BANKING REGULATION AND SUPERVISION IN JAPAN:

SOME ISSUES AND CONCERNS

by

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ABSTRACT

Despite significant changes to the governing institutional framework and to operational procedures, a number of serious doubts remain concerning the cost-effectiveness of banking regulation and supervision in Japan. This paper duly highlights these lingering doubts focussing, in particular, on failure resolution policy and the authorities' handling of the banks' bad debt problems. One of the main conclusions of the paper is that the present government's commitment to resolve the banking industry's bad debt problem by end-2004 is extremely unlikely to be met without a major injection of additional public funds.

INTRODUCTION

In recent years, major improvements have been made to both the institutional framework governing the regulation and supervision of Japanese banks, and to the operational procedures adopted by the various supervisory agencies. Despite such moves, however, a number of concerns remain, particularly in relation to the failure resolution policies adopted and to the authorities' handling of the banks' bad debt problems. Following a description and assessment of the recent evolution of bank supervisory policy in Japan, the problem areas highlighted above are examined in more detail. The scope for further increases in cost-effectiveness is clearly demonstrated, as is the need for an additional injection of public funds if the government's commitment to resolve the banking industry's bad debt problem by end-2004 is to be met.

THE EVOLUTION OF THE CURRENT INSTITUTIONAL FRAMEWORK

The institutional landscape governing the regulation and supervision of financial institutions in Japan prior to the reforms of 1998 is illustrated in **Exhibit 1**. The institutions involved comprised: the Ministry of Finance (MoF) [through its various bureaux]; the Bank of Japan (BoJ); the Ministry of International Trade and Industry (MITI); and various Self-Regulating Organisations (SROs).

Under the supervisory reforms of June 1998,[i] a new supervisory body, the "Financial Supervisory Agency" (**FSA**), was created. Acting as an agency under the Prime Minister's office, and hence independent of the MoF, it assumed the roles of licensing, inspection and supervision (of banks, securities firms and insurance companies) previously performed by the MoF.[ii] The **MoF's** banking and securities bureaux were merged to form a new "Financial Planning" bureau in charge of financial system planning; and the Securities and Exchange Surveillance Council was transferred from the MoF to the FSA. [For a summary of how the new agency was supposed to interact with existing supervisory institutions *see* **Exhibit 2**.]

Further changes resulted from the deposit insurance reforms of 1998.[iii] Firstly, the Deposit Insurance Law was amended in February 1998[iv] as part of a package of emergency measures - the so-called **"Financial Stabilization Law"** - designed to stabilise the financial system in the wake of the nervousness generated by the collapse of Yamaichi Securities and other financial institutions during the Autumn of 1997. The changes embraced, *inter alia*:

(a) A strengthening of the financial base of the Deposit Insurance Corporation (**DIC**) through the injection of public funds (¥30 trillion in total, comprising ¥7 trillion available to meet losses arising from failure resolution, ¥10 trillion available for the purchase of assets from failed financial institutions, and ¥13 trillion available to finance purchases of preferred stocks and subordinated debt from financial institutions [the last-mentioned is available through the "Financial Crisis Management Account" set up at the DIC]) and the conferment on the DIC of the power to issue bonds.

(b) An extension in the power of the Resolution and Collection Bank (**RCB**)[v] to allow it to take over the financial business of *any* failed financial institution (previously, such activity was confined to failed credit cooperatives). And

(c) the establishment of an "examining board" to administer the financial assistance available thorough the Financial Crisis Management Account in a fair and proper way, i.e. in accordance with a prescribed set of objective criteria.

Further reforms were implemented in October 1998 under the so-called **"Financial Revitalization Legislation"**. They were designed to develop and improve upon the then existing arrangements for the resolution of failed financial institutions. They involved, *inter alia*:

(a) The creation of two new bodies - the "Financial Reconstruction Commission" (**FRC**), which was set up in December 1998 under the Prime Minister's office to act as the organisation responsible for the disposal of bankrupt financial institutions and the recapitalisation of financial institutions with public funding (it was also expected to absorb the FSA by January 2001); and the "Resolution and Collection Corporation" (**RCC**), which was to operate as a private corporation along the lines of the US's Resolution and Trust Corporation - i.e. to buy the banks' bad loans, collect collateral and manage the assets until eventual disposal - and to result from the merger of the then existing RCB and the Housing Loan Administration Corporation.[vi]

(b) The establishment of a new account - the "Financial Revitalization (or Reconstruction) Account" - at the DIC with access to public funding of up to ¥18 trillion, which could be used for the conduct of financial revitalisation activities, such as the establishment of "bridge banks", the (temporary) nationalisation of financial institutions,[vii] and the purchase of financial institutions' assets. And

(c) the introduction of new approaches for the handling of failed and weak banks.

Until end-March 2001 (later extended by one year), the FRC would be able to deal with financial failures through liquidation, the appointment of financial administrators to take over the management of such institutions until they can be returned to private ownership - "bridge banks" can be established by the DIC to continue to make loans to "sound" borrowers while the search for a private buyer continues - or through special public management (i.e. nationalisation). Similarly, over the same period, the RCC can use the resources of the Financial Revitalisation Account to purchase non-performing loans from failed financial institutions placed under financial administration and from bridge banks, banks subject to special public management, and other financial institutions.

The final changes resulting from the deposit insurance reforms of 1998 arose from the implementation of the so-called **"Financial Function Early Strengthening Law"** in October 1998. They were designed to ensure the early restoration of financial stability by facilitating the swift disposal of financial institutions' non-performing loans and by establishing a new system for recapitalising weak but viable institutions. In connection with the latter, yet another new account

- the 'Financial Function Early Strengthening Account' - was established at the DIC, endowed with up to ¥25 trillion of public funds to be used by the RCC to purchase the common or preferred stocks, etc. of applicant institutions.[viii] This replaced the ¥13 trillion 'Financial Crisis Management Account' set up in February 1998 (*see* above).[ix]

The deposit insurance reform of 2000 cemented the reforms of 1998. For, under this revision to the Deposit Insurance Law, the potential size of public sector funds available for financial stabilisation was raised from ¥60 trillion - ¥25 trillion available to the 'Financial Function Early Strengthening Account' to recapitalise weak but viable institutions, ¥18 trillion available to the 'Financial Revitalisation Account' to finance revitalisation activities, and ¥17 trillion available to the DIC to fund losses arising from failure resolution, including the purchase of assets from failed financial institutions - to ¥66 trillion following a ¥6 trillion additional grant of government bonds to the DIC.

