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Banking Business in Japan

—Part II : Lending—

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This is the second part of the report of Japanese Banking System. Please refer to the Bulletin of Gakushuin Women's College No.15 (March 2013) for Part I: Financial institutions and fund raising.

1. Lending

(1) Loan to deposit ratio

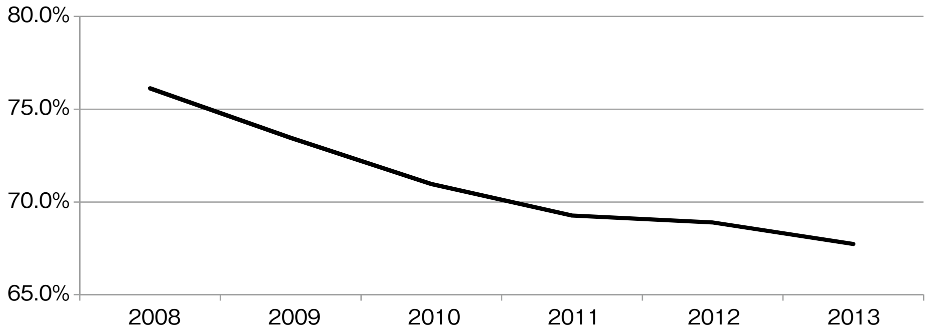
It is possible for banks to lend out most of their deposited money, but at least they have to reserve a fraction of total deposits so that cash is available when depositors want to make withdrawals. Banks also have to diversify their lending across a range of borrowers to reduce default risks.

A ratio called "loans to deposit ratio" is a statistic commonly used to assess bank liquidity. The definition is to divide the bank total loans by its total deposits.
Banks make their profits primarily by issuing loans. A loan is a liability for the individual or company receiving it, but for the bank it is an asset that provides income. So having a high loan to deposit ratio means the bank issues more loans out of their deposit and generates more income. However, the problem is loans do not always get repaid and could be defaulted. Besides, the banks need to repay the depositors upon request. So having a ratio too high puts the bank at high risk. On the other hand, a very low ratio means the bank could be at low risk but also that the bank is not utilizing their assets fully to generate income and could even end up at a loss.
American or European commercial banks typically lend 50 to 70 percent of their bank's assets to individuals and corporations, 10 to 35 percent to other banks and institutions in the financial market on short-term basis, and usually invest less than 20 percent into long term investments such as purchasing government bonds or company shares. In the United States, it is reported that loan to deposit ratio is now

at the lowest level in some 30 years – around 70 to 75%.

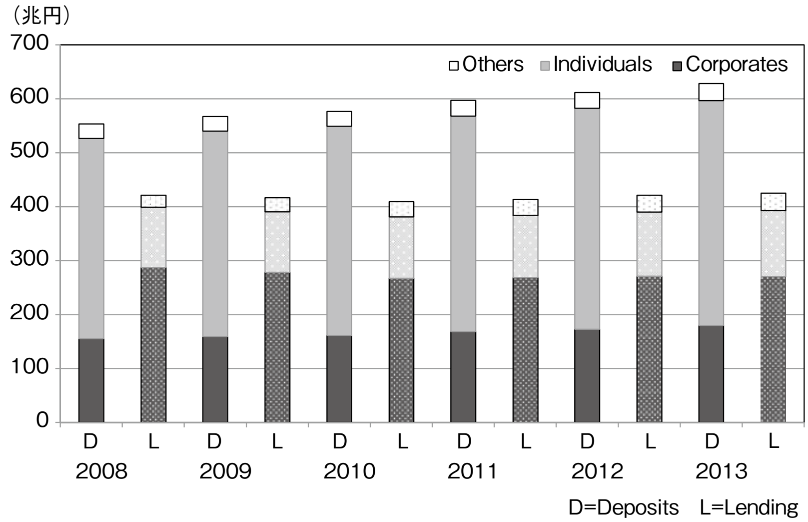
In recent Japan, loan-deposit ratio has shown a straight downward trend and fell to 67% by the end of 2013 (chart 1).
Deposits of Japanese banks are increasing steadily, and in 2012, the total amount of deposit of Japanese banks has exceeded JPY 600 trillion. Two-thirds of these deposits were made by individuals, and a little less than 30% were deposited by corporates.

