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# **Recapitalizing Japan's Banks: The Functions and Problems of Financial Revitalization Act and Bank Recapitalization Act**

*By*

**Mitsuhiro Fukao\***

## **Abstract**

The origin of the systemic problem of Japanese financial sector was the asset price bubble in the 1980s. In late 1997 when Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities failed successively. These sudden and disorderly failures created a panic among financial sectors because all the three institutions satisfied stipulated capital requirements under the regulations before the failures. In view of this severe problem, politicians finally moved quickly and two long-term credit banks were nationalized and large-scale bank recapitalization was carried out in early 1999 under two new laws legislated in late 1998; Financial Revitalization Act and Bank Recapitalization Act. This paper explains the economic roles of these new laws and examine the way they were actually implemented. Financial Revitalization Act is a special law regarding the resolution of insolvent deposit financial institution. Bank Recapitalization Act, on the other hand, concerns the capital injection to those financial institutions which are solvent, but losing the confidence of investors and depositors so that they are facing difficulties to raise capital in the market on their own.

## **Key Words**

financial crisis, bank recapitalization, bank supervision, prompt corrective action, capital standard

## **1. Introduction**

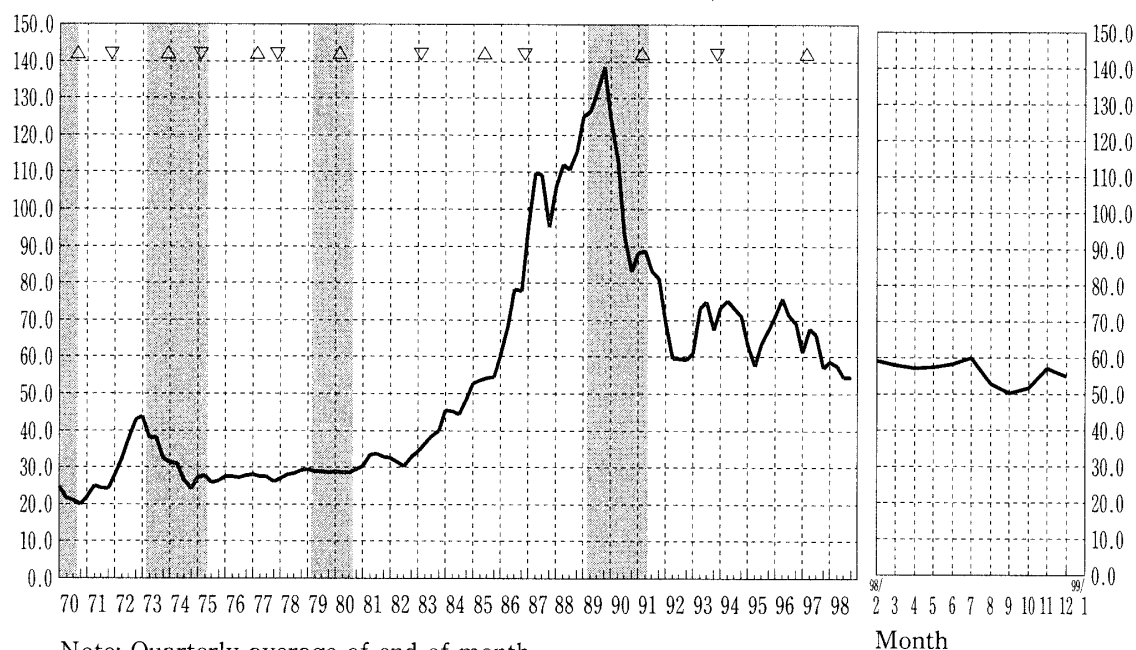
In November 1997, the failure of Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities sharply increased financial instability. These events generated a severe credit crunch in the Japanese financial market, inducing an extremely serious recession. Then what has caused this enormous problem for Japan? In my opinion, there are two factors behind this financial crisis.

One is the crash of the stock and real estate market bubble in the 1990s. Chart 1 shows the market value of the Tokyo Stock Exchange 1st section as a ratio to nominal GDP. Chart 2 shows the real estate price index in six major cities as a ratio to nominal GDP index. Both charts clearly show the tremendous magnitude of the asset-price

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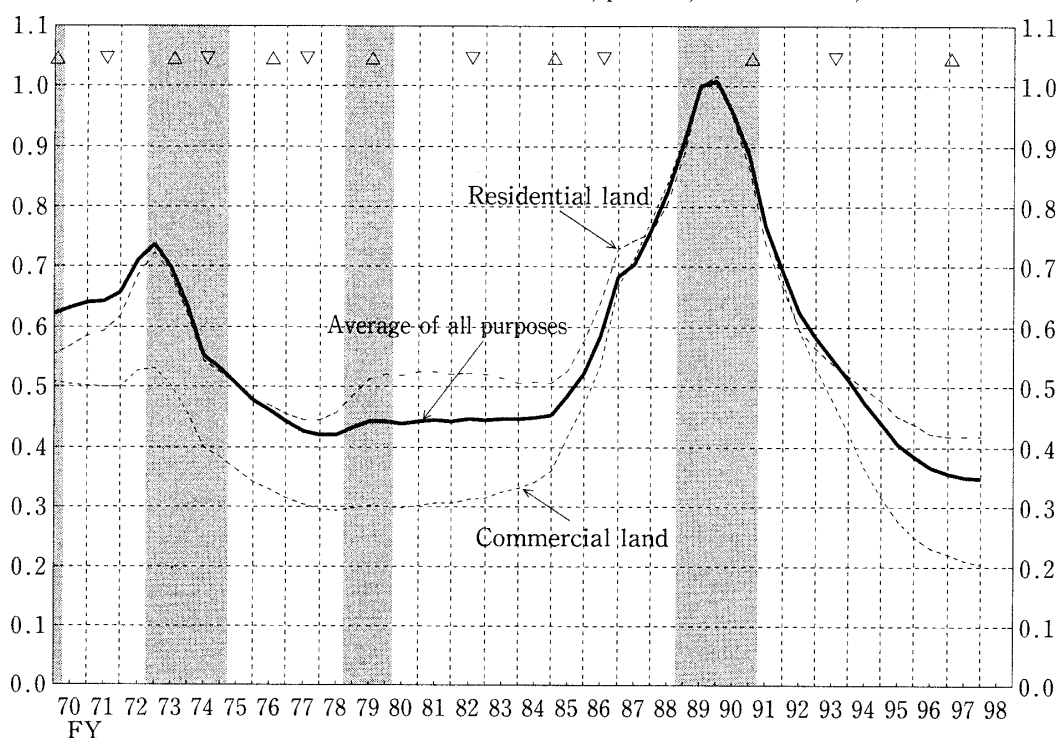
**Chart 1. Total Market Value of Stocks on the Tokyo Stock Exchange 1st Section**  
(Percent of nominal GDP)