Finally, under the supervisory reforms of 2000/01, a number of further significant changes were implemented. In July 2000, a new agency, the **Financial Services Agency** (FSA, mark II), emerged following the assumption of the licensing, inspection and supervisory functions of the old FSA, and the financial planning responsibility previously performed by MoF's Financial Planning Bureau.[x] In January 2001, the new FSA swallowed up the FRC, thereby assuming responsibility for the disposal of failed banks and financial crisis management also. It now operates as an external organ of the Cabinet Office. And, in June 2001, the new FSA announced plans to force banks to unwind their cross-shareholdings - *see* below. This would involve the creation of a new government-run body, the **'Banks Shareholding Acquisition**

Corporation' (BSAC), which would be able to buy shares, at "market" prices, from those banks unwilling to offload them on to the open market.   It was hoped that the scheme would be up and running by the end of fiscal 2001.

As a result of all these reforms, we duly end up with the *current institutional landscape,* which is illustrated in **Exhibit 3**.

POTENTIAL PROBLEMS WITH THE CURRENT INSTITUTIONAL FRAMEWORK

Given the similarities between Japan's FSA and our own - both are fully-integrated supervisory authorities - it would be surprising if at least some of the potential problems identified for the UK's institutional arrangements are not relevant to Japan. Typically, such *fears/concerns* surrounding the creation of a single regulator (outside the central bank) embrace the following, among others:[xi]

? that a bureaucratic leviathan, divorced from the industry it regulates, may result;

? that the economies of scale and scope arising from integration may be more meagre than anticipated;

? that the effective integration of the different functional regulators/supervisors, with very different cultural backgrounds, may prove difficult to manage;

? that a loss of specialist knowledge of supervisors (both firm-specific and industry-specific) may result;

? that problems are likely to arise in co-ordinating the activities of the supervisory authority, the central bank, and the Finance Ministry (and the deposit insurance agency in Japan's case) in the quest for financial stability; and

? that, without a change in supervisory culture, the reforms will prove to be a costly yet largely cosmetic exercise as the same personnel are reallocated to new functions and buildings/offices.

Whilst the new arrangements are still in their infancy, it is reasonably clear that:

- ? Notwithstanding the significant increase in the number of inspectors employed, the FSA is still under-resourced, given the tasks it is asked to perform.
- ? Although its earlier incarnation got off to a good start under the leadership of Mr. Hakuo Yanagisawa, the reformist zeal of the FSA has been subsequently questioned. It is to be hoped that Mr. Yanagisawa's return to the fold to head up the new FSA - he took control in December 2000 - has reinvigorated the reform process and re-established credibility in the institutional framework.[xii]
- ? Co-ordination and co-operation between the various parties might benefit from the introduction of UK-style 'memoranda of understanding', both to cover the form of co-operation expected in the event of a financial crisis[xiii] and bilateral arrangements with overseas supervisors.[xiv]
- ? The FSA and the BoJ might also benefit from a formalisation of their co-operation in the inspection/supervision of banks *via* the adoption of a "lead regulator" approach.

OPERATIONAL PROBLEMS

Again, despite recent changes in the conduct of banking supervision (*see* Hall, 1999b) and the switch in emphasis of inspection procedures since July 1999 away from assessing asset quality and in favour of an assessment of risk management capabilities and internal controls (*see* FSA, 1999), a number of concerns remain. The efficiency of the supervisory process would be enhanced, for example, if:

- ? internal audit was better resourced and treated more seriously;
- ? the quality of external audits was increased;[xv] [xvi]

- ? off-site supervision was improved and a better balance was struck between off-site supervision and on-site examination;
- ? supervision of banks became more risk-focused, based upon formal ratings (by both the FSA and the BoJ) of institutions; and
- ? local bankruptcy procedures were further reformed to facilitate the speedy and orderly resolution of failed institutions.

FAILURE RESOLUTION AND DEPOSIT INSURANCE : PROBLEMS AND CONCERNS

The existence of "prompt corrective action" (**PCA**) in Japan[xvii] - *see* **Exhibit 4** - and the recent reforms (discussed above) to the deposit insurance arrangements now allow, in principle, for the prompt resolution of insolvent banks, *via* liquidation, assisted merger, temporary[xviii] nationalisation or the use of the bridge bank scheme, and the disposal of their (and weak banks') bad debts, and the recapitalisation of "sound" but weak banks. In this manner, market discipline can be enforced and excess capacity reduced, even in the face of an official "too-big-to-fail" (or, as the Japanese Shadow Financial Regulatory Committee (1998) prefer, a "too-big-to-close" policy) doctrine. Supervisory forbearance can thus be superseded by prompt corrective action entailing, if necessary, speedy liquidation.

Notwithstanding these potential improvements, a number of problems and concerns remain:

- ? The authorities are still very reluctant to reduce excess capacity in the banking sector through outright liquidation; rather they prefer to use public management (i.e. nationalisation and the Bridge Bank Scheme) and assisted mergers to handle failed institutions[xix] because of their alarm at the pace of credit contraction. In this manner, "zombie"-like institutions are kept going well beyond their "sell by" dates!

? If a more realistic external assessment of banks' net worth was made, with banks being forced to write-off loan losses immediately, PCA could be used more forcefully to weed out poor management and liquidate terminally-ill institutions.

? In respect of the creation of the Financial Function Early Strengthening Account (which superseded the Financial Crisis Management Account), with up to ¥25 trillion available to recapitalise financial institutions, a number of criticisms have been made:

(i) to the extent that "weak" financial institutions are assisted, dangerous moral hazards are created, as it could give the impression that "weakness" is to be rewarded;[xx]

(ii) by sustaining over-capacity in the banking sector, it slows down the move to long-run equilibrium in the industry when each bank would be making a normal rate of return;[xxi]

(iii) because it does nothing directly to tackle the banks' bad debt problems, other than to increase their capacity to write-off bad debts, the money would be better spent closing failing institutions, disposing of their bad debts and paying off the depositors affected.