第１図　預貸率
Chart 1　Loan to deposit ratio



Data：Bank of Japan

第２図　日本の国内銀行の預金と貸出の推移
Chart 2　Deposits and Lendings of Japanese domestic banks



Data：Bank of Japan

Total outstanding of bank lending remains stable, but lending to corporates has decreased whereas lending to individuals has slightly increased. This implies that Japanese companies are cautious in business investment and did not have much demand for bank loans despite the continuous money easing of Bank of Japan.

(2) Basic types of loan

Most bank loans issued in Japan may be categorized into 4 types : loans on deeds, overdrafts, bills discounted, loans on bills.

ⅰ）Loans on deeds（証書貸付）

This is a type of loan that the bank issues a deed when providing loans with an original maturity of more than one year, and a specified schedule of principal and interest payments. This is the most standard type of lending, and more than 80% of lending in Japan is made as Loans on deeds, including long term business loans and personal mortgages.

ⅱ）Overdrafts　当座貸越

Usually the amount that a depositor can withdraw from the account is limited to the amount deposited. However, overdraft is an arrangement to allow some flexibility to take out more money than the account contains, up to a stated limit for a given period of time. The flexibility in that the amount or duration to be borrowed could vary is the advantage of overdraft, and for this reason overdraft is getting popular in Japan. Overdraft is quite common in UK or Germany, but not allowed as a facility in US.

ⅲ）Bills discounted　手形割引

Banks purchases promissory notes or drawn bills at less than the face value for early payment. For example, if the bill has a face value of JPY 100,000 the bank credits you with the amount of JPY 90,000, after deducting JPY 10,000 as discount interest and costs.

ⅳ）Loans on bills　手形貸付

Loans on bills are similar to loans on deeds, but the borrower needs to post bills as collateral to borrow money, and loans on bills are used for shot term lending such as a few months. The bank will provide money of the face value less the interest till maturity.

2. Loans of Corporate Finance

(1) Term loan

Financial products for corporate loans are not as standardized as those of deposits. In Japan, the majority is term loans with a specified schedule repayment of principal and interest. It is the case that when the term is shorter than one year, Loan on bills is arranged, whereas when the maturity is longer than one year Loan on deeds is issued.

Below are some other types of corporate loans.

(2) Syndicated Loan

Syndicated loan is a loan offered by a group of lenders in which a few banks each contribute a portion of the overall loan. Syndicate is a group of banks, sometimes involving as many as 100 banks. Banks will be exposed to unacceptable risk if they accept too large loans, say JPY 50 billion, and they prefer to participate in a number of syndicated loans and reduce risk by diversifying their lending. The borrower of synidated loan could be corporations, large projects, or sovereign.

The lead manager that serves as the head of the syndicate holds the primary responsibility for arranging the loans and mainly handles negotiation, and this bank generally takes the largest commitment of the loan. The lead manager will invite other banks called co-managers or joint mangers, to co-manage the loan. In Japan, it is the case that city banks serves as lead managers, and regional banks will be participants.

Syndicated loans became popular in 1970s, and the volume fell somewhat in 1980s after the debt crisis, but recovered later. In Japan, the total outstanding amount that was JPY 400 billion in 1997 has grown to JPY 58 trillion by 2010.

(3) Project Finance

Project finance is a type of term loan. Its significant feature is that the loan repayments are tied to the cash flow of a specific project rather than the parent companies credibility or assets. Usually the duration is much longer than conventional term loans, and structure is much more complex, and require time-consuming loan arrangements. Project finance has been used across the globe to finance power plants, natural resources such as gas, oil, mining plants, and infrastructures.

(4) Guarantee

Banks are prepared to provide Guarantee for certain fee. This is to guarantee a third party repayment and not a direct loan to the client, but in case the client cannot pay back, the bank has the responsibility to cover the payment, and in that sense, Guarantee is regarded as a type of loan. For example, a bank can grant guarantee to an exporter that an importer will pay for goods supplied.