Note: Quarterly average of end of month.

Source: Bank of Japan CD-ROM, 1999.

**Chart 2. Land Price Indexes of Urban Areas**  
(As a ratio of nominal GDP index; percent; semi-annual)



Note: Land price indexes of urban areas (six largest cities, second half of FY89 < end Mar 90 > = 100) / Nominal GDP index (second half of FY89 = 100).

Source: Bank of Japan CD-ROM, 1999.

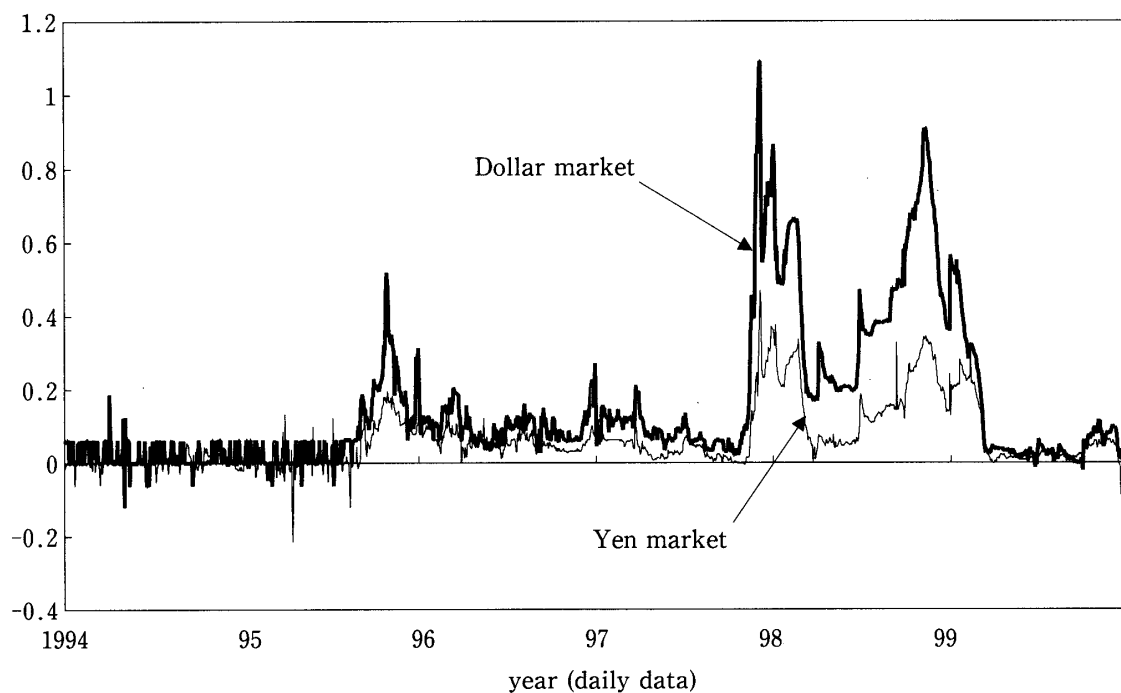
bubble in Japan.

The second is the lost confidence in the accounting and auditing system in Japan. We note that the actual amount of bad loans discovered at failed financial institutions has been far larger than the amount published prior to the failure. The Hokkaido Takushoku Bank was forced into bankruptcy even though it posted profits and paid dividends for the year to March 1997. Financial statements for that year reported Yen 0.3 trillion in capital; inspections after the failure found a negative equity of Yen 1.2 trillion as of March 31, 1998. This indicates a window-dressing of almost Yen 1.5 trillion.

Likewise, Yamaichi Securities was hiding Yen 260 billion of losses on securities investments — worth more than one-half of its equity capital — that neither Ministry of Finance inspections nor Bank of Japan examinations were reportedly able to uncover.

