Recent Banking Sector Reforms in Japan

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During the past year, in which major reforms to deal with the country's financial system problems were undertaken, the Bank of Japan focused on two tasks. The first was the establishment of a framework in which a bank failure could be handled in a flexible way with minimum negative impact on the stability of the financial system. It was thought essential to introduce a framework that could maintain the franchise value of a problem bank. This was particularly important for dealing with the failure of a bank like Long-Term Credit Bank of Japan (LTCB), which had an international presence and whose failure thus had systemic implications for the global financial system: as of the end of March 1998, LTCB had outstanding ¥51.5 trillion notional principal in derivatives transactions, which were typically cross-border. The second was to maintain the framework of capital injection using public funds. The Bank of Japan has argued that the core of Japan's financial system problems is the undercapitalization of many, if not all, Japanese banks. It was quite natural that an accelerated, accumulated charge-off of bad loans after the bursting of the bubble in the early 1990s ended up eating up the capital account of a bank. As banks' profitability and access to private capital markets were limited, public funds were almost the only source of money to immediately strengthen the capital position of viable banks.

Diet discussions produced two significant pieces of legislation: the Law Concerning Emergency Measures for the Reconstruction of the Functions of the Financial System, and the Financial Function Early Restoration Law. An outline of these laws is shown in Figure 1. The Law Concerning Emergency Measures for the Reconstruction of the Functions of the Financial System (commonly referred to as the Financial Reconstruction Law) is a useful framework within which the authorities can deal with a failed bank without necessarily finding a sound receiving bank

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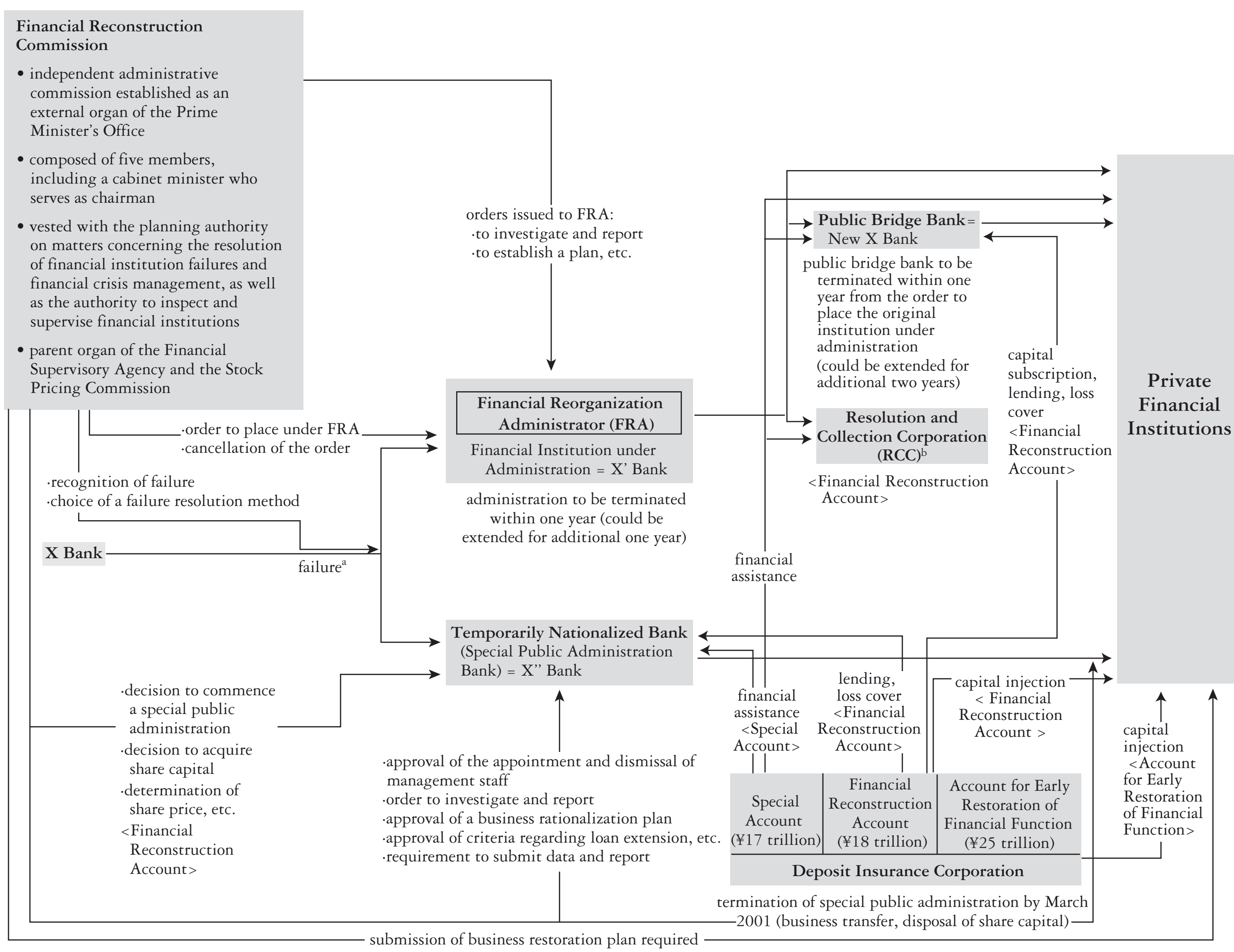
beforehand. LTCB was nationalized under the Financial Reconstruction Law. Under the framework, everything, including loss coverage and daily funding of a nationalized bank, is covered by the Deposit Insurance Corporation (DIC) in order to maintain the franchise value of the bank and to clean up its balance sheet. Throughout the temporary nationalization, until a sound receiving financial institution is found, the bank continues to provide its financial services while fully meeting its liabilities.

