

Article:

**Japanese financial institutions expanding abroad:  
Opportunities and risks**

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# Executive summaries

## **Japanese financial institutions expanding abroad: Opportunities and risks**

by **W. Raphael Lam**, International Monetary Fund

Overseas activities of Japanese financial institutions have risen, mainly in Asia, since the global financial crisis. Stagnant growth and low interest margins in Japan have added to incentives to seek opportunities abroad. This paper explores the determinants of Japanese banks' overseas expansion and assesses whether these cross-border activities will continue under the new macroeconomic policies often referred to as "Abenomics." The analysis finds that Japanese banks are well positioned to scale up foreign exposures, thanks to their relative resilient balance sheets and the robust growth in the region. Stronger domestic growth in Japan could mitigate the pace, but is unlikely to reverse a long-standing trend because empirical estimates suggest that global and regional factors play a more prominent role in the growth of cross-border claims. The increasing cross-border activity would pose funding risks and supervisory challenges that require continuous close monitoring. An incomplete set of domestic policies that fails to raise growth and exit deflation could, however, undermine the prospects of Japanese banks in expanding abroad.

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# Japanese financial institutions expanding abroad: Opportunities and risks

**W. Raphael Lam**

International Monetary Fund<sup>1</sup>

## **Abstract**

Overseas activities of Japanese financial institutions have risen, mainly in Asia, since the global financial crisis. Stagnant growth and low interest margins in Japan have added to incentives to seek opportunities abroad. This paper explores the determinants of Japanese banks' overseas expansion, and assesses whether these cross-border activities will continue under the new macroeconomic policies often referred as "Abenomics." The analysis finds that Japanese banks are well positioned to scale up foreign exposures, thanks to their relative resilient balance sheets and the robust growth in the region. Stronger domestic growth in Japan could mitigate the pace, but is unlikely to reverse a long-standing trend because empirical estimates suggest that global and regional factors play a more prominent role in the growth of cross-border claims. The increasing cross-border activity would pose funding risks and supervisory challenges that require continued close monitoring. An incomplete set of domestic policies that fails to raise growth and exit deflation could, however, undermine prospects of Japanese banks in expanding abroad.

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<sup>1</sup> The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

## Introduction

Cross-border activities of Japanese financial institutions have risen over the past few years, particularly in the Asian region. Overseas loans by major banks are growing by more than 20% year-on-year. Major Japanese banks have attained an important global and regional presence, particularly in areas of syndicated lending and project finance. Foreign claims on Asia have recouped the decline at the height of the global financial crisis and are now at levels comparable to the 2005-08 period. Moreover, major brokerage firms and life insurers have sought acquisitions or strategic partnership overseas.

The current trend is often compared to previous episodes of overseas expansion by Japanese financial institutions over last decades. Those episodes can be broadly classified in three waves (Figure 1): (i) the rapid expansion in the 1980s – up until the burst of the asset bubbles in 1990; (ii) the expansion during the mid-1990s; and (iii) the expansion abroad beginning from 2006 but temporarily slowed during the global financial crisis. A question to explore would be how the current trend of overseas expansion has similarities to these episodes.

In addition, this paper assesses whether this trend will continue under the government's new policy framework often referred to as Abenomics. The Bank of Japan's (BoJ) new quantitative and qualitative monetary easing (QQME) framework – part of the three-pronged strategies to revive growth and exit deflation – intends to encourage financial institutions to shift away from government bonds and take on greater exposures of risky assets (such as loans and investment securities).<sup>2</sup> An improved domestic outlook could increase financial institutions' inward focus to satisfy rising credit demand. On the other hand, uncertainty over the Japanese Government bond (JGB) market and yen movements may stimulate diversifying needs outside Japan. Are there new risks that may emerge in light of increasing cross-border activity and the implications for financial institutions and supervisors?

To answer these questions, the paper analyzes what factors contributed to the Japanese financial institutions' decisions to expand abroad recently. We undertake an empirical study on

several banking systems in advanced countries and examine their foreign claims. We then apply those empirical results to the Japanese banking system and assess the role of each contributing factor. The paper builds on the literature on cross-border banking [Berger et al. (2000), De Haas and Lelyveld (2010), De Young et al. (2009)] and international capital flows [Fratzscher (2012), Jotikasthira et al. (2012)].

Our empirical results show that several regional and domestic factors have contributed to overseas expansions. Stagnant growth and limited domestic credit demand have added incentives for Japanese financial institutions to seek opportunities abroad. Modest global uncertainty, large growth differentials and the resilience of domestic banking systems are key drivers for cross-border claims. Outside Japan, robust growth in Asia and deleveraging of European banks in the region contributed to a rise in cross-border lending. The exchange rate appreciation in the past years might have added incentives for expanding abroad.

This paper argues that the trend of expanding overseas is likely to continue, but will depend on a supportive domestic economy under successful Abenomics and careful risk management and supervision. Robust growth in Asia and sufficient liquidity at home would imply that the trend of expanding abroad is likely to continue. Although stronger domestic growth might slow the expansion pace, it is not expected to reverse the trend unless an incomplete Abenomics poses risks to domestic financial stability. Increasing cross-border activity also adds to funding risks and supervisory challenges that require continued close monitoring.