? The dangers of using deposit insurance to stabilise the banking and financial sectors have been vividly illustrated in Japan with the authorities failing to stick to their earlier pledge to remove the blanket coverage given to depositors at end-March 2001.[xxii] Under the revisions made to the Deposit Insurance Law in May 2000 (*see* DIC, 2000), all deposits are now protected until end-March 2002, with liquid deposits (i.e. current deposits, ordinary savings, etc.) enjoying full protection for a further year beyond that date. In other words, it won't be until at least end-March 2003 before depositors, once again, face "haircuts" beyond the ¥10 million (to cover both principal and interest) per customer per bank limit.

? Finally, despite the improvements made since its inception, deposit insurance arrangements in Japan remain vitally flawed because of their failure to embrace risk-related premia and the co-insurance principle, failings which create moral hazard for managers/shareholders and depositors alike (*see* Hall, 1999a and 2001b).

CONCERN ABOUT THE AUTHORITIES' HANDLING OF THE BANKS' BAD DEBT PROBLEMS

The nature of the problem.

The long-standing bad debt problem faced by Japanese banks since the bursting of the asset price bubble in the late 1980s/early 1990s (*see* BIS, 2001, and Hall, 2000) is inextricably linked to a number of factors, such as (*see* Hall, 1999c for further details):

(i) weakness of the domestic economy,[xxiii] which can only get worse in the light of recent world events and the limited scope for manoeuvre available to the Japanese government;[xxiv]

(ii) continuing weakness in the domestic property market;[xxv]

(iii) continuing weakness in the Japanese stock market;[xxvi]

(iv) excess capacity in both the banking and financial sectors (partly due to earlier "no failure" policies and supervisory forbearance);

(v) low profitability; and

(vi) continuing deflation, which exacerbates the corporate sector's ability to service its debts and raises the government's real debt burden.

What is the scale of the problem?

Despite many years of grappling with their bad debt problems - between fiscal 1992 and fiscal 2000, the banking industry has incurred ¥72 trillion of "losses" on its disposal of bad debts, including making direct write-offs of ¥31 trillion and transfers to allowances for loan losses of ¥36 trillion - the Japanese banking industry still faces a huge burden to overcome. The latest official figures available reveal that, for the deposit-taking sector as a whole, "bad" loans, when defined as *"risk management loans"* [which comprise "non performing loans" (i.e. loans to borrowers in legal bankruptcy plus past due loans in arrears by 3 months or more) plus "restructured loans" (*see* Hall, 2000, p.80, for a full definition)], amounted to **¥43.4 trillion at end-March 2001** (*see* **Exhibit 5**). This compares with a figure of ¥35.2 trillion recorded at the end of March 1998 when reasonable disclosure standards were first introduced (*see* **Exhibit 6**), and matches the industry's figure for "classified assets" - that is, loans classified as "bankrupt or *de facto* bankrupt", "doubtful" and "special attention" - posted for end-March 2001 under the "self assessment of asset quality" required by the Financial Reconstruction Law.

An alternative official definition of "bad" ("problem" is perhaps a better description) loans - *see* **Exhibit 7** - which also results from the FSA's aggregation of the institutions' self-assessment of asset quality, puts the headline figure at end-March 2001 at **¥82.7 trillion**, where this figure represents the *sum of Category II exposures* (i.e. those where the borrowers "need attention" and which *may* result in losses being incurred, and against which the FSA recommends provisions of around 15 per cent are held), *Category III exposures* (i.e. those thought *likely* to incur losses because the borrowers are "in danger of bankruptcy", although it may be difficult to quantify the scale of likely losses or judge when such losses are likely to occur - provisions of around 70 per cent are recommended in this case) and *Category IV* exposures (i.e. those deemed uncollectable or of no value because the borrowers are 'bankrupt or *de facto* bankrupt'). [The two "bad" debt measures can be reconciled by making an appropriate assumption about the amount of Category II exposures which are deemed "non-performing" - *see* Bank of Japan, 1998.] This represents over 12 per cent of the industry's credit exposures.

As if this was not confusing enough, the FSA revealed in April 2001 that the figures given out previously for Category II to IV exposures were, in fact, net figures, that is net of expected collateral collections arising from any "high quality" (e.g. deposits, Japanese government bonds, etc.) collateral held. The gross figures are, of course, considerably higher, leading the Democratic Party of Japan, the largest opposition party, to claim in April 2001 that the "real" level of problem loans was **¥151 trillion**, the sum of the gross figures for Category II to IV loans obtaining in March 2000.

Since then, the FSA has also revealed figures for the position ruling at end-September 2000, at least in respect of the banks. These show that the total of problem loans (i.e. those to "bankrupt or quasi bankrupt borrowers", those receiving "special attention" and others "needing attention") was ¥111 trillion, ¥47.4 trillion (43%) of which was covered by "prime" collateral or guarantees, or by special provisions (Bank of England, 2001a, p.47). If this "coverage ratio" still held at end-March 2001 and was typical of the whole of the deposit-taking sector, then the gross figure for Category II to IV loans at end-March 2001 would have been approximately **¥145 trillion** [i.e. ¥ $\left(\frac{82.75 \, x \, 100}{57}\right)$ trillion].

So what is the true scale of Japan's deposit-taking sector's current bad debt problem? The preceding analysis suggests that the upper and lower boundaries lay between ¥43 trillion and

¥145 trillion respectively (assuming the correct coverage ratio was applied) at end-March 2001, the latter falling to around ¥83 trillion if the FSA's estimated collateral collection proves correct. But this latter figure is still too high as an estimate of the industry's "bad" loans as it assumes that all Category II loans will turn sour (i.e. become "non-performing"). Without an accurate estimate of this migration of loans from "good" to "bad", however, it is impossible to provide an accurate estimate of the upper bad debt boundary. Many outside observers, nevertheless, fear that both the FSA's estimate of collateral coverage and the industry's assumed rate of migration of loans from Category II to Category III (and, indeed, out of Category I and from other categories into Category 4) will prove wildly optimistic, a fear heightened by the FSA's admission in July 2001 that the major banks had underestimated such loans by up to 30%. And the recent downturns in the domestic and world economies, matched by continuous falls in asset prices at home, can only serve to reinforce their scepticism. If the doubters are proved right, the Japanese banks will prove to be seriously under-provisioned, leading to yet further depletion of economic capital which the banks can ill afford at the present time.