The new capital injection framework under the Financial Function Early Restoration Law has available ¥25 trillion of public funds. The primary objective of the capital injection was to restore confidence in Japanese banks and thus in the financial system as a whole. There may be various reasons for the lack of confidence in banks. For example, unrealized capital losses from securities holdings were not deducted from capital in calculating the capital ratio. Although this practice is justifiable as long as a bank adopts "original cost accounting standards," the figures are publicly disclosed and market players could easily calculate the "effective capital ratio" by subtracting the unrealized losses from the capital position of a bank.

Figure 1

THE FRAMEWORK OF THE FINANCIAL RECONSTRUCTION LAW AND THE FINANCIAL FUNCTION EARLY RESTORATION LAW



[a]Temporary nationalization (special public administration) can be applied to a financial institution in danger of failure.
[b]RCC is authorized to purchase assets from financial institutions under administration, bridge banks, special public administration banks, and other financial institutions.

Furthermore, charge-offs and provisioning of Japanese banks were regarded as generally insufficient. Against this background, the Financial Reconstruction Commission (FRC) decided to take these two points into account in calculating the required capital for fifteen major banks. As shown in Tables 1 and 2, the total amount of public capital injected is ¥7.5 trillion. Of this, ¥6.2 trillion is in the form of preferred stock. The unrealized capital losses for the fifteen major banks as of September 1998 stood at ¥2.7 trillion. The amount of nonperforming loans to be disposed of as of the end of March this year stands at ¥9.0 trillion. This figure is based on the new guideline established by the FRC. Specifically, loans to borrowers who are judged "close to bankruptcy"—loans almost equivalent to the so-called grade III loans have to be written down by around 70 percent. Meanwhile, the substandard portion of any loan to a "marked" borrower, which includes past-due and restructured loans, is to be written down by around 15 percent. Other loans to a marked borrower should be written down by appropriate provisioning rates based on historical losses. (Thus, grade II loans are also to be appropriately disposed of.) Given the net core operating profit of ¥2.5 trillion, the total scale of capital injection—amounting to ¥9.5 trillion, including ¥7.5 trillion of public funds—is sufficient to cover both the unrealized capital losses from securities