## Past experience of overseas expansion by Japanese financial institutions

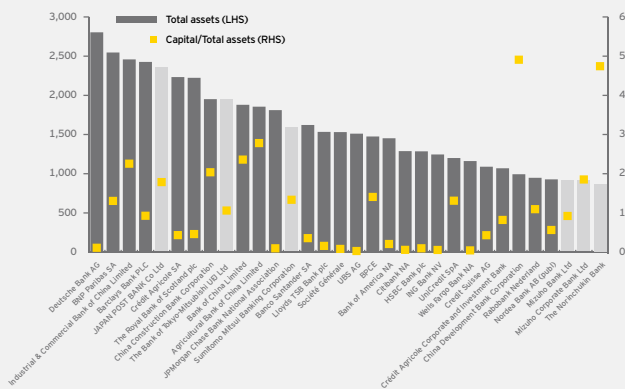
The various attempts of expanding abroad by Japanese financial institutions over the last few decades can be broadly classified into three waves. These earlier waves of expansion have somewhat resulted in losses for the financial institutions without helping them secure major global footing, except for a few megabanks and securities firms. The first wave of overseas expansion by Japanese financial institutions occurred during the mid-to-late 1980s, about the same time as when many real-estate and construction companies markedly increased their outward foreign direct investments (FDIs) (Figure 1). In addition to financing those FDIs by real-estate and construction

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<sup>2</sup> The three-pronged Abenomics strategies include flexible fiscal policy, aggressive monetary easing, and structural reforms to exit deflation and raise growth.

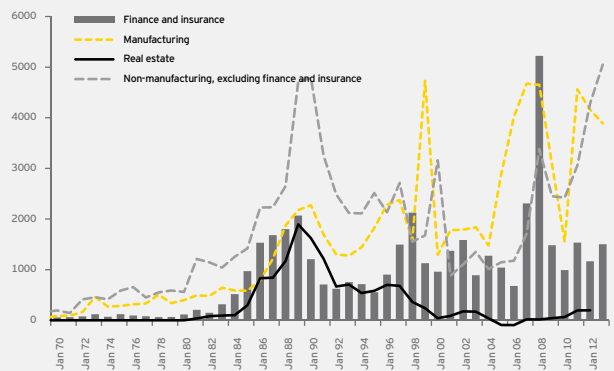
### Major global banks (by asset size) (in billions of USD and in percent)

Source: Bankers Acruity



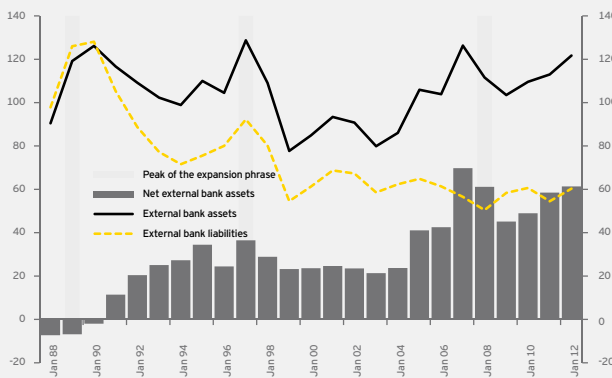
### Foreign direct investment abroad, by industry (in billions of yen)

Sources: Ministry of Finance and Haver



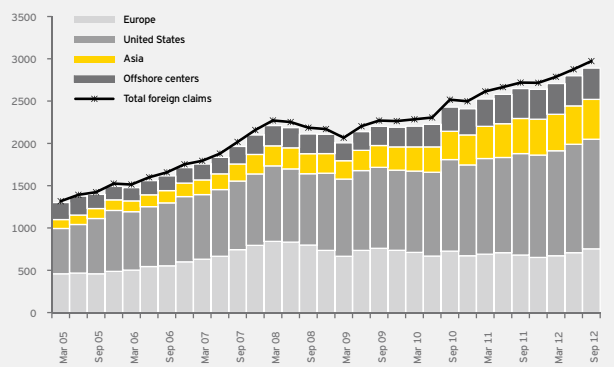
### External bank assets and liabilities (in trillions of yen)

Source: Haver



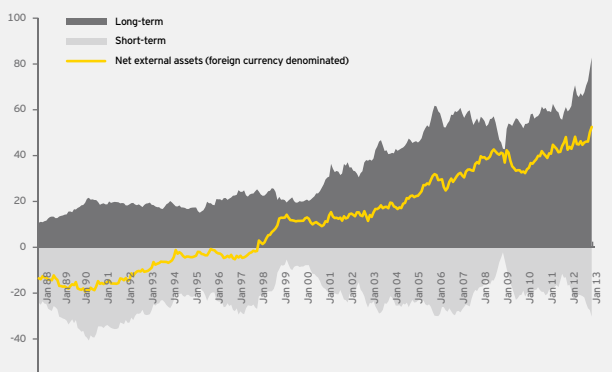
### Consolidated foreign claims for Japanese banks (in billions of USD)

Source: BIS



### Banks' net foreign-currency denominated external assets (in trillions of yen)

Source: Ministry of Finance



### Banks' yen-denominated net external assets (in trillions of yen)

Source: Ministry of Finance

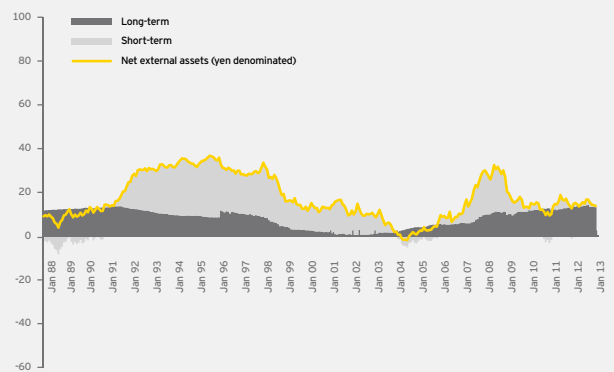


Figure 1: Japanese financial institutions: global ranking and expansion overseas

companies, banks also extensively established branches and subsidiaries abroad in major financial hubs, such as London and New York [Nolle and Seth (1996)]. The expansion was partly driven by strong growth in Japan, sizeable FDIs of Japanese corporations, yen appreciation and the need for diversifying bank lending. Following the bursting of asset bubbles in 1990, banks had to scale back their foreign claims or sold off foreign assets. External bank assets declined by more than 20% from the peak.

