



Foreign Banks in Japan

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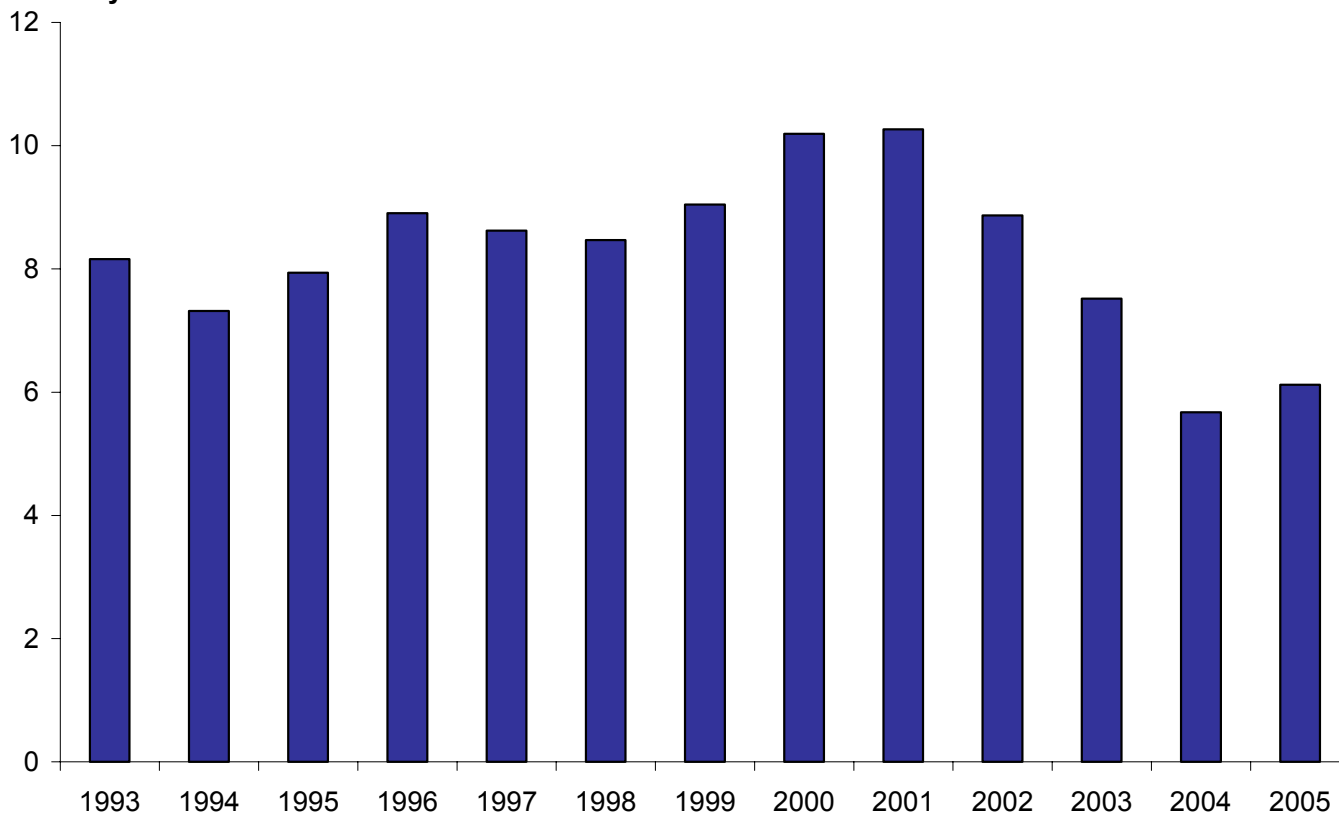
Potential impact of foreign banks