Table 1
AMOUNTS AND TERMS OF THE CAPITAL INJECTION

	Amounts of Public Funds to Be Injected (Billions of Yen)				
	Total	Preferred Stock	Subordinated Debt	Rate of Return[a]	Notes
Sakura	800	800	-	1.37	Preferred stock only
Dai-Ichi Kangyo	900	700	200	0.41~2.38	
Fuji	1,000	800	200	0.40~2.10	
Sumitomo	501	501	-	0.35~0.95	Preferred stock only
Sanwa	700	600	100	0.53	
Tokai	600	600	-	0.93~0.97	Preferred stock only
Asahi	500	400	100	1.15~1.48	
Daiwa	408	408	-	1.06	Preferred stock only, conversion right exercisable after three months
IBJ	600	350	250	0.43~1.40	
Mitsubishi Trust	300	200	100	0.81	
Sumitomo Trust	200	100	100	0.76	
Mitsui Trust	400	250	150	1.25	Conversion right exercisable after three months
Toyo Trust	200	200	-	1.15	Preferred stock only, conversion right exercisable after three months
Chuo Trust	150	150	-	0.90	Preferred stock only, conversion right exercisable after three months
Yokohama	200	100	100	1.13~1.89	
Total	7,459	6,159	1,300		

[a] The rate is for preferred stock. Figures are in percentages. Some banks launch different types of preferred stock.

Table 2
AMOUNTS OF CAPITAL ENHANCEMENT VERSUS ESTIMATED AMOUNTS OF NONPERFORMING LOANS (NPL) TO BE DISPOSED OF AND UNREALIZED GAINS/LOSSES FROM SECURITIES HOLDINGS
Billions of Yen

	Capital Enhancement				
	Total	Public Funds	Net Core Operating Profit (Estimated) March 1999[a]	NPL to Be Disposed of (Estimated) March 1999	Unrealized Gains/Losses from Securities Holdings Sept. 1998
Sakura	1,145	800	206	-994	-475
Dai-Ichi Kangyo	900	900	240	-970	-209
Fuji	1,217	1,000	215	-700	-588
Sumitomo	841	501	335	-1,050	46
Sanwa	880	700	305	-900	-25
Tokai	700	600	130	-560	-115
Asahi	645	500	136	-634	-158
Daiwa	460	408	53	-363	-381
IBJ	918	600	206	-900	-34
Mitsubishi Trust	300	300	213	-501	115
Sumitomo Trust	373	200	164	-395	-89
Mitsui Trust	509	400	95	-418	-362
Toyo Trust	300	200	105	-365	-144
Chuo Trust	222	150	60	-104	-185
Yokohama	200	200	75	-190	-73
Total	9,609	7,459	2,536	-9,044	-2,678

[a] Net core operating profit equals net operating profit (before transfer to general loan-loss reserves and before write-offs for trust accounts) minus profits earned from bond-related transactions.

holdings and the potential losses arising from the stricter guidelines for write-offs and provisioning. This will leave banks with sufficiently high capital ratios even after deducting unrealized losses from capital accounts, a calculation that is not required in bank financial statements under the original cost accounting standards.

Prior to capital injection, the FRC had to make sure that the banks were viable and that the investment would be fully recovered. A few cases gave rise to some uncertainties. In order to eliminate such uncertainties, the FRC required explicit plans to improve profitability that included, in some cases, withdrawal of all overseas offices. The "management improvement plan" was submitted to the FRC by each bank upon receiving capital and was made public subsequently. The FRC plans to check, on a regular basis, whether banks' actions continue to be consistent with the plans. Furthermore, for some banks, the timing for the government to acquire the right to convert preferred stock into common stock was set for a relatively short time after the injection. This suggests that the government could intervene directly in the management of these banks, should their performance prove to be less than satisfactory.