Japanese banks increased foreign lending to Asia again in the mid-1990s, in part to take advantage of the rapid growth in the region. Those loans were often denominated in foreign currency related to investment projects in the region. Following the Asian financial crisis, Japanese banks, however, incurred sizeable valuation losses and their nonperforming loans (NPL) rose sharply, forcing them to recede on overseas lending. External bank assets fell by about 40% in two years (Figure 1). Overseas losses, on top of domestic problems, had contributed to the subsequent banking crises in Japan that lasted until early 2000s. The banking crises have resulted in significant restructuring and consolidations that gave rise to a concentrated market, with a few megabanks in the form of financial groups, securities firms and life insurers.<sup>3</sup>

Overseas activities by Japanese financial institutions has risen again since 2005 despite the temporary decline during the peak of the global financial crisis. Japanese banks have also broadened their financing to non-Japanese entities and local demand. Recent developments and the factors contributing to the rise will be discussed in the next section.

Despite the rise and fall of overseas activities, net external assets for Japanese banks have been on an increasing trend over the last decades. This possibly suggests a change of funding source on overseas activity. In the years leading up to the Asian Financial crisis, Japanese banks have relied on foreign-currency financing that created a net liability position. Over time, Japanese banks have accumulated net external foreign assets while the short-term liabilities have remained stable, implying that banks have increasingly financed long-term overseas loans with domestic yen-denominated funds.

<sup>3</sup> Their asset sizes are among the largest global financial institutions.

(in percent)	Year-on-year growth	Cumulative growth from 2005-08	Cumulative growth since end-2008	Share of total consolidated claims
All countries	0.1	72.6	37.0	100.0
Europe, of which:	10.8	83.3	2.5	25.4
Peripheral European countries	-1.2	73.8	-22.5	2.8
Core European countries	15.1	88.6	7.0	17.0
United States	8.1	67.0	42.1	43.6
Asia Pacific, of which:	13.4	124.1	102.9	15.9
Advanced	17.2	126.9	105.6	9.9
Emerging	7.6	119.5	98.7	5.9
Offshore centers	4.4	19.2	62.4	12.4

**Table1: Cross-border consolidated foreign claims of Japanese banks**

Source: BIS.

1. As of September 2012.

2. Peripheral European countries include Italy, Ireland, Greece, Portugal and Spain.

3. Core European countries include France, Germany, Switzerland and the U.K.

### Recent developments in overseas activities

Japanese financial institutions have increased their overseas activities, mainly through takeovers and lending, subsequent to the global financial crisis, mostly in the Asian region. Stagnant domestic growth, relative resilience of Japanese banks through the global financial crisis and strong growth in Asia have contributed to the expansion abroad.

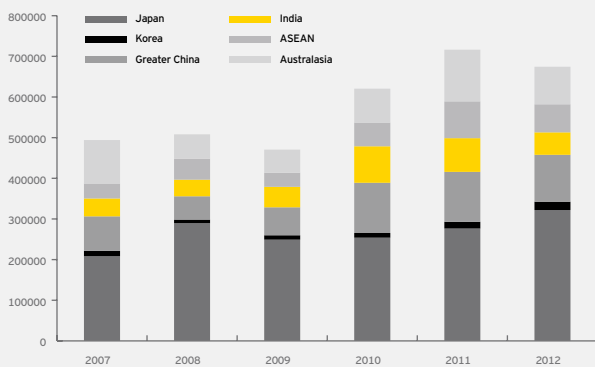
### Banking sector

Japanese banks have increased their cross-border activities, mostly to the Asian region. Cross-border consolidated claims of Japanese banks abroad have increased since 2005 and reached almost U.S.\$3t (about 15% of total banking and trust assets), according to the Bank of International Settlement (BIS). Claims on Asia have more than doubled since the global financial crisis (now accounting for about 16% of total foreign consolidated claims), and is now at levels comparable to the 2005-08 period. Exposures to Europe, however, have significantly slowed after the global financial crisis (Table 1 and Figure 1). A large share of the rising foreign claims is attributed to growing overseas loans by major banks. Overseas loans account for about 15%-20% of the total outstanding loan balance as of September 2012, with the lending activity to Asia being the strongest.



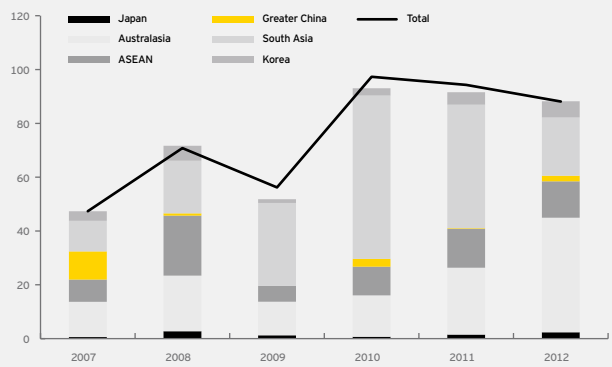
### Syndicated loans in Asia (in millions of USD)

Sources: Dealogic and Thompson One



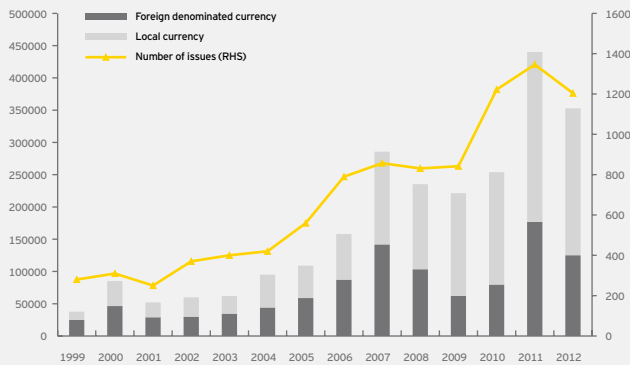
### Project finance in Asia (in billions of USD)

