Daiwa Securities

Daiwa's View

Pandemic-led change in banks' balance sheets and JGB market

- Compared to pre-pandemic levels, banks' balance sheets have expanded rapidly with higher exposure to interest rate risk
- Interest rate risk shock can easily occur during recovery from an economic crisis
- Given change in stance at overseas central banks and end of BOJ governor's term slated for next year, JGB market participants also needs to adopt risk management perspective

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Pandemic-led change in banks' balance sheets and JGB market

Balance sheets at Japanese banks increased by 17% vs. pre-pandemic levels (end-2019)

Triggered by the COVID-19 pandemic, balance sheets at Japanese banks have changed substantially. Total assets as of end-November 2021 stood at Y1,331tn, up 17% or Y202tn from pre-pandemic December 2019. This was mainly due to the following factors on the liability side: (1) an inflow of deposits (up Y109tn) related to subsidies and cash payout under the pandemic programs and (2) a Y75tn increase in borrowings from the BOJ owing to aggressive utilization of COVID-19 special operations. On the other hand, loans on the asset side increased by only Y34tn. Procured funds were allocated mostly to cash and due from banks (up Y119tn), which appear to be mainly deposits at the BOJ's current accounts, and also to investment securities (up Y28tn).

Regional financial institutions saw an increase in interest rate risk exposure in line with balance sheet expansion

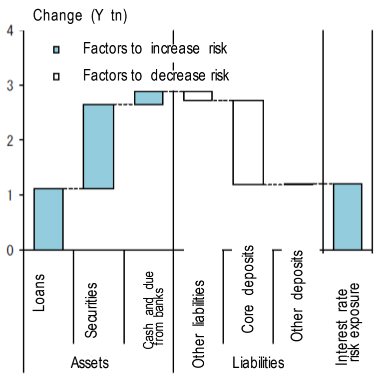
On 27 January, the BOJ released a report in Japanese about balance sheet operations at regional financial institutions during the pandemic in the Financial System Report Annex Series. The difference in their balance sheets before and after the pandemic is largely proportionate to that at domestic banks. The total of deposits and borrowings from the BOJ increased by Y90tn, while loans increased by only around Y20tn, with an increase in cash and due from banks as well as securities. With the increase in loans and securities, interest rate risk exposure is increasing with the banking accounts. Of note is that the increase in core deposits, one liability item, is contributing to a decline in interest rate risk. Deposits have sharply increased during the pandemic, and we need to monitor how much money will remain in deposits.

Balance Sheets at Japanese Banks as of Nov 2021 (vs. Dec 2019, Y tn)

Assets	1,331	202	Liabilities	1,280	206
Cash and due from	363	119	Deposits	909	109
Investment securities	244	28	Borrowings from BOJ	114	75
Central governr	87	7			
Municipal bond:	27	7			
Corporate bond	31	1			
Stocks	14	-5			
Foreign securiti	64	12			
Loans and bills discc	558	34	Stockholders' equity	51	-4

Source: BOJ; compiled by Daiwa Securities.

Change in Interest Rate Risk Exposure in Banking Accounts (regional financial institutions)



Source: BOJ; compiled by Daiwa Securities
Notes: (1) Change from end-Mar 2020 to end-Jun 2021.
(2) Universe consist of regional banks and shinkin banks.

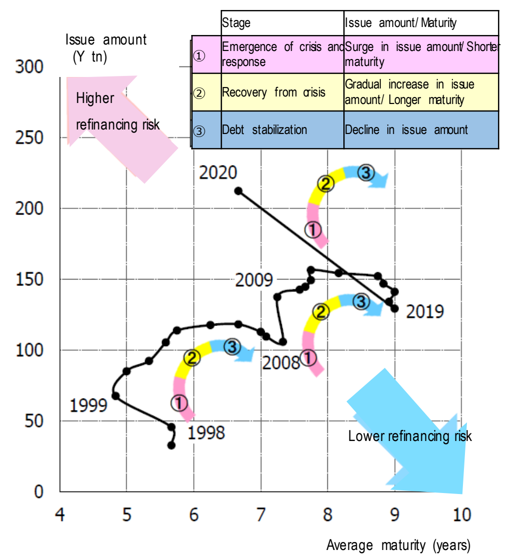
Interest rate shocks during recovery from crises noted at the Advisory Council on Government Debt Management