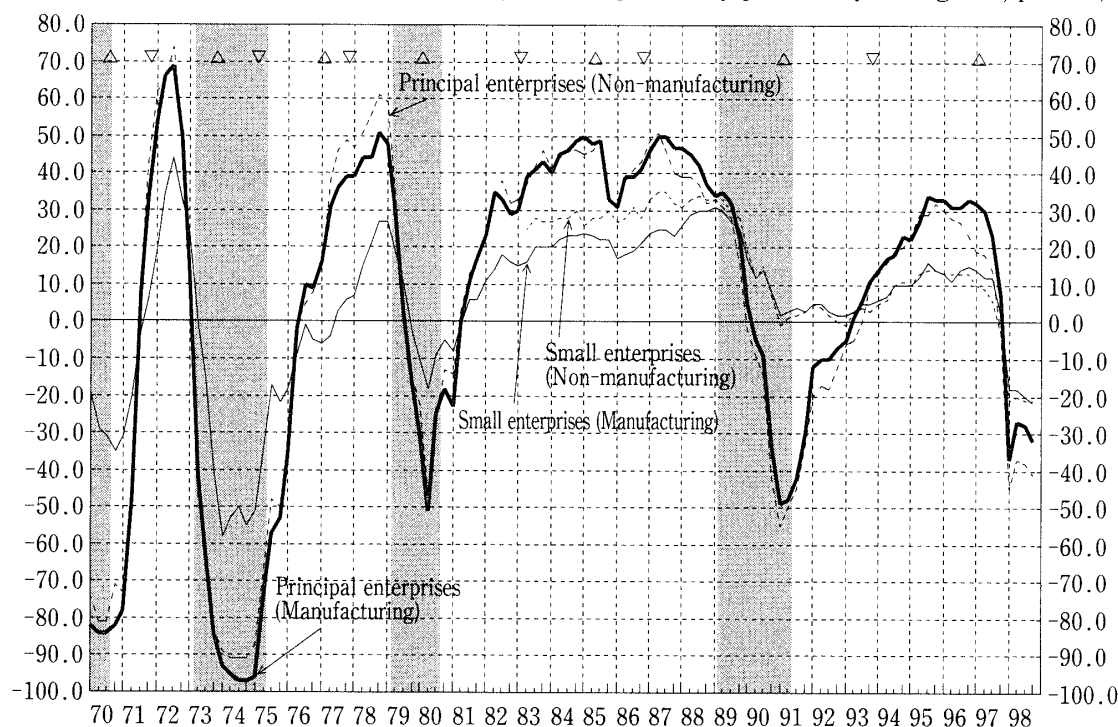
These financial-institution failures have exacerbated suspicions both at home and abroad regarding the financial statements and regulatory supervision of Japanese financial institutions. It was this mistrust of financial statements that widened the Japan premium charged in overseas markets (see Chart 3), blocked the domestic call market (which is used for short-term interbank loans), and multiplied the number of cash-pressed financial institutions turning to the Bank of Japan for loans. Japanese financial markets clearly experienced a kind of credit crunch because of a rash of failures, declining asset prices, and growing mistrust of financial statements and regulators (see Chart 4). This credit crunch in turn cut into corporate investment and hiring, increased bankruptcy rates, and reduced consumption and housing investments because workers feared for losing their jobs. That resulted in a further contraction of

Chart 3. Japan Premium



Note: Japan premium = (3-month TIBOR rate) - (3-month LIBOR rate).

Source: Fukao, Mitsuhiro ed., *Empirical Analysis of Financial Recession*, Nihon Keizai Shimbun Sha, 2000, (in Japanese), p.146.

**Chart 4. Diffusion Index of the Lending Attitude of Financial**(Based on the *Short-term Economic Survey of Enterprises in Japan* <'Easy' - 'Tight'>; percent)

Source: Bank of Japan CD-ROM, 1999.

credit in what became a vicious cycle. In other words, unreliable financial statements had proved a serious impediment to the functioning of a market economy.

The contraction was somewhat abated by the Emergency Economic Package announced by the Liberal Democratic Party and Ministry of Finance at the end of 1997. The government prepared Yen 13 trillion for the capital injection to solvent banks and Yen 17 trillion for the protection depositors of failed banks. The Ministry of Finance should have used the fund effectively: by forcing banks to write off all the bad loans, the financial institutions and the financial oversight by the government could have regained the public confidence. However, most of the money was left unused. Only Yen 1.8 trillion of Yen 13 trillion was thinly injected to 21 large banks at the end of March 1998 without any complete examination or comprehensive cleanup of bank balance sheets.

The failure of the capital injection became apparent only a few months later. In the summer of 1998, the stock price of Long-Term Credit Bank of Japan (LTCB) fell sharply when Sumitomo Trust and Banking effectively refused the merger with LTCB. LTCB was a big bank with Yen 26.2 trillion of asset at the end of March 1998. In October 1998, just before the Long Term Credit Bank of Japan went bankrupt, Financial Revitalization Act and Bank Recapitalization Act were enacted in disorderly atmosphere. This time, the government prepared Yen 60 trillion, about 12 percent of GDP: Yen 25 trillion for the capital injection into solvent banks under Bank Recapitalization Act, Yen 18 trillion for the resolution of failing banks under Financial Revitalization Act such as the capital injection into rescue banks, bridge banks, and the disposition of bad loans, and Yen 17 trillion for the protection of depositors by Deposit Insurance Corporation.

Under Bank Recapitalization Act, Yen 7.5 trillion of capital was injected to 15 major banks at the end of March 1999. Unlike the former attempt, this program was much better designed, succeeding to eliminate persistent Japan premium that started in late 1997 (Chart 3).

## 2. Function of the Acts

The purposes of these two laws could be summarized as follows: Financial Revitalization Act is a special law regarding the resolution of insolvent deposit financial institution; Bank Recapitalization Act, on the other hand, concerns the capital injection to those financial institutions which are solvent, but losing the confidence of investors and depositors so that they are facing difficulties to raise capital in the market on their own.

Where the regulatory authority judges that a financial institution has a negative equity, or likely to stop repaying the deposits in the near future, Financial Revitalization Act is to be applied. By putting the institution under national receivership, the law tries to protect their customers including both depositors and borrowers. After the effective nationalization, however, this Act attempts to privatize the institution promptly, by making the management efficient, injecting capital, and disposing of its bad loans. Public funds are going to be used to protect the depositors and to replenish its damaged capital base. On the other hand, where a financial institution is solvent but under-capitalized, Bank Recapitalization Act is to be applied. Public funds are going to be injected to its capital base. By doing this, it will be possible to stabilize the performance of financial institution and restore the credibility towards them.