Sources: Dealogic and Thompson One



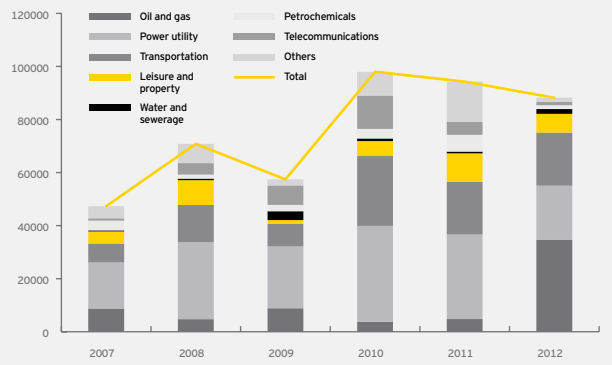
### Syndicated loans in Asia (ex Japan) (in millions of USD unless otherwise stated)

Sources: Dealogic and Thompson One



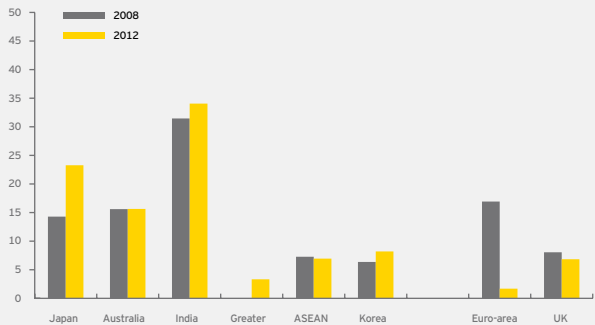
### Project finance in Asia, by industry (in millions of USD)

Sources: Dealogic and Thompson One



### Project finance in Asia Pacific (ex Japan) by the nationality of parent banks (in percent of the proceeds of top 25 mandated arrangers)

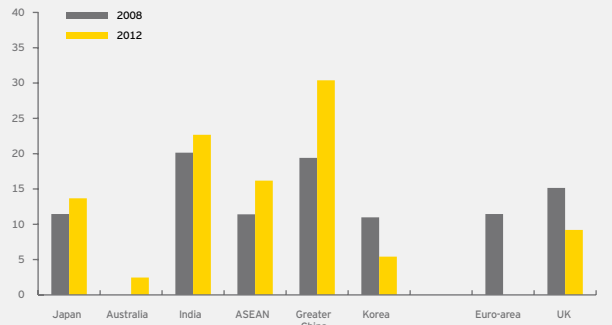
Sources: Dealogic and Staff estimates



1. Based on the nationality of parent mandated arrangers in percent of the proceeds for top 25 mandated arrangers.

### Syndicated loans in Asia Pacific (ex Japan) by the nationality of parent banks (in percent of proceeds of top 25 mandated arrangers)

Sources: Dealogic and Staff estimates



1. Based on the nationality of parent mandated arrangers in percent of the proceeds for top 25 mandated arrangers.

Figure 2: Project finance and syndicated loans in Asia and the role of Japanese banks

Japanese banks expanded their overseas network through various forms of ownership. Besides setting up local branches and subsidiaries, banks have sought the expansion of customer base and business functions through business alliances and investments in overseas financial institutions, and exploiting different forms of ownership structures tailored to local markets (e.g., financial holding company in the United States, bank subsidiary in China). The expansion abroad has placed Japanese banks among the key players in regional and global syndicated loans and project finance (Figure 2). Megabanks have stepped up project finance and syndicated loans business, particularly in Asia, because of their strong balance sheets and long-term approach in lending. Besides interest income on lending, banks also earn fees from arranging and underwriting deals. In Asia, syndicated loans are often raised in local currency and by multiple banks across a number of countries, thereby requiring a sound financial base for the lead banks. Project finance is largely related to financing infrastructure projects such as utilities, transportation and communications. The three megabanks in Japan have been increasing their participations in these markets, particularly following the exit of European banks (Tables A1 and A2 in the Appendix).

The performance of overseas lending among major Japanese banks has been stronger in several ways compared to their domestic lending. Overseas gross profits now account for about 30% of total gross profits (about half of which arise from net interest income). Net interest margins for overseas loans have improved after the global financial crisis and exceeded those for domestic loans. As megabanks have been cautious in lending abroad to firms with established credit history, credit risks on overseas loans are moderate. The average risk-monitored loans ratio for overseas lending was about 0.7% as of September 2012, much lower than that on domestic lending (about 2%). Syndicated loans underwritten by Japanese major banks to established foreign firms usually have high investment ratings and, therefore, relatively low credit risks. Those loans to firms in emerging markets are relatively small as a proportion of the overall overseas lending (less than the global average in proportion), and about one-fifth of the syndicated loans have covenants that limit credit risks. Although project finance could be more risky because of the longer duration, it is usually backed by underlying

infrastructure assets.<sup>4</sup> At the margin, overseas loans therefore appear more profitable in general but are associated with less risk.