Is a speedy resolution to the banks' bad debt problems possible without a further public injection of capital?

Earlier this year, the Japanese government announced plans to force banks to write-off their existing bad debts within 2 years and any new bad debts which surfaced, within 3 years (*see* next section). With the clean-up "deadline" apparently in danger of slipping to the year 2007, it is instructive to question if even this less demanding target is realistic without a further injection of public funds. For, while the FSA insists that the ¥15 trillion still potentially available at the Financial Function Early Strengthening Account will only be used to recapitalise the banking system in the event of a systemic crisis, and Mizuko Holdings maintains that new preference share issues will be used by the major banks to raise new capital should current FSA inspections of loan books (*see* below) suggest further provisions are called for, others argue that further injections of public funds will inevitably prove necessary, even if no systemic crisis emerges. [Some also fear that the risks of contagion will be heightened if any preference shares issued are simply absorbed by affiliated companies and/or life assurance companies.]

The "arithmetic" required to prove or disprove the latter view is, unfortunately, problematic given the considerable uncertainty surrounding the relevant data. At the *individual bank level*, the "manageability" of the bad debt problem over a given period of time depends on a number of factors, such as:

(i) the stock of existing "bad" debts;

(ii) the scale of new bad debts likely to arise over the specified time horizon;

(iii) the current stock of specific loan loss provisions;

(iv) the value of loan collateral that can be collected;

(v) the value of unrealised gains on securities holdings;

(vi) the current level of capital maintained;

(vii) the bank's ability to generate new capital internally (i.e. from operational profits) over the specified time horizon; and

(viii) the bank's ability to raise new capital externally, at reasonable cost, over the specified time horizon.

Even if we can agree on (i), the level of bad debts that really matters to the banks - i.e. [(i) + (ii)] - [(iii + (iv)] - is subject to the uncertainty surrounding (ii) and (iv), both of which are open to a degree of manipulation by the banks themselves. Similarly, attempts to make up for any impairment of capital (which, at least for internationally-active banks, is constrained by the 8% minimum risk assets ratio laid down by the Basel Committee) caused by their bad debt problems will be subject to the uncertainty surrounding items (vii) and (viii) and their ability to realise any remaining paper profits that arise from item (v). If we assume, however, that over the specified time horizon, the capital market refuses to supply more external capital (at reasonable cost), that the Japanese stock market fails to pick-up, and that operating profits fail to improve much beyond recent levels (they amounted to only ¥446 billion for the banking industry in fiscal 2000 - *see* FBAJ, 2001), then individual bank attempts to unilaterally (i.e. without government support) solve their bad debt problems will crucially depend on the current capital margin maintained above the required 8% [4% for "domestic-only" operators] minimum risk assets ratio and their share of industry profits. And, in connection with the latter, mergers, especially between institutions of a similar size, may not be the answer (*see* Drake and Hall, 2002), although they might, of course, render the combined entity "too-big-to-close", one possible rationale behind the latest mega-merger proposals recently announced by Asahi Bank and Daiwa Bank.

Collectively, the banking industry has to deal with those "bad" loans which have either not been provisioned against or adequately collateralised - the "problem loans to be disposed of" shown in **Exhibit 6**, estimates for which, though unreliable (Hall, 2000), used to be provided by the MoF/FSA. Again, its ability to "manage" the situation over any given time horizon depends on the same range of factors identified immediately above.[xxvii] So, any significant deterioration in the industry's bad debt position, whether caused by the economic downturn at home or abroad, or resulting from a more realistic appraisal of borrowers' ability to pay and/or assessment of the value of loan collateral, will put severe pressure on capital, which may prove difficult to replenish from either internal or external sources.

Recent government initiatives to alleviate the banks' bad debt burden.

The first serious attempt to assist the banks came in the form of the capital injections made under the deposit insurance reforms. By 8 July 2000, ¥8 trillion (¥7.45 trillion of which was injected in March 1999 to 15 institutions, with the rest being injected into a further 7 banks during fiscal 1999) had been injected under the ***Early Strengthening Law***. Over the same period (it all took place in March 1998), 21 banks enjoyed ¥1.8 trillion of capital injections under the ***Financial Stabilization Law***.

Sales of bad debts to the RCC (previously, the HLAC and the RCB) was seen as another means of providing some relief. Over the period fiscal 1995 to end-fiscal 1999, the book value of credits assumed by the HLAC was ¥4.658 trillion. Over the same period, ¥3.447 trillion (at book prices) of credits were transferred to the RCB [including ¥21 billion from healthy banks in fiscal 1999]. But, since its establishment in April 1999, only ¥1 trillion or so of bad loans have been sold to the RCC.

A package of proposals announced in June 1998 (*see* LDP, 1998) was also designed to ease the banks' burden. This comprised:

(a) the establishment of a new body to arbitrate or mediate between interested parties involved in claims on collateralised real estate;[xxviii]

(b) enhancement and extension of the public auction process;

(c) provision of tax relief on losses arising from the renouncement of claims on collateral;

(d) promotion of the secondary market for asset-backed securities (part of the 'Big Bang' reform package);

(e) speeding up of the rate of disposal of bad loans by the RCB;[xxix] and

(f) expansion of the Cooperative Credit Purchasing Company's functions, and resumption of its purchases of bad loans from the banks.[xxx]

This was followed in April 2001 with a further package of proposals. Banks would be forced to accelerate their disposal of bad loans, i.e. banks to be forced to write-off (rather than provision against) existing "bad" (defined as loans to bankrupt or virtually bankrupt borrowers) loans in 2 years, and newly-classified bad loans within 3 years. Banks which failed to do so would be required to sell the loans to the RCC. And, a new government-backed (it would subscribe $^1/_3$ of the capital) fund, tentatively named the **Bank Equity Purchasing Corporation**, would be established to buy around ¥11 trillion of banks' cross-shareholdings over a 3-year period. Shares were to be repackaged and sold on to private investors eventually.