At the 53rd round of the Advisory Council on Government Debt Management held by the Ministry of Finance in November 2020, council member Shigeru Yoshifuji, senior managing executive officer of MUFG Bank, noted points to keep in mind regarding lengthening of debt composition in JGB issuance as well as investors' risk tolerance. During economic crises, such as the financial crisis in the 1990s and the global financial crisis in 2008, the scale of JGB market issuance increases due to large-scale fiscal spending. As it is difficult to substantially increase superlong JGBs in a single fiscal year, JGB issuance is mainly increased through short-term/intermediate JGBs, leading to shortening of the average maturity for debt procurement ('emergence of crisis and response'). Meanwhile, during the recovery from the crisis, the issuance of long-term/superlong JGBs increases in order to lengthen the redemption maturity ('recovery from crisis'). Yoshifuji noted that if interest rate risk exposure at financial institutions were high in these situations, a sudden rise in interest rates would be easily induced. The rise in interest rates and high volatility after the VaR shock in 2003 and the Kuroda bazooka in 2013 were given as concrete examples. Recently, due to the influence of COVID-19 measures, calendar-based market issuance in FY20 exceeded Y200tn for the first time. Issuance of Y198tn is expected in FY22, as well, with the average maturity of issued bonds lengthening due to further issuance of 40-year JGBs. Potential risk may be increasing during the period of recovery from the pandemic.

Given changes in monetary policy, JGB market participants will likely need to adopt a risk management perspective

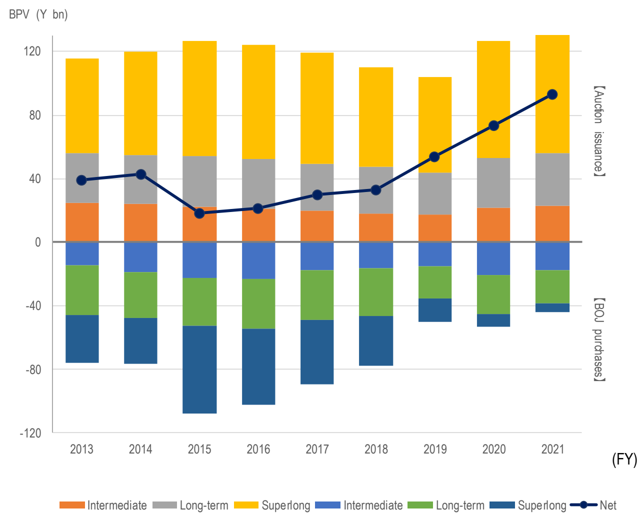
The JGB market saw a rise in volatility due to a change in actions at the central bank, such as large-scale easing in 2013 and the introduction of negative interest rates in 2016. Since the introduction of the yield curve control (YCC) policy in September 2016, the market has enjoyed low volatility under the stable interest rate policy, except for during the pandemic. However, with the Fed gradually turning into an 'inflation fighter,' led by Chair Jerome Powell, the situation has changed substantially. In Japan, as well, with the end of BOJ Governor Haruhiko Kuroda's term in April 2023 approaching, various speculation has emerged regarding issues such as the possibility of the YCC target being shifted to a shorter maturity and revisions to forward guidance. Financial institutions' balance sheets, which have expanded rapidly due to the pandemic, entail an interest rate risk. Furthermore, the BOJ has been reducing purchases of supelrong JGBs in reverse proportion to the lengthening of the maturities of JGBs issued. Accordingly, interest rate risk exposure, which is supplied in the market, tends to increase. This year, it appears likely that JGB market participants will need to adopt a risk management perspective.

JGB Market Issuance and Average Maturity (flow)



Source: MOF materials; compiled by Daiwa Securities.

JGB Issuance and BOJ Purchases (simple conversion to interest rate risk exposure)



Source: MOF, BOJ; compiled by Daiwa Securities.
Note: Actual results up to Dec are proportionally allocated for FY21 data.

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