What are the reasons behind the enactment of these laws? For Financial Revitalization Act, it could be argued that bankruptcy code and reorganization order, which nearly corresponds to Chapter 10 of the former US Bankruptcy Act of 1898, were not designed to deal with the insolvency of financial institutions. Under these laws, often applied to the resolution of insolvent industrial companies, procedures are taken through suspending the repayment of the debts that had existed before the failure. These actions are necessary to treat all the creditors of the insolvent company equally. But for a large-sized financial institution, which holds enormous number of clearing accounts for depositors and financial transactions with both domestic and overseas clients, to suspend the payment only for a few days would give tremendous adverse effects on the financial market. Depositors would not be able to make their daily payments and those clients who could no longer borrow from the bank would face the risk of chain-reaction bankruptcy. So as to avoid such a broad range of negative effects, the disposal of insolvent banks should not accompany a general suspension of payment.

Financial Revitalization Act is designed for those financial institutions having a large influence on the stability of financial system, or having an important role in particular region. When those banks face financial difficulties, the Act fully protects their creditors by using public funds. At the same time, the Act penalizes both shareholders and the management of the banks. Looking at the structure of this Act, a few problematical points could be raised. Although Financial Revitalization Act is the legislation with time limit until March 2001, it will be necessary, even after its

expiration, to maintain the Act as a permanent law so as to deal with insolvent financial institutions with substantial amendments.

Financial Revitalization Act was applied to the Long Term Credit Bank of Japan in October 1998 and to the Nippon Credit Bank in December of the same year, and both banks were put under national control. There was an argument that by putting those banks under national control, enormous number of settlements over transactions on financial derivatives would come up simultaneously and this would create a disorder within the world financial market. Nonetheless, thanks to the corporation of financial regulatory authorities, it did not bring about any turmoil to the market. In addition, all the depositors were protected, and chain-reaction bankruptcy was avoided. One of the purposes of the Act, namely, to protect the clients of the bank, was thus achieved. On the other hand, the authorities concerned must work harder to privatize those banks under a national receivership, or to lead them to make a fresh start by transferring their business to a third party.

With regard to Bank Recapitalization Act, it is not necessary to have such legislation, unless there is a sense of financial disorder as strong as there is today. Capital of private enterprises should be raised through voluntary market transactions. Looking from the economic point of view, shares can be issued in the market, so long as the business condition is disclosed sufficiently and investors can expect a reasonable return on the investment corresponding to the risk involved. The expected return on stock, which investors require the company to earn explicitly or implicitly, is called the cost of shareholders' equity, i.e. the total amount of both dividend and the capital gain.

However, when the confidence in the financial system is seriously eroded, it is extremely difficult for financial institutions with large loan portfolio to disclose the details of their business conditions to such an extent that investors become satisfied. Therefore, even for those banks which have positive going concern values, it would be almost impossible to raise a large sum of capital for stabilizing their business conditions, since investors require extremely high cost of shareholders' equity. Where the risk of market failure caused by the incomplete transmission of information is larger than the risk of government failure, it would be possible to justify the capital injection of public fund to financial institutions.

It is not clear whether Bank Recapitalization Act was legislated on the basis of such a policy decision, but the legislation itself can be justified with this logic of economics.

### **3. Remaining Problems in the Financial Revitalization Act**

Financial Revitalization Act should be applied to financial institutions in the same way as the normal bankruptcy procedures are applied, although public funds are used to protect their creditors. Where the going concern value of a financial institution exceeds the liquidation value, reorganization would be desirable. But where the going concern value is less than the liquidation value, an orderly and gradual liquidation would be desirable. In both cases, shareholders' capital will be cancelled and the board members will have to resign.

The following problems arising from Financial Revitalization Act could be pointed out:

Firstly, where a financial institution is put under the national control, the nationalized bank has to honor the existing employment contracts, since the status of juridical person of the bank is maintained. As a result, unlike the case of bankruptcy of an ordinary corporation where most employees are dismissed, the employees of a failed financial institution are well protected even though their compensation can be cut by 25 percent at most. Moreover, all the liabilities to workers will be protected in the same manner as other liabilities. Therefore, even a very generous retirement allowance will be protected with the public fund.

Secondly, in the resolution of an insolvent financial institution under Financial Revitalization Act, all of its subordinated debt will be protected. The subordination closes of these debts are triggered only when the issuing financial institutions apply to the court for the protection under the bankruptcy code or reorganization order. Since the resolution procedure under Financial Revitalization Act is not counted as a formal bankruptcy procedure, all the subordinated debts of Japanese financial institutions are treated as ordinary debt and protected by the public funds. In this regard, the primary problem lies in the past financial supervisory policy that allowed banks to count such "subordinated debts" as their BIS capital.

In the resolution procedure of Long-term Credit Bank of Japan and Hokkaido Takushoku Bank, for example, their subordinated debt did not work as capital. Therefore, it is necessary to re-examine the contracts of subordinated debts, and those debts. Those debts to which subordination close is not applicable within the framework of Financial Revitalization Act or any succeeding law for the resolution of insolvent financial institutions should be excluded from the BIS capital with a 5-year transition period.

#### **4. The Choice of Laws for a Particular Financial Institution**

The major problem in applying Financial Revitalization Act and Bank Recapitalization Act would be the choice of law to a particular financial institution.

The government can underwrite capital increase of a particular bank under Bank Recapitalization Act, only when the bank has positive equity capital. In addition, the stocks or preferred shares bought by the government must be marketable. Thus, in order for the government to recapitalize a particular bank, the business condition of the bank needs to become stable through the capital increase, and also there is an expectation of a reasonable return on the injected public fund.

In case of Financial Revitalization Act, on the other hand, a financial institution can be put under the national control (outright nationalization) or under the national receivership with an assignment of financial receivers. To put a bank under the effective national control so as to protect their depositors and borrowers, one of the following conditions needs to be satisfied; i.e. the bank has negative equity capital, the bank has stopped repaying their deposits, or there is a strong possibility of suspending the repayment.