In confirmation of the government's plans to set up a public share-buying body, the FSA unveiled a refined version of the April 2001 proposals in June 2001.

The measures were designed to do two main things: to stabilise the banking system's capital base by making it less vulnerable to stock market volatility; and to boost the stock market by removing the dampening effect caused by the banks unwinding of cross-shareholdings. The plans involved the following:

(a) A bank's holdings of equities to be limited, in value, to 100% of its tier one capital by 2004. This would force the industry to dispose of approximately ¥14 trillion (or $^1/_3$ of the total) of equity holdings by then.

(b) A new, government-run body, the **"Banks Shareholding Acquisition Corporation"**, to be set up to buy, at "market" prices, those shares which banks voluntarily wish to dispose of in this way. Financed by the banks (those using its services would have to contribute 8% of the value of the shares sold to it) and borrowings from private sector institutions, the new body, which was established on 30 January 2002, will be able to purchase up to ¥2 trillion (if necessary, the figure may be raised at a later date) shares over a 5-year period. After 10 years, the corporation is to be wound up, with any losses falling, in the first instance, on the member banks and, if they exceed member banks' contributions, subsequently on the government.

Yet another package of proposals emerged in September 2001, when the FSA announced a new "three pillared" scheme to tackle the banks' bad debts. This would involve: more rigorous (annual – previously biennial - and follow-up) inspections of the banks' books by the FSA;[xxxi] requiring the banks to set aside higher provisions against their bad debts to large corporate borrowers;[xxxii] and encouraging the banks to sell their doubtful loans to the RCC.[xxxiii]

Finally, in October 2001, a bill allowing the RCC to buy a broader range of bad debts at "market" prices from the banks was approved. The assets must be disposed of within 3 years of the date of purchase.

Notwithstanding the "time inconsistencies" facing Japanese policymakers (*see* Hall, 1999c), the magnitude of the tasks facing them and the flurry of recent initiatives, significant doubts about the authorities' handling of the banks' bad debt problems persist.

Specifically:

(i) Given what has happened in the past,[xxxiv] few outside observers accept that the "official" bad debt figures provide a realistic picture of the true scale of the problem.

(ii) Similarly, many fear that the industry's current level of provisions is inadequate given its over-optimistic outlook for the future, its overstatement of the value of collateral,[xxxv] its reduced willingness to forgive debt,[xxxvi] and the apparent ease with which loans can migrate between loan classification categories.

(iii) In the light of the above, the rapidly deteriorating domestic and world economies,[xxxvii] the continuing weakness in domestic stock and property prices, and the continuing intensification of competition post-Big Bang, few believe the problem can be speedily resolved - even with the latest initiatives on stream - without a further massive injection of public funds.[xxxviii]

(iv) The operations of the RCC, to date, have been called into question given the low level of its bad debt acquisitions and its failure to dispose of such assets (and accompanying collateral) in a prompt fashion (criticisms made earlier of the RCB). Whilst the measures adopted in October 2001 should, to a degree, address both issues,[xxxix] critics worry about the definition of "market price" likely to be adopted, the ability of current RCC staff to handle the scale and complexity of debt work-outs envisaged, and the uncertainty

> voices express concerns about the scope for market manipulation, the potential scale of losses to be borne by the public purse, the distortions created in the capital allocation process, the resulting insulation of Japanese companies against market pressures to restructure, and the temporary nature of the respite secured from the share over-hang.

It remains to be seen which group is proved right: the Japanese authorities or the critics!

More generally, whilst acknowledging the political difficulties faced by the administration, most outside observers remain concerned at the apparent lack of political will for a speedy solution to the bad debt problem. Despite Prime Minister Koizumi's apparent early zest for reform, under the "no gain without pain" banner, resolution of the problem by end-March 2004 has since been called into question.[xlii] Can Japan and the World Economy really afford any further delay?

SUMMARY AND CONCLUSIONS

? Japan's institutional arrangements for supervision are likely to be subject to the same set of potential problems as ours in the UK, given the similarities between the two countries' integrated financial services regulators (both of which are blessed with the same acronym, FSA).

? The cost-effectiveness of banking supervision could be yet further enhanced if a number of supervisory reforms were to be adopted.

? Despite the existence of a sound institutional framework for the resolution of the failed financial institutions, more could be done to tackle the problem of moral hazard facing the banking industry and to liquidate terminally-ill institutions, thereby reducing the level of excess capacity in the financial services industry.

? Notwithstanding the imminent adoption of new initiatives to assist the banks in the disposal of their bad debts, more needs to be done, and soon, to assuage investors' fears and to limit the potential damage of the debt overhang on the recovery prospects of the Japanese, Asian and World economies alike.

In particular:

(i) a more transparent approach to the calculation of the banking industry's bad debts should be adopted;

(ii) a more realistic assessment of the likely future repayment prospects of the banks' borrowing customers should be made, taking account of the recent dramatic downturns in the national, regional, and international economies;[xliii]

(iii) a more realistic assessment of the value of the collateral backing the banks' bad loans should be undertaken, reflecting the latest falls in asset prices experienced in Japan;

(iv) additional provisions should be promptly set aside by banks to reflect the new balance sheet realities revealed by the above actions;

(v) those rendered insolvent by the adoption of the above measures should be liquidated, using the full resources available to the DIC, with depositors receiving compensation in line with the *de jure* arrangements applying before the emergency measures of 1998 were introduced (i.e. 100% "haircuts" being enforced above the ¥10 million per customer per account level) once the end-March 1992/3 deadlines have passed; and vigorous use of PCA should be made to weed out the "terminally ill" institutions and poor management;

(vi) finally, those temporarily weakened by the adoption of the above measures but which remain solvent and are thought likely to survive and return to soundness in the long term, should receive capital injections from the Early Strengthening Account at the DIC (¥15 trillion is still available) with appropriate action being taken to "discipline" the management and shareholders responsible for allowing the situation to develop in the first place and to ensure an appropriate "restructuring" of the banks.