Nonetheless, overseas expansion also brought new risks. Foreign currency and maturity mismatches are likely to rise going forward as the long-term funding base in Japanese banks has fallen short of total external loans. Japanese banks extend most overseas lending in U.S. dollar and in long maturity for which they do not have a natural funding base. These create dollar funding risks and add to the maturity mismatch in foreign lending. Major banks have increased their local deposit base (e.g., corporate deposits) – accounting for about half of the funding base – but it still falls short of the total external loans. Banks, therefore, rely on short-term financing sources, such as yen-dollar basis and currency swaps, that are subject to volatility, and by issuing foreign exchange-denominated bonds. The loan-to-deposit ratio for overseas loans continues to exceed 100% (compared to the loan-to-deposit ratio for domestic loans of about 70%), potentially contributing to funding risks. Funding cost and availability depend on credit ratings, which also affect prospects of securing certain lines of business. In the event of credit downgrades, funding costs could rise substantially and the loss of certain lines of business precipitate initial difficulties.

#### **Nonbank sector: life insurers and securities firms**

The trend of expanding abroad is not limited to Japanese banks only. Major life insurers have begun to strengthen their overseas business, especially in Asia, by acquiring or affiliating with local insurers for long-term profitability.<sup>5</sup> They usually expand via incremental capital and building alliances, typically involving minority stakes rather than aggressive acquisitions. To gain competitiveness in local markets, they broaden the range of products and services (e.g., medical insurance) and increasingly rely on more efficient distribution channels (e.g., selling through banks “bancassurance”).<sup>6</sup> To date, as the majority of overseas investments are minority interests, the risk and return from overseas business for major life insurers tends to be modest.

<sup>4</sup> According to the Bank of Japan, default rates on selected overseas loans ranged from 0.4-1.3 percent, much lower than the respective loan margins (Financial System Report Chart III 3-11). Banks are relatively cautious in choosing overseas loan extension and setting loan conditions.

<sup>5</sup> As life and nonlife insurers tend to lower their weight of their stockholdings, they are likely to reinvest these funds in overseas mergers and acquisitions.

<sup>6</sup> “Bancassurance” accounts for about 35-70 percent of new business premium in Asia.

Despite the recent setback in global operations, leading Japanese securities firms sought to counter diminishing prospects by expanding overseas. Outward FDIs on financial services (banks and insurers) surged in 2008 on the account of Nomura Holdings, a securities firm, acquiring the European arms of Lehman Brothers. The market share of the leading Japanese securities firms outside Japan is relatively limited in most areas such as financial advisory roles in mergers and acquisitions, capital market issuance and underwriting [Thomson Reuters (2012)]. This is because of limited expertise in executing services outside Japan, and relatively higher funding costs on foreign-currency instruments than other leading global peers, possibly due to lower credit ratings.

#### Factors contributing to increasing cross-border activity

Several domestic and regional factors have contributed to the increasing trend of overseas activity among Japanese financial institutions. First, limited domestic opportunities have forced major Japanese banks to look for opportunities and expand overseas. Credit demand was sluggish in the past few years due to stagnant growth, though it has picked up recently. Large corporations have limited funding needs as they accumulated sizeable surpluses (rising to about 6% of GDP).<sup>7</sup> Structural factors – such as high leverage among SMEs, aging population and sluggish growth in Japan's regions – have limited domestic opportunities. At the same time, low interest rates have persisted for a decade but lingering deflation has limited the decline of real interest rate to sufficiently stimulate credit demand. Shrinking net interest margin on loans (about 0.6%-1.2% now relative to about 1.2%-2.1% in early 2000s) tends to limit banks' core profitability as interest income accounts for more than two-thirds of banks' total income.

In addition, major banks have remained resilient during the global financial crisis and have the capacity to take on more foreign exposures. They have abundant yen liquidity supported by a stable deposit base, and have further strengthened their capital adequacy (Tier-1 ratio at 12%) after the global financial crisis, in part to meet the Basel III requirements. The resilience of the

<sup>7</sup> Estimates suggest that business capital expenditures for fixed investments only account for less than 30 percent of the total credit demand. External financing through capital increases has been negative (on average about ¥5 trillion per year) for the past decade due to weak equity markets. Bank lending has somewhat picked up recently, reflecting reconstruction and housing loans demand.

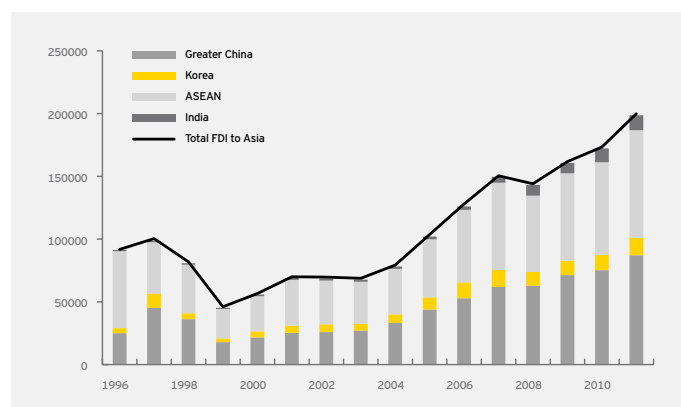


Figure 3: Outward FDI to Asia (in 100 millions of yen)

Source: Haver

balance sheets of Japanese banks has placed them in a better position to further expand overseas, despite lingering global uncertainty. The exchange rate has appreciated until recently, which may offer an additional incentive for expanding abroad.

Regarding regional and global factors, robust growth and large financing needs in Emerging Asia offer new business opportunities for Japanese banks. Japan's proximity to the rest of Asia is an advantage. Major banks have also benefited from the increasing outward FDI and trade links of Japanese firms. Financing needs for infrastructure in Emerging Asia are large (about US\$8t), according to the Asian Development Bank. These generate demand for cross-border financial activity between Japan and various FDI destinations (Figure 3). Moreover, the deleveraging of European banks since 2010 has accelerated the pace of overseas expansion. Japanese banks, among other local Asian banks, have stepped up financing to gain market share against the scaling back of European banks in the region.