Whether the financial institution has negative equity or whether there is a possibility of suspending repayment of deposits would decide the Acts to be applied. In practice, however, to which category the bank is going to be classified depends upon the judgement of the authority. Between a well-capitalized bank and an insolvent



bank, there are numerous financial institutions that are more or less marginally capitalized. Whether a particular bank can survive or not depends not only upon the management but also on the macro-economic conditions domestic or overseas. In addition, one of the reasons behind the long-term stagnation in Japan lies in the credit crunch or in the aggressive withdrawal of lending by weakened financial institutions. Japan's economy will recover only if financial institutions revive through the successful operation of both Financial Revitalization Act and Bank Recapitalization Act. This would make it difficult for the Financial Reconstruction Commission, responsible for the exercise of these two laws, to make a judgement.

There is one way to avoid this very difficult problem. If Bank Recapitalization Act is applied properly, it can also bring about the objective of Financial Revitalization Act. For example, let us suppose that a bank issue preferred shares to the government under the following conditions:

- (1) The government provides public funds to recapitalize a bank only when the bank successfully raises additional capital on their own efforts in the market. By doing so, the bank would have to make themselves more attractive to investors.
- (2) Preferred shares are paid prior to ordinary shares in terms of distribution of dividend and residual asset.
- (3) If the bank cannot pay dividend, the voting rights with preferred shares will be restored. In this case, the government should be able to exercise over one-half of the voting rights.
- (4) If the net worth of the bank before the public capital injection is depleted by the loss arisen after the capital increase, pre-existing ordinary shares should be cancelled with no compensation, and the preferred shares held by the government are to be converted into ordinary shares.
- (5) After a lapse of time, the government can convert their preferred shares into ordinary shares at the lower price between the one at the time of capital increase, or at the exercise of the conversion privilege.
- (6) The public funds can only be used to recapitalize the bank itself, rather than its subsidiaries or SPC (Special Purpose Companies).

If the capital injection scheme is designed in such a way, the government can obtain the control of the bank when the financial condition of the bank deteriorates. If a financial institution loses its pre-injection equity capital, all the pre-existing ordinary shares will be cancelled, and nationalization of such an institution will be achieved automatically. On the other hand, if the business conditions of the institution improves and its stock price starts to rise, the government can obtain ordinary shares by exercising the conversion right of its preferred shares, and it can make a profit by selling them in the market. Thus, by applying Bank Recapitalization Act carefully, it will be possible to achieve the objectives of Financial Revitalization Act as well.

The Shadow Financial Regulatory Committee (Japan) published a statement outlining this capital injection scheme in December 1998.<sup>1</sup>

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<sup>1</sup>See Shadow Financial Regulatory Committee (Japan) Statement # 3, "Urging a Proper Implementation of Prompt Corrective Action, Financial Revitalization Act, and Bank Recapitalization Act," December 8, 1998 which is reproduced as an appendix of this paper.

## 5. Evaluating the application of Bank Recapitalization Act

The Financial Reconstruction Commission injected Yen 7.46 trillion to 15 major banks at the end of March 1999. The used instruments are as follows (see Tables 1, 2 and 3):

Yen 5.56 trillion: preferred shares convertible to common shares

Yen 0.60 trillion: preferred shares not convertible to common shares

Yen 1.30 trillion: subordinated bonds or loans

The preferred shares are non-cumulative type and, after a certain waiting period (3 months to 7.5 years depending on the bank), the shareholders can unilaterally convert them into ordinary shares. When pre-determined dividends are paid to the preferred

**Table 1. Amount of Capital Raised**

(hundred million yen)

	Capital Injected by the Government			Self Raised Capital			Grand Total
			Total			Total	
Industrial Bank of Japan	Preferred Shares	3,500	6,000	Shares	670	3,180	9,180
	Subordinated Bonds	2,500		Others	2,510		
Dai-Ichi Kangyo Bank	Preferred Shares	7,000	9,000			—	9,000
	Subordinated Loans	2,000					
Sakura Bank			8,000	Shares	862	3,450	11,450
	Preferred Shares	8,000		Others	2,588		
Fuji Bank	Preferred Shares	8,000	10,000	Shares	2,170	2,170	12,170
	Subordinated Bonds	2,000					
Sumitomo Bank	Preferred Shares	5,010	5,010	Others	3,400	3,400	8,410
Daiwa Bank	Preferred Shares	4,080	4,080	Shares	522	522	4,602
Sanwa Bank	Preferred Shares	6,000	7,000			1,800	8,800
	Subordinated Bonds	1,000		Others	1,800		
Tokai Bank	Preferred Shares	6,000	6,000	Shares	1,000	1,000	7,000
Asahi Bank	Preferred Shares	4,000	5,000	Shares	1,448	1,448	6,448
	Subordinated Loans	1,000					
Bank of Yokohama	Preferred Shares	1,000	2,000			—	2,000
	Subordinated Loans	1,000					
Mitsui Trust and Banking	Preferred Shares	2,502	4,002	Shares	275	275	5,112
	Subordinated Loans	1,500			※835		
Mitsubishi Trust and Bankin	Preferred Shares	2,000	3,000			—	3,000
	Subordinated Bonds	1,000					
SumitomoTrust and Banking	Preferred Shares	1,000	2,000	Shares	※900	※900	3,730
	Subordinated Bonds	1,000		Others	830		
Toyo Trust and Banking	Preferred Shares	2,000	2,000	Shares	1,000	1,000	3,000
Chuo Trust and Banking			1,500	Shares	375	717	2,217
	Preferred Shares	1,500		Others	342		
Total	Preferred Shares	61,592	74,592	Shares	10,057	21,527	96,119
	Subordinated Bonds			Others	11,470		
	Subordinated Loans	13,000					