Through these actions, the credibility and cost-effectiveness of the supervisory process can be enhanced, to the benefit of Japan and the World economy.

EXHIBITS

EXHIBIT 1 : INSTITUTIONAL LANDSCAPE GOVERNING THE REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN JAPAN PRIOR TO THE REFORMS OF 1998*

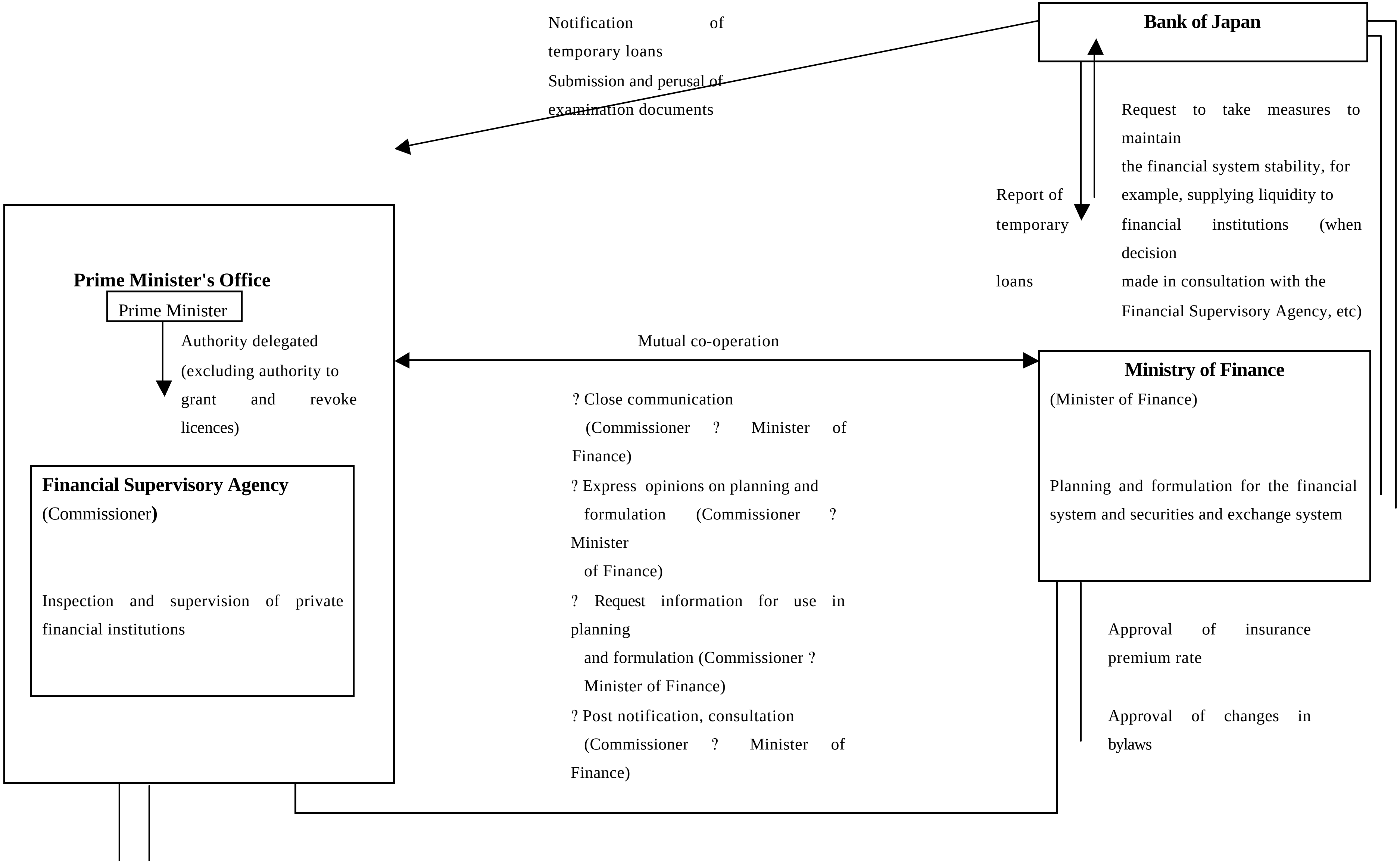
	Main Regulatory Bodies Involved	Main Responsibilities	Governing Legislation
A. Banking Industry	1. Ministry of Finance		(i) Banking Law of 1981;
	(i) Banking bureau	(i) Licensing, inspection and guidance, supervision of banks' "banking operations" (by the Commercial Banks and Special Banks Divisions); Supervision of Bank of Japan (by the Co-ordination Division)	Law Concerning Concurrent Operation of Trust Business by Ordinary Banks 1981; Long-Term Credit Bank Law of 1952
	(ii) Securities Bureau	(ii) Supervision of banks' securities business	(ii) Securities and Exchange Law of 1948; Banking Law of 1981; Trust Business Law of 1922; Financial System Reform Law of 1993; Anti-Monopoly Law of 1947
	(iii) International Finance Bureau	(iii) Licensing and approval of banks' foreign exchange business (by International Banking Division)	(iii) Foreign Exchange and Foreign Trade Control Law of 1947; Foreign Exchange Bank Law of 1954
	2. Bank of Japan	On-site examination of client institutions holding current accounts with BoJ	Bank of Japan Law of 1942
B. Securities Industry	1. Ministry of Finance		
	(i) Securities Bureau	(i) Licensing, inspection, supervision and guidance of securities firms	(i) Securities and Exchange Law of 1948; Law Concerning Foreign Securities Firms of 1971; Financial System Reform Law of 1993
	(ii) International Finance Bureau	(ii) Enforcing foreign exchange regulations	(ii) Foreign Exchange and Foreign Trade Control Law of 1980
	(iii) Securities and Exchange Surveillance Council	(iii) Inspection and supervision of securities firms; investigation of suspected criminal offences	(iii) Securities and Exchange Law of 1948
	2. Bank of Japan	Inspection of securities companies dealing in government securities	Bank of Japan Law of 1942