The current trend of overseas expansion appears to have some differences from previous episodes, though new challenges are likely to emerge. In the past, Japanese banks have largely expanded abroad to support the corporate expansion of Japanese firms. But over the past few years, financial institutions have also moved toward extending loans to non-Japanese entities, now reaching 70% of overseas loans. Second, over time Japanese banks have accumulated net external foreign assets while the short-term

liabilities have remained stable. While part of the increase is attributed to higher foreign assets held by trust banks, the increase may suggest that banks have relied on domestic yen-denominated funds to finance long-term overseas loans.

#### Empirical analysis in cross-border activity of Japanese banks

To analyze the role of these factors in contributing to the rising cross-border bank lending, the paper conducts an empirical analysis to assess determinants of banks' overseas expansion. The analysis also provides insights into whether the current trend is different from previous episodes. Several other studies also looked into the factors contributing to cross-border banking [Shirota (2013), and Focarelli and Pozzolo (2005)] through factor analyses and institutional features.

The empirical analysis here uses the quarterly consolidated year-on-year growth of foreign claims on an immediate-borrowers basis published by the Bank of International Settlement (BIS). The sample is from 1984 to 2012, spanning across a panel of banking systems consisting of both origination and destination of cross-border claims. The origination countries/regions are mostly advanced economies, including Australia, Japan, France, Germany, Italy, Switzerland, Sweden, the U.K., the U.S., and developed Europe. The destination countries or regions include emerging Asia (China, India, ASEAN 5), developing Europe, and Latin America. The foreign claims (FC) are in U.S. dollar terms and are subject to valuation changes driven by exchange rate movements, which could be partly controlled by including the weighted exchange rates as an explanatory variable.<sup>8</sup> The explanatory variables are broadly classified into three categories with the specification as follows:

$$FC_{i,t} = \beta_0 + \gamma_{i,j} + \beta_1^{\bullet} FC_{i,t-1} + \beta_2^{\bullet} GF_t + \beta_3^{\bullet} RF_t + \beta_4^{\bullet} HF_t + \epsilon_{i,t}$$

where  $i$  and  $j$  stand for origination and destination countries/regions of foreign claims, respectively. A fixed effect coefficient  $\gamma_{i,j}$  is included for each group. The explanatory variables include:

- ▶ **Global factors (GF)** - consisting of the VIX index, and the Fed Fund rate.

- ▶ **Regional factors (RF)** - consisting of growth differentials and real effective exchange rate movements between destination and origination countries/regions. The regression also considers alternative indicators of growth differentials using the change of fixed investments.
- ▶ **Home factors (HF)** - consisting of domestic interest rates, real effective exchange rates, growth of domestic credit to GDP ratio, several indicators for the soundness of the banking systems in origination countries/regions that include Tier-1 capital ratios, nonperforming loan ratios and the return on assets.

The empirical results underscore the role of various factors in contributing to the growth of banks' foreign claims in Japan and other advanced countries (Table 2). First, higher global uncertainty (measured by the VIX index) tends to reduce banks' activities abroad, though the net adverse impact on Japanese banks is relatively less than other countries. Second, in terms of regional factors, interest rates at the destination, as a proxy for the tightness of financing conditions, also play some role. Third, the growth differential is also an important driver for banks' foreign claims. For instance, a 1percentage-point increase in the real growth differential could increase the foreign claims by about 0.3-1.6 percentage-points. While a currency appreciation in the origination countries tends to increase banks' activity overseas, the coefficients are not statistically significant across all specifications. Regarding home factors, higher domestic credit growth is generally associated with slower growth overseas, possibly suggesting some substitution in banks when extending credit between home and abroad. Moreover, the soundness of banking systems at home is statistically significant in banks' overseas activities. Stronger banks' balance sheets, such as higher capital adequacy ratios and lower nonperforming loan ratios, are often associated with higher cross-border activity.

The empirical results also provide insights into whether the current trend would continue, and how it may be affected by the new policy framework in Japan. Applying the estimated results to Japan would imply that global and regional factors play a key role in explaining the rise of foreign claims. As an illustration, Japanese banks' foreign claims on Asia have grown by 103% since the end of 2008, of which about 40 percentage-points is attributed to a decline in global uncertainty, as proxied by the VIX index, while regional factors contributed another

<sup>8</sup> Including the exchange rate as an explanatory variable controls partly for valuation changes in the BIS data. Strictly speaking, the exchange rate to be included should reflect the composition of foreign claims of origination countries/regions. By using the real effective exchange rate based on external trade weights as a proxy would imply an assumption that those weights are identical to those of foreign claims composition.