※ Conversion of Convertible Bonds

Source: Financial Reconstruction Commission

**Table 2. Injected Capital and Means of Capital Increase**

	Preferred Shares			Subordinated Bonds and Subordinated Loans		
	Capital Increased hundred million yen	Dividend Yield	Waiting Period for Conversion	Capital Increased hundred million yen	Yield	Duration
Industrial Bank of Japan	1,750	1.40%	4 years and 5 months	2,500	Initial 5 yrs: 6 m yen L+0.98%	Perpetual
	1,750	0.43%	4 years and 3 months		After 6 yrs: 6 m yen L+1.48%	
Dai-ichi Kangyo Bank	2,000	0.41%	5 years and 4 months	1,000	Initial 5 yrs: 6 m yen L+0.75%	10Years
	2,000	0.70%	6 years and 4 months	1,000	Initial 6 yrs: 6 m yen L+0.75%	
	3,000	2.38%	corporate bond type		After 7 yrs: 6 M yen L+1.25%	11Years
	Sakura Bank	8,000	1.37%	3 years and 6 months	—	
Fuji Bank	3,000	2.10%	corporate bond type	2,000	Initial 5 yrs: 6 m yen L+0.65%	Perpetual
	2,500	0.55%	7 years and 6 months		After 6 yrs: 6 m yen L+1.35%	
	2,500	0.40%	5 years and 6 months		After 11yrs: 6 m yen L+2.15%	
Sumitomo Bank	2,010	0.35%	3 years and a months	—	—	—
	3,000	0.95%	6 years and 4 months			
Daiwa Bank	4,080	1.06%	3 months	—	—	—
Sanwa Bank	6,000	0.53%	2 years and 3 months	1,000	Initial 5 yrs 6m: 6 m yen L+0.34%	Perpetual
					After 5yrs 7m: 6 m yen L+1.34%	
Tokai Bank	3,000	0.93%	3 years and 3 months	—	—	—
	3,000	0.97%	4 years and 3 months			
Asahi Bank	3,000	1.15%	3 years and 3 months	1,000	Initial 10yrs: 6 m yen L+1.04%	Perpetual
	1,000	1.48%	4 years and 3 months		After 11yrs: 6 m yen L+2.54%	
Bank of Yokohama	700	1.13%	2 years and 4 months	500	Initial 5 yrs: 6 m yen L+1.65%	Perpetual
					After 6 yrs: 6 m yen L+2.15%	
	300	1.89%	5 years and 4 months	500	Initial 5 yrs: 6 m yen L+1.07%	10Years and a monts
					After 6 yrs: 6 m yen L+1.57%	
Mitsui Trust and Banking	2,502	1.25%	3 months	1,500	Initial 5 yrs: 6 m yen L+1.49%	10Years
Mitsubishi Trust and Banking	2,000	0.81%	4 years and 4 months	1,000	Initial 5 yrs: 6 m yen L+1.75%	
					After 6 yrs: 6 m yen L+2.25%	
SumitomoTrust and Banking	1,000	0.76%	2 years	1,000	Initial 7 yrs: 6 m yen L+1.53%	12Years
Toyo Trust and Banking	2,000	1.15%	3 months	—	—	
Chuo Trust and Banking	1,500	0.90%	3 months	—	—	
Total	61,592	—	—	13,000	—	—

Note: Yen L means yen LIBOR.

Source: Financial Reconstruction Commission

shareholders, they cannot exercise their voting rights. However, when the company fails to pay dividends, the holders of preferred shares can exercise their voting right. When the issuing banks are liquidated, the preferred shareholders have a senior claim amounting to the paid-in price of the share on the remaining assets over the common shareholders.

This capital injection scheme has the majority of desirable features I pointed out in Section 4. Twelve out of 15 banks raised some capital from the private sources at the time of this public capital injection (point 1). Points 2, 5 and 6 are generally met. Regarding relatively weak three banks, the government can control more than one-half of outstanding shares if the government converts preferred shares into ordinary shares (point 3). In addition, at the time of this capital injection, Financial Reconstruct-

**Table 3. Equity Capital (Including Public Fund, Outstanding at the end of March 1999)**  
(hundred million yen, %)

	Tier I		Tier II		Equity Capital		Risk Asset Total	share
		Public Fund		Public Fund		Public Fund		
Industrial Bank of Japan	17,941	3,500	15,039	2,500	32,980	6,000	295,810	11.1
Dai-Ichi Kangyo Bank	20,728	7,000	19,493	2,000	40,221	9,000	375,656	10.7
Sakura Bank	23,645	8,000	17,656		41,301	8,000	340,000	12.1
Fuji Bank	23,280	8,000	22,870	2,000	46,110	10,000	434,500	10.6
Sumitomo Bank	22,093	5,010	20,545		42,638	5,010	415,000	10.3
Daiwa Bank	8,677	4,080	5,288		13,966	4,080	105,000	13.3
Sanwa Bank	21,813	6,000	18,205	1,000	40,018	7,000	370,000	10.8
Tokai Bank	15,700	6,000	10,170		25,870	6,000	213,000	12.1
Asahi Bank	12,312	4,000	10,987	1,000	23,299	5,000	203,623	11.4
Bank of Yokohama	3,732	1,000	3,984	1,000	7,464	2,000	78,700	9.5
Mitsui Trust and Banking	7,127	2,502	4,760	1,500	11,887	4,002	78,870	15.1
Mitsubishi Trust and Banking	7,599	2,000	5,702	1,000	13,301	3,000	127,091	10.5
Sumitomo Trust and Banking	7,580	1,000	5,530	1,000	13,110	2,000	107,000	12.3
Toyo Trust and Banking	5,408	2,000	3,327		8,735	2,000	60,997	14.3
Chuo Trust and Banking	3,566	1,500	1,742		5,308	1,500	39,270	13.5
Total		61,592		13,000		74,592		

Note: Fuji Bank includes Yasuda Trust and Banking

Source: Financial Reconstruction Commission

**Table 4. Closing of Foreign Branches**

Bank of Yokohama	Complete Withdrawal By March 1999
Daiwa Bank	Complete Withdrawal By March 2000
Mitsui Trust and Banking	Complete Withdrawal By March 2000
Chuo Trust and Banking	Complete Withdrawal By March 2000
Toyo Trust and Banking	Complete Withdrawal By March 2001

**Changes in the Number of Foreign Branches and Subsidiaries**

	March 1998	March 2003	Change in the Number	Rate of Change (%)
Industrial Bank of Japan	38	28	-10	-26
Dai-Ichi Kangyo Bank	46	31	-15	-33
Sakura Bank	46	32	-14	-30
Fuji Bank	43	27	-16	-37
Sumitomo Bank	64	36	-28	-44
Sanwa Bank	45	33	-12	-27
Tokai Bank	46	21	-25	-54
Asahi Bank	21	6	-15	-71
Mitsubishi Trust and Banking	19	10	-9	-47
Sumitomo Trust and Banking	16	6	-10	-66

Source: Financial Reconstruction Commission

tion Commission forced banks to come up with strong restructuring plans (Tables 4 and 5).