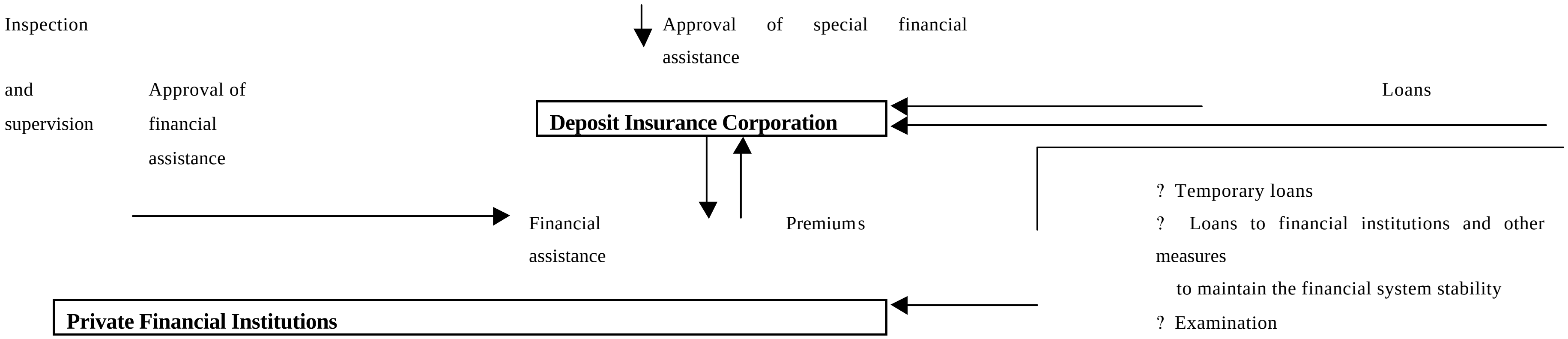
	3. Ministry of International Trade and Industry	Overseeing the running of the commodities market in Japan	Commodity Exchange Act
	4. Self-regulating organisations		
	(i) Japanese Securities Dealers Association	Regulation of the broking industry	
	(ii) Commodity Futures Association	Regulation of the commodity trading industry	
C. Funds management and investment advisory industries	1. Ministry of Finance (via the Securities Bureau)	Licensing, inspection, supervision and guidance of investment advisory companies; licensing, inspection, supervision and guidance of investment management companies	Law for Regulating Securities Investment Advisory Business of 1986; Securities and Investment Trust Law of 1951
	2. Self-regulating organisations		
	(i) Investment Trust Association	(i) Regulation of the funds management industry	
	(ii) Japanese Securities Investment Advisers Association	(ii) Regulation of the securities investment advisory industry	

*Insurance companies were supervised by the Insurance Department of the Banking Bureau of the Ministry of Finance in accordance with the Insurance Business Law of 1996 and the Financial System Reform Law of 1993.

Source: Hall, 1998a, p.177

EXHIBIT 2 : RELATIONSHIPS BETWEEN THE FINANCIAL SUPERVISORY AGENCY, THE MINISTRY OF FINANCE, THE BANK OF JAPAN AND THE DEPOSIT INSURANCE CORPORATION IN 1998





Source: MoF, 1998a

EXHIBIT 3 : THE CURRENT INSTITUTIONAL STRUCTURE OF BANKING REGULATION AND SUPERVISION IN JAPAN

Prime Minister's Office

Financial Services Agency[1]
Functions:
? licensing of private financial institutions
? inspection and supervision of private financial institutions
? resolution of problem banks,[2] securities firms and insurance companies
? financial crisis management
? ?regulation of financial markets[3]
? ?financial system planning

Bank of Japan
Functions:
? on-site examination of client financial institutions holding current accounts with it
? liquidity assistance to promote financial stability

Deposit Insurance Corporation
Functions:
? ?depositor protection
? ?to promote financial stability

Notes:

1 An agency, under the Cabinet Office, which began operations in July 2000 following the assumption of the financial planning responsibilities previously performed by the Financial Planning Bureau of the Ministry of Finance, and the licensing, inspection and supervision functions previously performed by the Financial Supervisory Agency. It also absorbed the Financial Reconstruction Commission in January 2001.

2 This also involves the Resolution and Collection Corporation and, in the near future, will also embrace the Banks' Shareholding Acquisition Corporation.

[3] Carried out through the Securities Exchange Surveillance Commission, which was absorbed from the Ministry of Finance by the old Financial Supervisory Agency on its inauguration in 1998.

EXHIBIT 4 : JAPAN'S VERSION OF PROMPT CORRECTIVE ACTION

Class of Action	Capital Adequacy Ratio Trigger: BIS Standard[1]	Capital Adequacy Ratio Trigger: Adjusted[2] national standard[3]	Action to be Taken
1	Less than 8%	Less than 4%	To order the formulation and implementation of a management improvement plan
2	Less than 4%	Less than 2%	To order such measures or implement such restrictions as: ? formulation of a plan to increase capital ? restraint on the increase of total assets or reduction of total assets ? prohibition on entering new business fields ? curtailment of current business operations ? prohibition on opening new offices and curtailment of offices currently operated ? curtailment of business activities of subsidiaries and overseas affiliated companies, and prohibition on establishing such entities ? restraint or prohibition on paying dividends ? restraint on paying bonuses to directors and other senior officers ? restraint or prohibition on taking deposits at high interest rates
3	Less than 2%	Less than 1%	To order reductions in businesses, a merger or closure
4	Less than 0%	Less than 0%	Usually,[4] to order the suspension of some or all of the business activities[5]

Notes:

1. To be adopted by banks operating overseas whether through branches or subsidiaries.
2. The original "national standard" ratio was calculated as the sum of capital plus certain reserves as a percentage of the daily average of total assets less some special reserves. Under the subsequent revisions, the numerator included debt raised through the issue of subordinated debentures but excluded special reserves and unrealised gains on securities holdings. Moreover, the denominator was eventually represented by the "total of weighted risk assets", as calculated under the BIS "rules" (*see* Hall, 1993, p.189).
3. To be adopted by those banks without foreign branches or subsidiaries.
4. These actions, however, cannot be taken in the following cases: (i) if the net value of assets, as with unrealised gains of the financial institution, is positive; and (ii) even when the net value of assets, as with unrealised gains, is negative but is expected to become positive once allowance is made for implementation of management improvement plans and other specific measures, the rates of business income and expenditure, profitability and bad debt ratios.
5. A business suspension can also be ordered, even when a financial institution does not belong to this class, when the net value of assets, including unrealised losses, is negative (or when it is clearly expected to become negative) or because of a lack of liquidity.