- 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

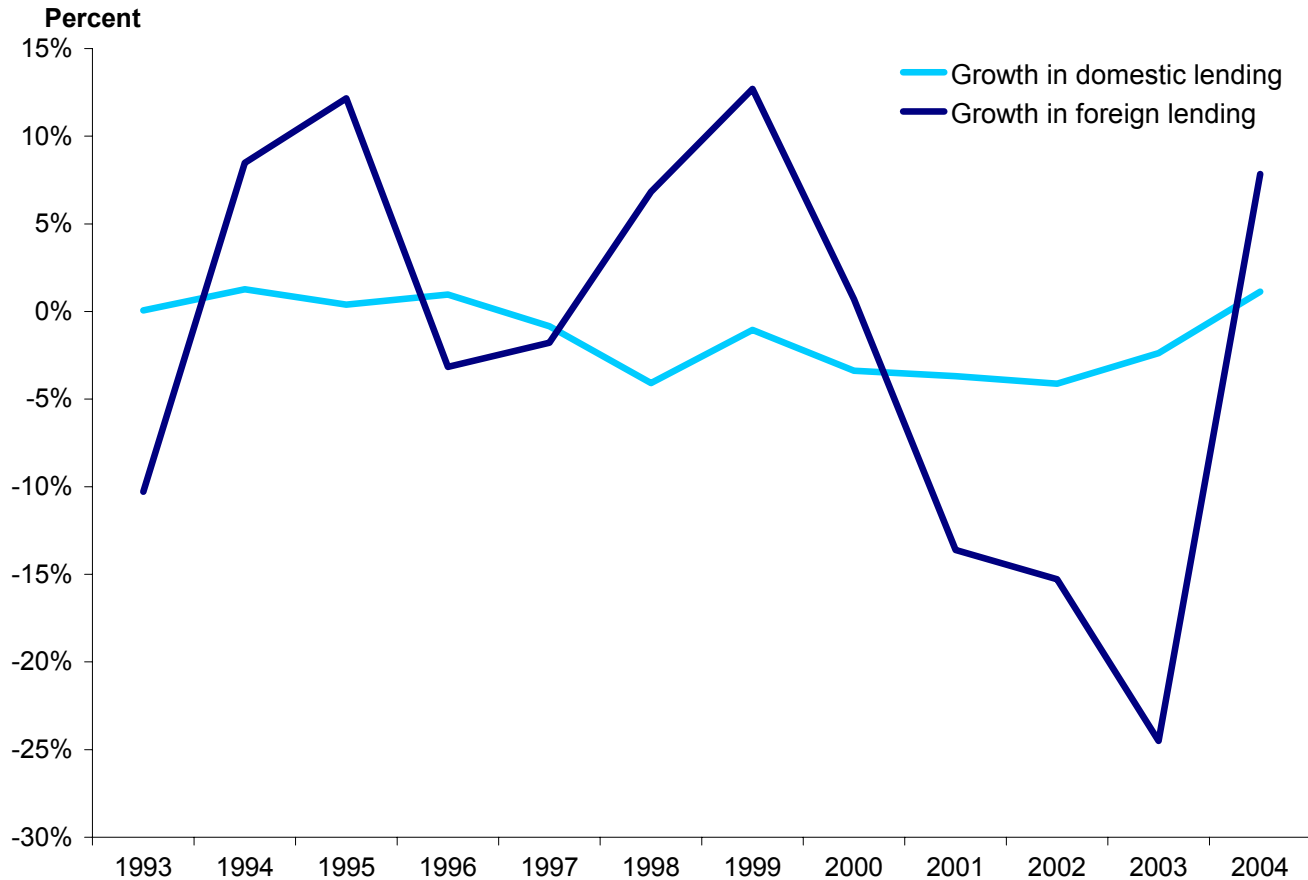
Trillion yen



Source: Bank of Japan

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