However, there are some worrisome points. Firstly, when some banks tried to raise capital from private sources before the public capital injection, they apparently put pressures on some relatively weak borrowers to buy their shares. Since this is a

**Table 5. State of Restructuring**

(million yen, %)

	Number of Employees			Personnel Costs			Other Costs		
	March 1999	March 2003	Rate of Change	March 1999	March 2003	Rate of Change	March 1999	March 2003	Rate of Change
Industrial Bank of Japan	4776	4482	-6	68600	68000	-1	60700	49800	-18
Dai-Ichi Kangyo Bank	16130	13200	-18	165600	138300	-17	166200	149300	-10
Sakura Bank	16700	13200	-21	179900	152100	-16	195300	185700	-5
Fuji Bank	14250	13000	-9	153000	137500	-10	137000	132500	-3
Sumitomo Bank	15000	13000	-13	156100	147300	-6	137800	128900	-7
Daiwa Bank	7640	6300	-18	63000	52300	-17	91778	89569	-2
Sanwa Bank	13600	11400	-16	148400	125600	-15	144400	140900	-2
Tokai Bank	11125	9731	-13	111600	92700	-17	89705	82996	-8
Asahi Bank	12800	11800	-8	113700	107000	-6	94000	93000	-1
Bank of Yokohama	5718	4512	-21	50500	43000	-15	41700	40000	-4
Mitsubishi Trust and Banking	4932	4695	-5	68293	62640	-8	60086	59828	-0
Sumitomo Trust and Banking	5900	5200	-12	61000	52000	-15	56500	53600	-5
Toyo Trust and Banking	4100	3400	-17	42300	38100	-10	30700	30000	-2
Misui Trust and Banking + Chuo Trust and Banking	9980	8900	-11	91600	82100	-10	78300	71600	-9
Total	142651	122820	-14	1473593	1298640	-12	1384169	1307693	-6

Source: Financial Reconstruction Commission

kind of double gearing, which erodes the capital base of banks, the authorities should have monitored these problematical behaviors more closely. Secondly, when the preferred shares are converted into ordinary shares by the government, the government's stake loses seniority over the pre-existing ordinary shares. Therefore, the government has to carefully decide the timing of conversion into ordinary shares so as not to subsidize junior shareholders of marginally capitalized banks. Thirdly, I still have an impression that the write-off of bad loans has not been completed yet especially for relatively under-capitalized banks. Finally, the profitability of Japanese banking sector has not recovered yet. The spread of average lending rate over market interest rate has been rather stable in the past several years in spite of the increasing loan-loss rate.

Therefore, we have to monitor the application of the two Acts by the financial regulatory authorities carefully so as not to distort the functioning of incentive mechanism for shareholders, managers, employees and customers of Japanese financial institutions.

## Appendix

### Shadow Financial Regulatory Committee (Japan) Statement # 3

#### Urging a Proper Implementation of Prompt Corrective Action, Financial Revitalization Act, and Bank Recapitalization Act

December 8, 1998

*The members of Shadow Financial Regulatory Committee in Japan are: Mitsuhiro Fukao (Keio University), Chair; Kazuhito Ikee (Keio University), Takatoshi Ito (Hitotsubashi University), Mitsuru Iwamura (Waseda University), Yuri Okina (Japan Research Institute), Hideki Kanda (University of Tokyo), Yutaka Kosai (Japan Economic Research Center), Akiyoshi Horiuchi (University of Tokyo), Takeo Hoshi (University of California, San Diego). Mitsuru Iwamura could not participate in the process of drafting the current proposal. The committee acknowledges the financial support from Tokyo Center for Economic Research.*

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#### Summary of the statement

1. The regulatory authority and policy makers should:

- (1) implement Prompt Corrective Action, Financial Revitalization Act, and Bank Recapitalization Act strictly in their stated purposes.
- (2) use public funds to recapitalize a bank only when the bank successfully raises additional capital on their own efforts in the market.
- (3) require banks to disclose the exact amount of non-performing loans with a rigorous application of classification.
- (4) clarify the responsibility and the scope of the regulatory authorities.
- (5) clearly define the objectives of the manager of a nationalized bank or a bank under receivership, so that those banks can be sold off or re-privatized without undue delay.

2. Bank managers and the public should recognize:

- (1) that it is utmost important to formulate a clear plan to make Japanese banks profitable in the near future.
- (2) that restructuring of banking industry inevitably apply further downward pressure to the economy.
- (3) that substantial decline of indirect finance is inevitable.
- (4) that restructuring and scale reduction alone cannot improve the quality of bank management. The Japanese banks need forward looking strategies to survive the

international competition.

### **1. Implementation of Financial System Stabilization Policy**

- (1) The regulatory authority should implement Prompt Corrective Action, Financial Revitalization Act, and Bank Recapitalization Act strictly in their stated purposes.

The regulatory authority must not apply Bank Recapitalization Act to recapitalize insolvent banks or banks with negative going concern value (in the sense they are not likely to yield profits in the future). An insolvent bank should be put under a national receivership under Financial Revitalization Act. Prompt Corrective Action should be applied to a solvent but undercapitalized bank before it receives public funds for recapitalization. By applying these laws properly, the regulatory authority can induce correcting the state of overbanking.