With regard to the underwriting terms of the preferred stock, three factors were assessed: a) the performance of the bank (for example, profitability, funding capacity), b) the nature of the instrument (for example, the date when conversion rights are exercisable and the minimum exercise price), and c) the management improvement plan. These factors were put into an evaluation model to calculate the appropriate cost of capital. With regard to the management improvement plan, positive factors such as restructuring, cost reduction, and corporate reorganization were reflected in the rate of return in a way that made the capital cost cheaper for those banks with more comprehensive measures. This gave an incentive to banks to positively restructure their business.

As part of their management improvement plans, banks will pursue rationalizing efforts. Table 3 shows the

Table 3
PLANNED BANK RESTRUCTURINGS

	Workforce			Personnel Expenses			Nonpersonnel Expenses, Excluding Investment in Mechanization		
	Number of Personnel at End of March 1999	Number of Personnel at End of March 2003	Percentage Change	Expenses at End of March 1999 (Billions of Yen)	Expenses at End of March 2003 (Billions of Yen)	Percentage Change	Expenses at End of March 1999 (Billions of Yen)	Expenses at End of March 2003 (Billions of Yen)	Percentage Change
Sakura	16,700	13,200	-21.0	180	152	-15.5	195	186	-4.9
Dai-Ichi Kangyo	16,130	13,200	-18.2	166	138	-16.5	166	149	-10.2
Fuji [a]	14,250	13,000	-8.8	153	138	-10.1	137	133	-3.3
Sumitomo	15,000	13,000	-13.3	156	147	-5.6	138	129	-6.5
Sanwa	13,600	11,400	-16.2	148	126	-15.4	144	141	-2.4
Tokai	11,125	9,731	-12.5	112	93	-16.9	90	83	-7.5
Asahi	12,800	11,800	-7.8	114	107	-5.9	94	93	-1.1
Daiwa	7,640	6,300	-17.5	63	52	-17.0	92	90	-2.4
IBJ	4,776	4,482	-6.2	69	68	-0.9	61	50	-18.0
Mitsubishi Trust	4,932	4,695	-4.8	68	63	-8.3	60	60	-0.4
Sumitomo Trust	5,900	5,200	-11.9	61	52	-14.8	57	54	-5.1
Mitsui Trust/ Chuo Trust [b]	9,980	8,900	-10.8	91	82	-10.4	78	72	-8.6
Toyo Trust	4,100	3,400	-17.1	42	38	-9.9	31	30	-2.3
Yokohama	5,718	4,512	-21.1	51	43	-14.9	42	40	-4.1
Total	142,651	122,820	-13.9	1,474	1,299	-11.9	1,384	1,308	-5.5

[a] Unconsolidated basis.

[b] After-merger figures are used for end of March 2003.

outline. To cut personnel expenses 12 percent by March 2003, the workforce will be reduced by 14 percent. Non-personnel expenses will also be curtailed, with the exception of investments for automation. As for overseas business, five banks, of which one is a regional bank, plan to withdraw entirely from abroad, and most other banks are closing unprofitable overseas branches or reviewing the business structure of these branches. Banks have also made the capital enhancement measure an opportunity for mergers and tie-ups. In this way, developments leading to an overall reorganization of the financial industry are currently under way.

Undoubtedly, the capital injection is an important step in the right direction. But it is not the ultimate measure to achieve the final goal of overcoming the banking problem. Further steps must be taken. Banks must remove bad loans from their balance sheets to improve their cash flow. This is an important step toward restoring their financial intermediary function, which in turn would contribute to an economic recovery. Also, further consolidation is necessary. By promoting consolidation in an effective way, the banking system will gain efficiency and profitability.

