But will also increase average spreads, making market more desirable to foreign banks
  - Importance of foreign banks as competitive fringe may increase
- Impact of consolidation in Japanese banking
  - Foreign studies: Mergers adversely impact equity values of clients of acquired bank, suggesting lost relationship value
    - Karceski, Ongena, and Smith (2004) for Norway; Carow, Kane, Narayanan (2005) for U.S.
    - Clients of acquiring bank often unaffected, or even positively affected
  - Some evidence that small and medium enterprises disproportionately affected
  - Again, speaks to importance of foreign banks as a competitive fringe

# Conclusion

- Foreign banks operating in Japan do not appear to behave so differently than their domestic counterparts
  - Activity highly positively correlated with domestic banks
  - But with developed capital markets, unclear that diversification is very important
- Rather than arguing against allowing foreign banks, similarities suggest that openness to foreign banks is a natural policy for a developed banking system like Japan's
  - Domestic banks compete effectively
    - CDH (2001) profitability of foreign and domestic banks in Japan 1988-1995 about identical
  - Positive impact on regulation (e.g. Shinsei) and domestic bank management by providing competition
- Fundamentals suggest that value of foreign banks as a competitive fringe will increase in Japan going forward