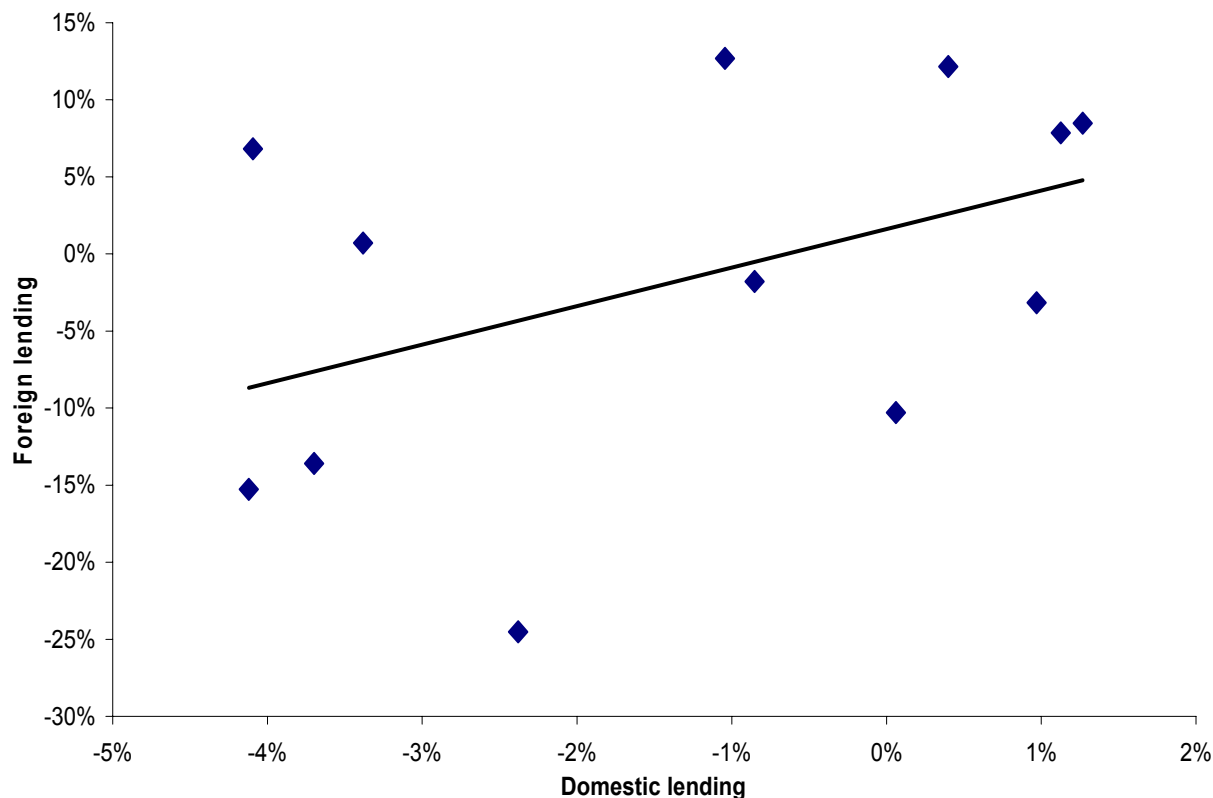
Annual Bank lending Growth 1993-2004 (%)



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)

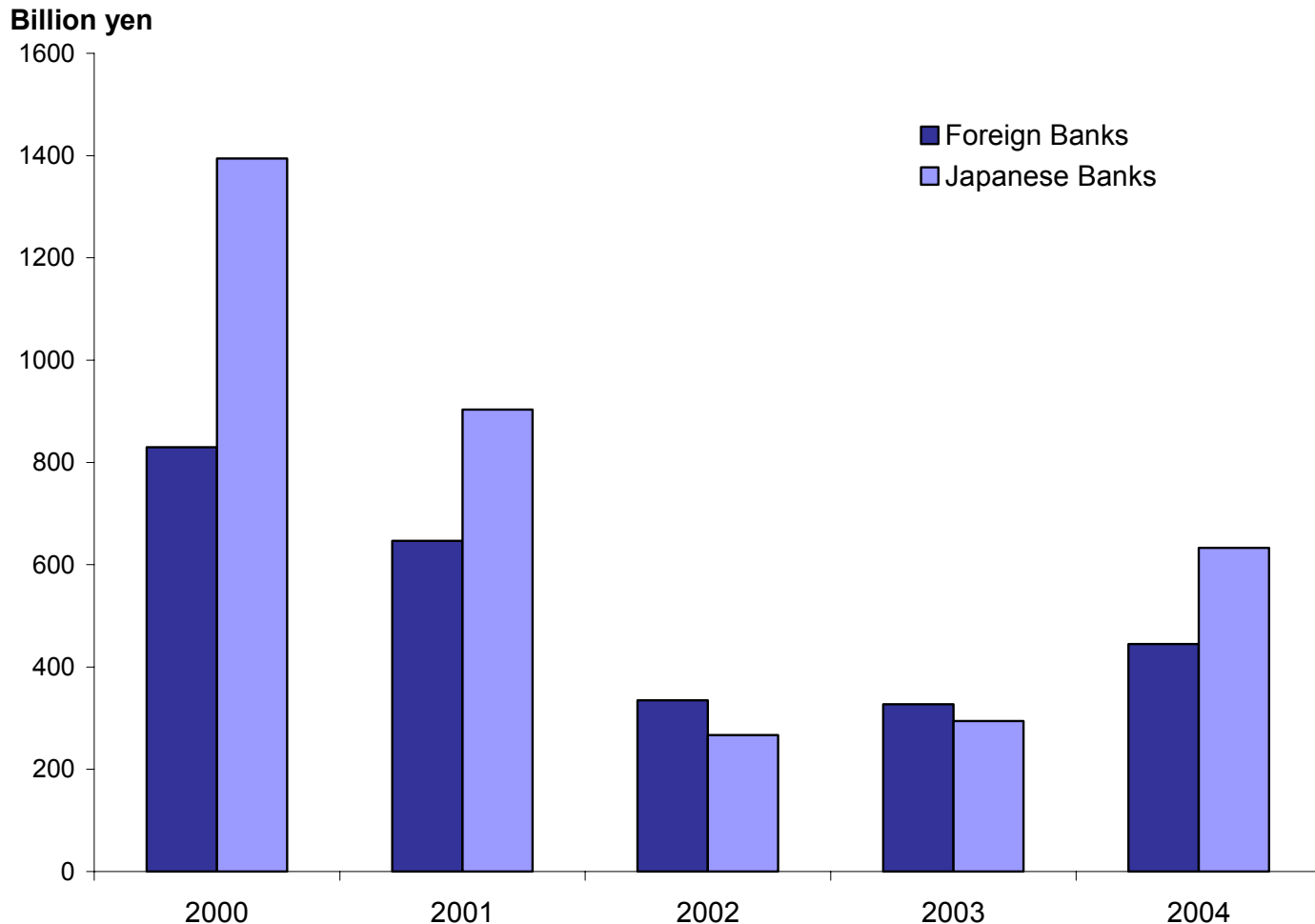
(100 billion yen)