With regard to the removal of bad loans from banks' balance sheets, an important element is to provide the market with adequate infrastructure. Measures have been taken in this area. They include the creation of the RCC—the Resolution and Collection Corporation—as a result of a merger between the Resolution and Collection Bank (RCB) and the Housing Loan Administration Corporation (HLAC). A feature of the new law is that the RCC can now purchase bad loans not only from failed banks but also from solvent operating banks, helping them to remove their bad loans from their balance sheets. In addition, a legal framework for securitization of bad loans using special-purpose companies is now in place and is thus available. It is expected that banks will start to utilize these measures. An important prerequisite in this regard is that transactions are executed at market price or fair value, that is, a price that can be obtained by an objective method that effectively reflects the true value of real estate and related loans. This is a key feature for restoring business confidence in the real estate market. With regard to consolidation, we are starting to see good signs in the form of mergers and alliances in the context of capital injection, with the announcement by some banks of explicit plans. Banks are expected to identify the business areas of relative advantage from a deregulated wider choice of financial business and seek further profitability and efficiency through consolidation in the broader context of the Japanese Big Bang.

The measures taken so far are intended to restore the financial intermediary function and to reform our banking system into a sounder, more efficient, and robust financial industry. It is quite obvious that an improved financial industry will better serve the economy in the longer run. But in the meantime, the transition might exacerbate uncertainties in various parts of the economy. For example, large-scale disposal of real estate may have a negative impact on land prices. Such uncertainties in the transition process may be an argument for macroeconomic policies to support the economic recovery. Also, it will be necessary to handle the remaining problems in the banking

Table 4
BANK OF JAPAN ACCOUNTS
Billions of Yen

Assets		Liabilities and Capital Accounts	
Gold	432.8	Banknotes	51,286.6
Cash	265.3	Current deposits and other deposits	6,174.8
Commercial bills discounted	11.4	Deposits of the Japanese government	2,024.3
Loans	1,302.9	Bills sold	9,999.1
Bills purchased	5,175.3	Japanese government securities borrowed	3,898.3
Japanese government securities in custody	3,898.3	Other	686.1
Japanese government securities	49,469.5	Allowances and accrued liabilities	2,898.1
Foreign exchange	3,574.9	Capital	0.1
Loans to Deposit Insurance Corporation	6,652.7	Reserves	2,132.6
Deposits with agencies	3,354.2	Total	79,100.3
Cash collateral in exchange for Japanese government securities borrowed	4,101.2		
Other	861.4		
Total	79,100.3		

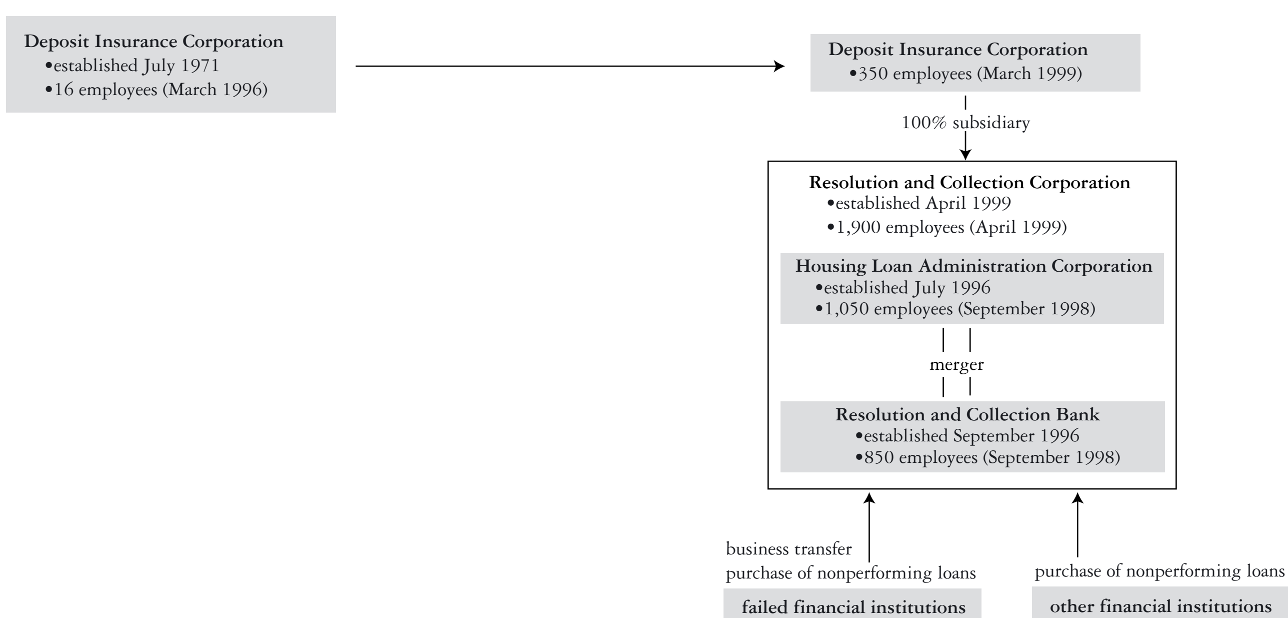
Note: Figures are as of end of March 1999.