In applying Bank Recapitalization Act, banks' security holdings should be evaluated using the lower of their historical costs and their market value. The classified loans should be evaluated as the present discount value of the future recoverable amounts. When a bank effectively guarantees borrowings by insolvent customers, the expected loss should be subtracted from bank capital. Currently, all the general loan loss reserves are included in the broadly defined bank capital, but the reserves for expected loss from substandard loans should be excluded from capital.

When Hokkaido Takushoku Bank failed last year, and when LTCB (Long-term Credit Bank) was nationalized this year, their subordinated debts were not subordinated under those circumstances. The regulatory authority should scrutinize the subordination clauses for subordinated debts, and those debts that would not be subordinated when a bank is nationalized or is put under national receivership as specified in Financial Revitalization Act should be excluded from bank capital (possibly after 5 years or so of transition period).

- (2) The government should use public funds to recapitalize a bank only when the bank successfully raises additional capital on their own efforts in the market.

The government should use public funds to recapitalize a bank only when the bank successfully raises additional capital on their own efforts in the market. Since Bank Recapitalization Act aims to help banks that are undercapitalized but have positive going concern value, the government should not inject public funds into banks whose viability is doubted by the market.

Public funds should be used to recapitalize the bank itself, rather than its subsidiaries or SPC (Special Purpose Companies). The Financial Supervisory Agency is on the right track on this issue. When the government purchases preferred shares to recapitalize a bank, the bank should be allowed to deduct the dividend payments on the shares for corporate tax purposes to avoid burdening the bank with high dividend payments.

According to the media reports, the banks that accept public funds would be required to increase their loans to small and medium enterprises. It is true that injection of public funds increases risk-taking capacity of banks and increases their lending capacity. When the banks extend loans, however, the banks should exercise their own judgement on whether the expected profits on the loans are high enough to compensate for the risk. It is wrong for the government to impose the quantity target for the amount or growth of such loans.

The preferred shares purchased by the government must be preferred not only in

payout of dividends but also in division of proceeds from liquidation. To achieve the fairness between shareholders, the potential voting right of a preferred share should be made proportional to the paid-in amount of the preferred share relative to the market price of common share. It is desirable to make the preferred shares convertible into common shares, so that the government can gain from share price increase following successful restructuring of banks.

The subordinated debts bought by the government should be subordinated to other debts when the bank is nationalized or put under national receivership defined in Financial Revitalization Act.

- (3) The regulatory authority should demand banks to thoroughly disclose the amount of bad loans.

The regulatory authority should demand Japanese banks to start using IASC (International Accounting Standards Committee) or FASB (Financial Accounting Standard Board) standards. Ever changing disclosure standard for bad loans for Japanese banks has been seriously hurting the credibility of Japanese financial system. Each bank should be required to disclose all the problem loans for the consolidated account, classified according to the extent of loan losses.

The regulatory authority should publish the standard reserve ratios for bad loans based on the present discount values of collectible amounts. If a bank chooses to use non-standard reserve ratios, the regulatory authorities should require the bank to explain in detail.

- (4) The government should clarify the responsibility and the scope of the regulatory authority.

Demarcation among various supervisory authorities—Financial Revitalization Committee, Financial Supervisory Agency, Ministry of Finance, Deposit Insurance Corporation, and the Bank of Japan—must be clarified by the government. The scope of responsibilities has to be clearly defined.

For instance, many examiners at Financial Supervisory Agency formally belong to Ministry of Finance and the ministry rather than the agency handle their personnel matters. We believe the situation is problematic and suggest the complete transfer of the examiners to Financial Supervisory Agency.

At the same time, Financial Supervisory Agency is seriously underfunded and understaffed. The government should provide funding and staff that are sufficient to carry out prompt examinations of problem banks.

- (5) The government should clearly define the objectives of the manager of a nationalized bank or a bank under receivership, so that those banks can be sold off or re-privatized without undue delay.

The government should provide incentives to the managers of nationalized banks, such as LTCB, so that they try to re-privatize the banks as fast as possible. For example, the government may wish to pay an extra bonus to the managers who can privatize the failed financial institutions quickly.

## **2. Reconstruction of Banking Industry and Financial System**

- (1) Bank managers need to formulate clear plans to make their banks profitable in the



near future.

Managers at major banks should be responsible in formulating a clear plan to regain the confidence of the market. They should present a clear picture on how recapitalization with public funds help the banks to regain the profitability, how quickly they plan to shed non-profitable business lines, and which business areas they plan to focus on.

- (2) Restructuring of banking industry inevitably apply further downward pressure to the economy.

Making the financial system free from burdens of non-performing loans is necessary for the Japanese economy to resume growth in the medium-run. Reorganization of banks and restructuring of banking industry, however, will deepen the recession in the short-run. Many insolvent and unprofitable corporations, which have been supported by their banks, are likely to fail. The exit of unprofitable firms naturally accompanies the necessary structural shift of the Japanese economy. A drastic policy is desired to achieve the structural adjustment at the minimal social cost.

- (3) Substantial decline of indirect finance is inevitable.

Injection of public funds to the banking sector may stop the competitive collection of bank loans, but the amount of bank loans has been declining for structural reasons. Banks have to obtain adequate profit margin so as to cover the expected loan loss rates. This is likely to increase the average loan interest rates.

- (4) Restructuring and scale reduction alone cannot improve the quality of bank management. The Japanese banks need forward looking strategies to survive the international competition.

Across the board wage cut may help the harmony among employees by maintaining the existing wage structure, but may encourage talented employees to leave. In order to survive the international competition in financial services, retaining talented people by recognizing their market value becomes increasingly important. Bank managers may want to introduce the salary structure that more reflects the difference in productivity of individual employee. They may try reducing the total number of employees while increasing the average salary for the remaining employees.