	<u>Standard Deviation</u>	<u>Sharpe Ratio (μ/σ)</u>
<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



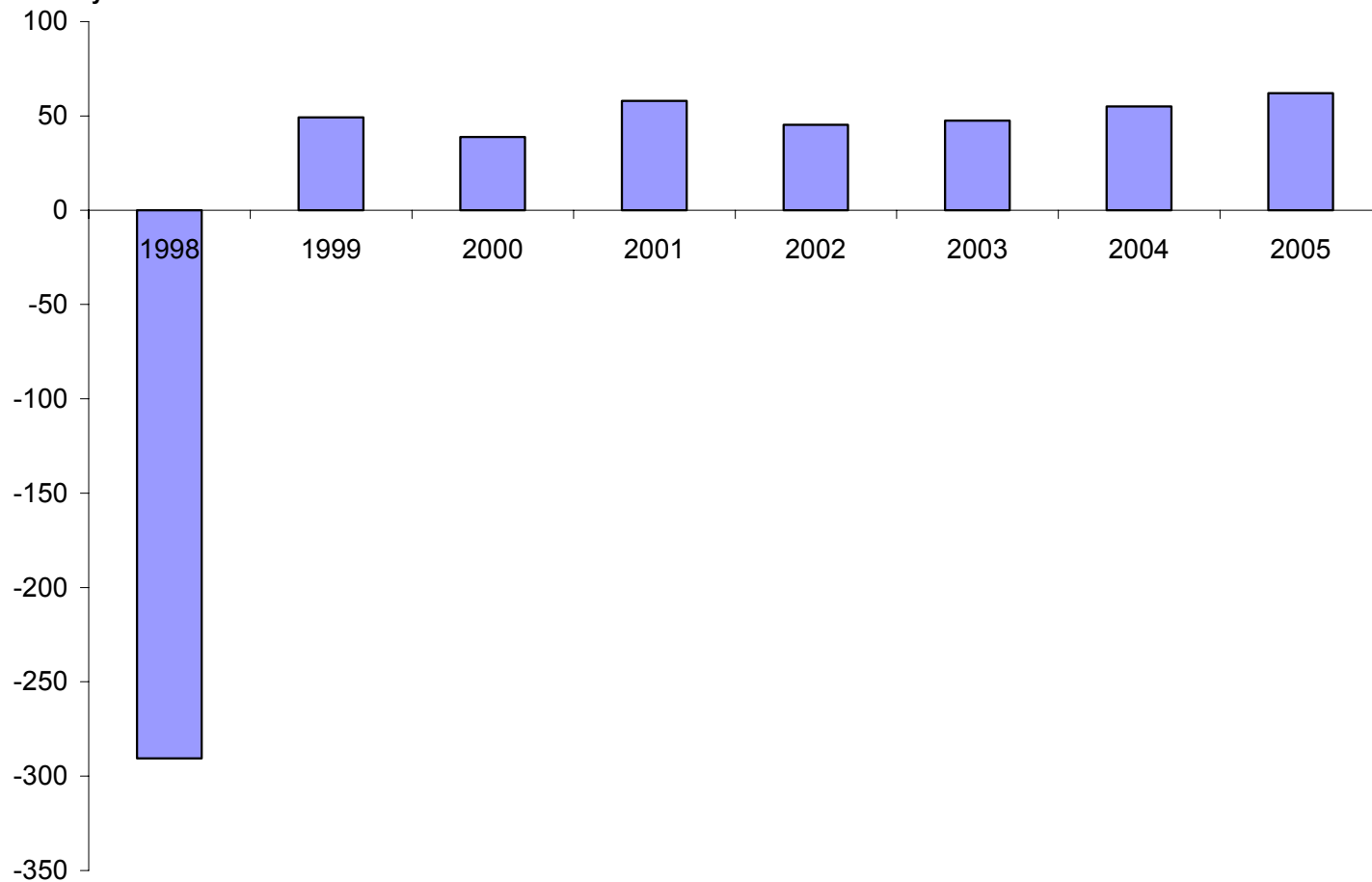
Evidence of link between bond underwriting and lending