Dependent variable: Foreign claims (year-on-year percentage change $(i,j)$ )				
Origination	Specification			
	European banks only	All	All	All
Destination countries/regions	All (1)	All (2)	Grouped by regions excluding China (3)	Grouped by regions (4)
Fixed effects $(i,j)$	Y	Y	Y	Y
Constant	<b>171.1<sup>a</sup></b> (54.8)	<b>127.6<sup>a</sup></b> (40.9)	49.7 35.2	<b>65.60<sup>c</sup></b> (38.1)
Lagged foreign claims (yoy pct. change)	<b>0.45<sup>a</sup></b> (0.05)	<b>0.48<sup>a</sup></b> (0.04)	<b>0.58<sup>a</sup></b> (0.61)	<b>0.58<sup>a</sup></b> (0.05)
<b>Global factors</b>				
Lagged VIX index	<b>-1.01<sup>a</sup></b> (0.21)	<b>-0.70<sup>a</sup></b> (0.21)	<b>-0.44<sup>a</sup></b> (0.15)	<b>-0.63<sup>a</sup></b> (0.18)
Lagged U.S. Fed-fund rates	<b>0.27<sup>b</sup></b> (0.09)	<b>0.17<sup>b</sup></b> (0.08)	<b>0.15<sup>b</sup></b> (0.09)	<b>0.17<sup>b</sup></b> (0.06)
<b>Regional factors</b>				
Real growth differential $(i,j)$	0.78 0.69	<b>1.66<sup>b</sup></b> (0.73)	0.59 0.48	<b>1.02<sup>b</sup></b> (0.56)
dln (REER differential $(i,j)$ )	-4.62 3.80	-7.32 8.00	-7.27 5.32	-5.27 4.95
Interest rates (j)	-	<b>1.19<sup>c</sup></b> (0.64)	-1.16 1.86	-1.06 1.54
<b>Home factors</b>				
Interest rates (i)	-1.08 1.09	-	-	-
Lagged domestic credit/GDP (i)	<b>-24.2<sup>b</sup></b> (11.0)	<b>-18.6<sup>b</sup></b> (8.8)	-2.32 8.15	-6.63 8.26
Soundness of banking system (i)				
Capital adequacy (Tier 1 ratio)	<b>17.45<sup>a</sup></b> (4.51)	<b>13.05<sup>b</sup></b> (5.04)	<b>8.8<sup>*</sup></b> (4.9)	<b>10.02<sup>c</sup></b> (5.09)
Nonperforming loans ratios	<b>-7.57<sup>a</sup></b> (2.05)	<b>-5.5<sup>b</sup></b> (2.6)	<b>-5.77<sup>a</sup></b> (1.3)	<b>-4.3<sup>b</sup></b> (1.9)
Returns on assets	-15.6 (18.6)	20.8 (17.4)	<b>17.5<sup>*</sup></b> (10.3)	<b>22.4<sup>c</sup></b> (13.3)
R-squared	0.40	0.36	0.49	0.49
Number. of observations	535	863	389	496
Number of origination countries or regions	5	9	9	9
Number of destination countries or regions	7	7	3	4

**Table 2: Empirical analysis on bank's foreign claims 1/ 2/**

Source: author's estimates.

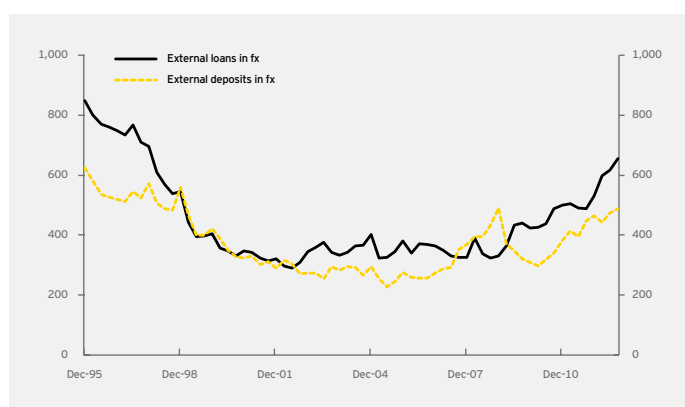
1. Notation i and j refer to origination and destination countries or regions of the foreign claims, respectively.

2. "a," "b," and "c" denote the statistical significance at 1%, 5%, and 10%, respectively.

20–25 percentage-points. Regarding home factors, the resilience of the Japanese major banks, particularly the strengthening of capital adequacy and low NPLs during the global financial crisis, contributed to about one-third of foreign claims growth. The substitution between domestic and foreign credit contributed modestly, by about 5 percentage-points.

### Outlook and policy implications

Expansions abroad by Japanese financial institutions is welcome, though a gradual and cautious approach in overseas strategies is warranted. Financial institutions' expansion overseas helps improve their profitability by better allocating their liquidity and developing local markets in the Asian region. Banks may also favor a gradual expansion to maintain their balance sheets under



**External foreign currency-denominated loans and deposits of Japanese banks vis-a-vis all sectors**

(In USD billion)

Source: BIS Locational Banking Statistics Table 7.

the global regulatory reform agenda (e.g., Basel III requirements). A rapid expansion could lead to buying foreign assets at high prices or entering unfamiliar local markets that could eventually result in heavy losses, as was the case in the late 1980s and 1990s.

Higher overseas exposures may add to funding risks that would require continued close monitoring by supervisory authorities. Securing stable and long-term dollar funding has remained a risk for Japanese financial institutions. Supervisors should encourage banks to further improve their resilience against shocks by strengthening their funding sources and risk management, such as by closely monitoring the overseas maturity mismatch and foreign currency-denominated loans-to-deposits ratios. At the same time, overseas activities add to the challenges of cross-border supervision of financial institutions. Cross-border risk monitoring arrangements with foreign supervisory authorities can help monitor risks from cross-border activities, including foreign exchange funding risks. In that regard, the supervisory agencies in Japan have signed the Multilateral Framework for sharing information on global systemically important banks (G-SIBs) collected through the FSB Data Gap Initiatives in early 2013 based on discussions at the Financial Stability Board (FSB).

According to the empirical results, the key determinants for Japanese banks to expand abroad are mostly driven by global and regional factors. Policies under Abenomics would mostly affect domestic outlook and exchange rates [IMF (2013)] in exiting deflation and lifting growth. Successful policies may also reinforce the trend of going overseas by financial institutions if there are positive spillovers globally and to the region. Recovery in domestic opportunities may slow the expansion pace but empirical estimates suggest that the substitution effect between domestic and overseas lending contributed modestly to the trend (about 5% in the growth of foreign claims in Japan).

Ensuring a complete package of Abenomics would be important for financial stability. An incomplete set of policies that fails to raise growth and reverse the rising public debt-to-GDP ratios, however, could pose risks for domestic financial stability, which could have implications for foreign exposures, as was the case in the late 1980s and in the early 2000s.