system in a smooth way under the current safety net framework, fully acknowledging the importance of preventing any major financial disruption from materializing.

Another unique aspect of the central bank involvement in dealing with the financial instability is the lending to the DIC. Table 4 shows that the outstanding amount of such loans by the Bank of Japan stood at ¥6.7 trillion as of the end of March. Given the long-term nature of such loans, a disproportionate increase may threaten flexible monetary operation by the Bank. Against this background, the Bank has reiterated that the loans to the DIC must be of a temporary nature, or a "bridge financing," until they are replaced by loans from private financial institutions in the future. This was the case with the loan to the DIC for the purpose of capital injection. The DIC primarily carried out auctions to borrow money from private financial institutions on a government-guaranteed basis. The auctions to finance the DIC for the purpose of capital injection proved to be very successful. Foreign institutions were active participants. As a result, the DIC was able to raise ¥6.3 trillion at a cost well below the current official discount rate of 0.5 percent. The remaining ¥1.2 trillion was financed by the Bank of Japan at the official discount rate. The FRC gave assurances that the DIC would repay the loan from the Bank of Japan in four years at the latest. In addition, in order to diversify the funding instruments for the DIC, the Bank is asking the DIC to issue government-guaranteed bonds.

The safety net that has been built up over the years is quite comprehensive. Given the current status of the Japanese banking system, this is indispensable. But it has side effects too: the cost of public intervention and moral hazard, among others. These are not consistent with the principles of the Big Bang (Free, Fair, Global). That is why the safety net is designed to be a temporary framework, with all depositors and creditors fully protected in any bank failure until March 2001. There are arguments for extending this period because the banking system may continue to be fragile. But we intend to adhere to the original plan as it will encourage banks to take measures to restructure themselves into a more competitive industry in a timely manner. Depositors will naturally become more selective in choosing their banks as March 2001 approaches. This means that banks have a limited time to transform themselves into a stronger industry. Meanwhile, a study group consisting of academics, regulators, and

Figure 2
The Structure of Japan's Safety Net



central bankers has been set up to design a new safety net framework that would be consistent with the more efficient and competitive financial system expected to emerge in the years beyond March 2001.

Measures taken so far will certainly contribute to the restoration of the financial system. We recognize that we have been criticized for slowness in taking action, but the problem we have been dealing with is unprecedented in terms of scale and seriousness and the instruments initially available to handle the problem were very limited. Only three years ago, the DIC had a staff of only sixteen and as little as ¥390 billion in funds. Now, as Figure 2 shows, the DIC along with the RCC has more than 2,000 staff members and ¥60 trillion of public funds available. The flexibility of the safety net has evolved significantly over the years. In fact, more than fifty institutions have already been resolved since 1992 under the deposit insurance framework. In dealing with the problem, the Bank has consistently tried its best to fulfill its responsibility to maintain financial system stability. There were painful moments, such as the loss of the ¥80 billion investment in Nippon Credit Bank and the subsequent criticism of the Bank, but it is our belief that the Bank's actions were necessary to avert a major disruption. Indeed, a systemic crisis has been successfully avoided in Japan, and we remain fully committed to our responsibility to prevent any crisis that could threaten the stability of the financial system. Hopefully, before long, our efforts to overcome the country's banking problems will represent an episode in history that we can look back on with pride and satisfaction.