3. Loans of retail banking sector

There are various type of loans for individual. Mortgage loan is major, but we are seeing development of more and more telephone or internet banking these years.

(1) Mortgage loan

Mortgage is a loan secured on the property. Mortgages are used by individuals and businesses to make purchase of real estate. A home buyer pledges his or her house to the bank and borrow the loan. If the buyer / borrower get defaulted, the bank can foreclose and clear the loan using the income of selling the house. As the loan is secured, the bank is less at risk, and will bear lower rate of interest than unsecured overdraft or personal loan.

Features of mortgage loans, such as term, interest rate, way of repayment varies considerably.

Most mortgage loans have 15 to 30 year term. With a fixed rate mortgage, the borrower repays a same rate of interest for the life of the loan whereas with a floating rate mortgage (also known as variable rate mortgage) the interest rate fluctuates with the financial market environment. Combinations of fixed and floating rate mortgage are also available. Generally the loans amortize, and the amount of principal payment is scheduled but some loans have no amortization. In Japan, there are basically two type of payments for amortized loans-- equal-principal monthly payments (元利均等返済) and equal monthly payments with interest (元金均等返済). Please refer to "4. Repayments".

Almost any bank in Japan offers mortgage loans. Typically, long term prime loan plus spread is the base for interest rate, and monthly repayments with half a year bonus payments is a standard frequency of repayment, but early repayment is possible,too. In 2010, the share of mortgage loan in Japan was 27% in of the total loan. Reflecting the current low interest rate, fixed rate mortgage is increasing, but floating rate mortgage is still the majority.

Needless to say, housing market is an important factor for mortgage. Many homeowners in US got into financial troubles as the housing price fell around 2006, and subprime mortgage loans in US became the root cause of Lehman shock that happened in 2008.

(2) Personal Loan

Personal loan is a loan for an individual of a specific amount for a specific loan period. This loan is often unsecured. In Japan there is a variety of personal loan depending on the usage, such as auto loan, shopping loan, apartment loan, reform loan etc.

(3) Credit card (card loan)

Credit card is another type of lending. Credit card users make purchase using the cards, and receive a statement of indebtedness to the credit card company. Users are allowed to choose whether to pay off the whole amount or pay a portion upfront and pay back the rest later. The usage of the loan is not specified, but the term is relatively short from a few weeks up to 5 years.

(4) Internet banking

Today millions of people use internet banking. Since the 1990s, there has been a steady growth of internet banking by individuals for home banking purpose. Transaction cost for the bank is significantly lower compared to branch based activities, and is expected to see greater use in the future.

4. Repayments

Loans could be categorized into basically three types by way of repayment: Amortized loan, bullet loan and balloon loan.

(1) Amortized loan

Amortized loan is a loan paid back in installments, and the principal of the loan is paid down over the life of loan according to a specified schedule, typically through equal payments. In this way, the principal gets paid periodically, which has the advantage of mitigating risk gradually by reducing borrower's debt on a regular basis. Mortgage loans are typically amortized loans.

There are two methods of repayment for amortized loan in Japan -- equal total payment（元利均等返済）and equal-principal payment（元金均等返済）. Suppose this is a monthly repayment loan, for the former you repay every month the same total amount that includes both principal and interest whereas for the latter you pay back same principal amount plus interest every month. It is clear how much to repay every month for the former but you repay less principal and more interest compared to the latter after all. For the latter you repay same amount of interest each month, so your interest burden will decrease over time, and your total monthly payment will decline. The total interest payment will be less for the former, but the burden of repayment at the beginning is heavier compared to the latter.

（2）Bullet loan and Balloon loan

A balloon loan is a loan that the final payment is substantially larger than the preceding payments. Only a small part of loan is repaid during the loan period, and the majority repayable at the maturity. A bullet loan goes one step further, and this loan does not amortize and the entire loan amount should be repaid at the end of the loan period.

The advantage of these types of loan is that the borrower doesn't have to start pay back immediately. These loans could be applied to companies or project that do not generate cash flow for the first several years or when refinancing is anticipated.. But the borrower should be well prepared to have sufficient cash flow to pay off the loan at maturity.

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（本学非常勤講師）