### Conclusions

Cross-border activities of Japanese financial institutions have increased over the past few years, particularly in the Asian region. The relative resilience of Japanese banks during the global financial crisis has allowed them to take on further foreign exposures. Stagnant growth and low interest margins in Japan have added to incentives to seek opportunities abroad. Outside Japan, higher growth in Asia and deleveraging of European banks in the region also contributed to a rise in cross-border lending. The recent expansion has, in some aspects, been broader than previous overseas expansion waves of the mid 1980s and 1990s. Japanese financial institutions have broadened their funding sources and extended finance not only to Japanese corporates abroad but also to local firms.

As the global recovery takes hold and growth in Asia is expected to remain robust over the medium term, Japanese banks will likely continue the trend. Stronger domestic growth in Japan could slow the pace, but is unlikely to reverse a long-standing trend, because empirical estimates suggest that global and regional factors play a more prominent role in the growth of Japanese cross-border claims. An incomplete set of policies under Abenomics, however, could pose risks for financial stability that could halt overseas expansion.

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But higher overseas exposures may add to funding risks that would require continued close monitoring by supervisory authorities. Securing stable and long-term dollar funding has remained a risk for Japanese financial institutions. At the same time, overseas activities add to the challenges of cross-border supervision of financial institutions. Overseas expansion by Japanese financial institution is welcome, but would warrant a gradual and cautious approach in light of earlier episodes in the late 1980s and 1990s.

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Appendix 1

Top 25 mandated arrangers	2012	2011	2010	2009	2008	2007	2012	2011	2010	2009	2008	2007
Parent nationality	Distribution in each region (numbers)						Total amount of proceeds (in USD m)					
Asia Pacific	21	20	21	14	16	15						
<b>Japan</b>	<b>5</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>3</b>	13,596	7,479	3,540	4,538	7,392	-
Australia	4	4	4	4	4	4	9,138	12,892	5,198	6,748	8,077	-
India	5	8	7	4	4	5	19,897	42,597	52,063	28,352	16,279	-
Greater China	2	2	3	0	0	0	1,946	1,886	14,743	-	-	-
ASEAN	4	1	3	2	3	3	4,061	1,616	2,298	1,419	3,767	-
Korea	1	2	1	1	2	1	4,788	4,539	1,855	603	3,294	-
Europe	4	5	4	11	9	9						
<b>Eurozone</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>9</b>	<b>7</b>	<b>6</b>	985	1,678	2,379	6,833	8,757	-
U.K.	3	3	2	2	2	3	3,994	3,440	816	1,110	4,172	-
Others	-	-	-	-	-	1						-
Total	25	25	25	25	25	25	88,119	91,317	97,511	56,422	56,422	
Asia Pacific	Average ranking 1/						Amount of proceeds (in percent of industry total)					
<b>Japan</b>	4	11	16	10	8	21	15	8	4	8	13	-
Australia	11	8	12	8	12	9	10	14	5	12	14	-
India	8	5	4	5	15	10	23	47	53	50	29	-
Greater China	22	22	15	-	-	-	2	2	15	-	-	-
ASEAN	17	23	16	22	15	-	5	2	2	3	7	-
Korea	3	15	7	18	6	2	5	5	2	1	6	-
Europe												
<b>Eurozone</b>	20	22	20	14	16	13	1	2	2	12	16	-
U.K.	16	19	22	22	19	19	5	4	1	2	7	-
Others	-	-	-	-	-	-						-
Total												

Table A1: Project finance in Asia by top mandated arrangers, by parent nationality

1. Average for top arrangers that were among the top 25 list for at least two consecutive years.



<b>Top 25 Mandated Arrangers</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>
Parent Nationality	Distribution (numbers)					Total amount of proceeds (in USD m)				
Asia Pacific	23	19	21	19	19					
<b>Japan</b>	3	3	3	3	3	24,419	26,323	18,170	7,839	14,749
Australia	1	1	1	1	-	4,378	5,680	4,514	1,878	-
India	4	4	5	3	4	40,488	50,725	63,822	37,999	25,946
ASEAN	5	6	3	3	3	28,893	36,233	16,089	11,085	14,700
Greater China	9	4	9	9	6	54,256	31,773	63,762	33,502	24,996
Korea	1	1	-	-	3	9,672	5,002	-	-	14,145
Europe and N. America	2	6	4	6	6					
<b>Eurozone</b>	<b>0</b>	<b>2</b>	<b>2</b>	<b>3</b>	<b>3</b>	-	7,614	9,610	6,310	14,763
U.K.	2	3	2	3	3	16,426	28,470	20,270	9,130	19,519
U.S. and Canada	-	1	-	-	-	-	5,706	-	-	-
Total/industry total	25	25	25	25	25	260,594	299,211	281,191	160,773	198,952
	Average ranking 1/					Amount of proceeds (in percent of industry total)				
Asia Pacific										
<b>Japan</b>	7	7	10	15	11	9	9	6	5	7
Australia	17	15	18	20	-	2	2	2	1	0
India	13	10	8	5	16	16	17	23	24	13
ASEAN	14	15	15	10	12	11	12	6	7	7
Greater China	17	14	18	13	17	21	11	23	21	13
Korea	3	17	-	-	13	4	2	0	0	7
Europe and N. America										
<b>Eurozone</b>	-	22	15	19	12	0	3	3	4	7
U.K.	7	11	6	13	6	6	10	7	6	10
U.S. and Canada	-	14	-	-	-	0	2	0	0	0

**Table A2: Syndicated loans in Asia Pacific (ex Japan) by top mandated arrangers, by parent nationality**

1. Average for top arrangers that were among the top 25 list for at least two consecutive years.

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