- 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

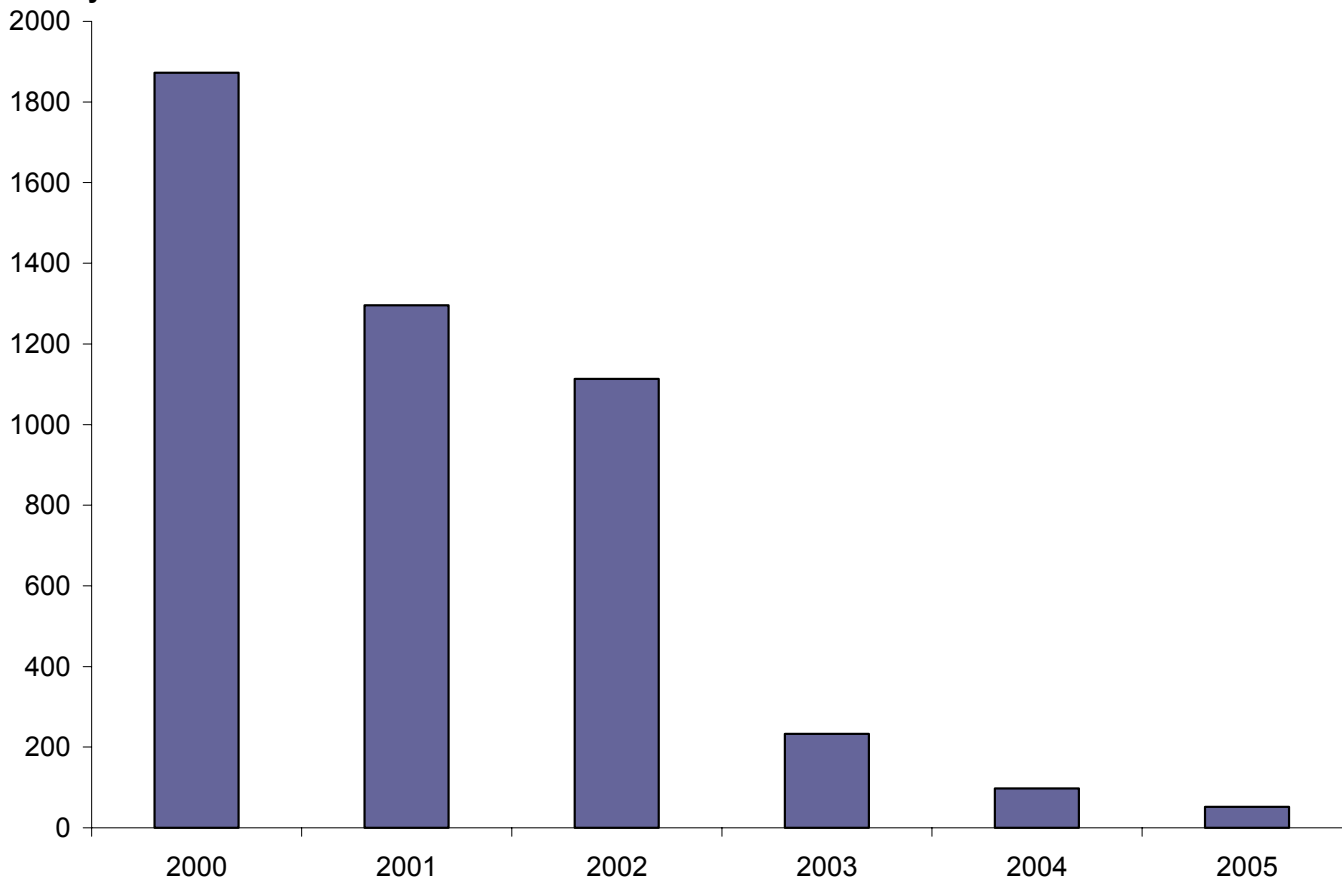
Billions yen



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

Shinsei outstanding NPLs

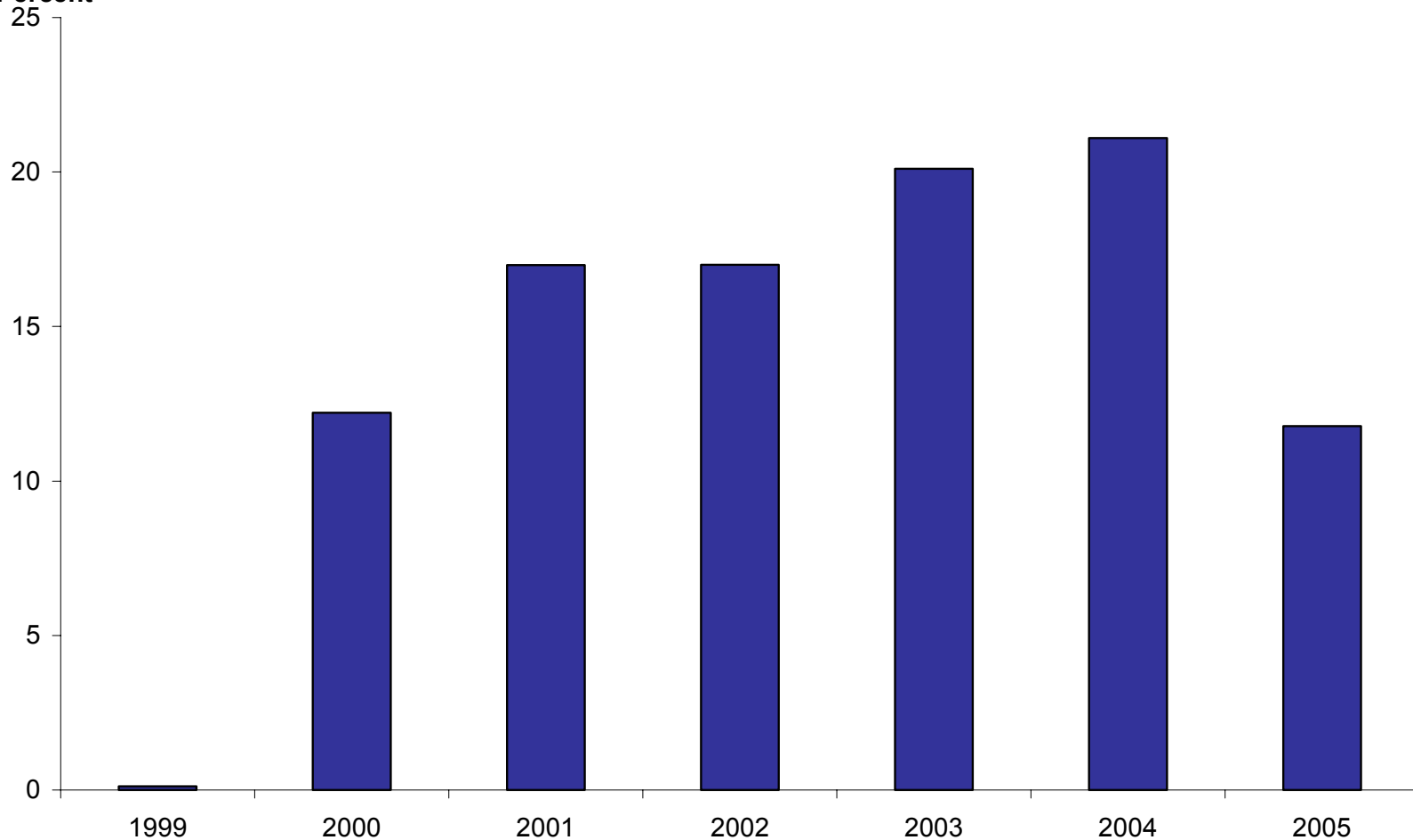
Billions yen



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