Source: Japanese Ministry of Finance (1996); FBAJ (1999)

EXHIBIT 5 : "BAD" LOANS OF JAPANESE DEPOSIT-TAKING INSTITUTIONS BY INDUSTRY GROUPING, AS AT END-MARCH 2001 (¥bn)[1]

Category of Institution	Number of Institutions	Bankrupt Loans[2]	Past Due Loans		Restructured Loans	Total of "Bad" Loans	% of Total Loans
			6 PDL[3]	3 PDL[4]			
City Banks	9	952	7,638	466	3,838	12,895	5.40
Long-Term Credit Banks	3	536	1,068	23	1,539	3,167	9.98
Trust Banks	6	295	1,610	23	1,291	3,219	7.51
Major Banks Sub-Total	18	1,783	10,316	513	6,668	19,281	6.15
Regional Banks	64	1,085	5,366	120	2,991	9,563	7.03
Regional Banks II	55	461	2,108	39	1,062	3,671	8.23
All Banks	137	3,330	17,791	673	10,721	32,515	6.58
Co-operative Type Institutions	711	1,568	6,165	154	3,047	10,934	8.27
All Deposit-Takers	848	4,897	23,955	827	13,769	43,448	6.94

Notes:

1. Tokyo Sowa Bank, Niigata Chuo Bank and bankrupted co-operatives are excluded from the data.
   [N.B. data for the Nippon Credit Bank is included.]
2. i.e. Loans to borrowers in legal bankruptcy.
3. Past due loans in arrears by 6 months or more.
4. Past due loans in arrears by more than 3 months but less than 6 months.

Source: FSA, 2001

EXHIBIT 6 : THE EVOLUTION OF THE "BAD" LOANS OF THE JAPANESE BANKING SECTOR, 1992-2001

Date	"Bad" Loans Outstanding (¥ billion)	Stock of Specific Provisions Outstanding (¥ billion)	Estimate of "Problem Loans to be Disposed of"[1] (¥ billion)
End of March 1992	7,000-8,000[2]	--	--
End of March 1993	8,400[2]	--	--
End of March 1994	10,500[2]	--	--
End of September 1994	13,300[2]	--	--
End of March 1995	11,640[2]	--	--
End of September 1995	38,086[3]	6,961	18,587[4]
End of March 1996	34,799[5,6]	12,530[5]	8,305[5]
End of September 1996	29,228[7,8]	9,948[7]	7,303[7]
End of March 1997	27,900[9,10]	12,343[9]	4,685[9]
End of September 1997	28,078[11,12]	13,993[11]	4,348[11]
End of March 1998			
Under "old" disclosure standards	24,979[13,14]		N.A.
Under "new" disclosure standards	35,207[13,14]	19,035[13]	1,583[13,15]
End of March 1999	38,656	14,802	N.A.
End of March 2000	41,367[16]	11,500[16]	N.A.
End of March 2001	43,448	10,039	N.A.

Notes:

1. This figure represents an estimate by the Ministry of Finance of the scale of loans for which possible losses have not been provided nor that are likely to be covered by collateral (i.e. loan losses considered "irrecoverable" and not provided for).
2. Ministry of Finance estimate of "nonperforming loans" for the 21 largest banks. Figure include claims against customers who went bankrupt and claims on which interest payments were more than six months overdue due to the suspension of interest payments, but *exclude* "restructured loans" (i.e. those on which interest payments have been cut) and the bad debts of affiliates.
3. Figures include "restructured loans" (i.e. loans on which interest rates have been reduced to below the ruling official discount rate) for the first time and now cover all Japanese deposit-taking financial institutions (i.e. city banks, long-term credit banks, trust banks, regional banks, and co-operatives).
4. The figure is *inclusive* of possible losses (estimated at ¥7,700 billion) resulting from exposure to the eight *jusen* companies.
5. The figures *exclude* the Kizu Credit Cooperative (with about ¥1,190 billion in problem loans), the Fukui Prefecture First Credit Cooperative (¥2.6 billion), the Osaka Credit Cooperative (¥270 billion), and Taiheiyo Bank (¥330 billion).
6. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help (including forgiving loans), estimated at ¥3,795 billion for all "major" banks (i.e. excluding regional banks and co-operatives) at end of March 1996.
7. Loans to *jusen* companies are *excluded*, as are the Kizu Credit Cooperative (with approximately ¥1,190 billion in problem loans), the Osaka Credit Cooperative (¥270 billion), the Kenmindaiwa Credit Cooperative (¥15 billion), and Sanyo Credit Cooperatives (¥17 billion).

8. The figure *excludes* loans to borrowers to which the lending bank is extending help (including forgiving loans), estimated at ¥3,724 billion for all "major" banks (i.e. excluding regional banks and co-operatives) at end of September 1996.
9. The figures *exclude* the Hanwa Bank (with around ¥190 billion in problem loans), the Sanpuku Credit Cooperative (¥26 billion), and the Hanshin Labor Credit Cooperative (¥3.5 billion).
10. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help (including forgiving loans), estimated at ¥3,373 billion at end of March 1997 for all "major" banks (i.e. excluding co-operatives but *including* regional banks for the first time).
11. The figures *exclude* the Hokkaido Takushoku Bank, Hanwa Bank, Hanshin Labor Credit Cooperative, Tokai Credit Cooperative, Toki Credit Cooperative, Kitakyushu Credit Cooperative, Kanagawa Credit Cooperative, Tanabe Credit Cooperative, and the Choginosaka Credit Cooperative.
12. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help, estimated at ¥3,084 billion at end of September 1997 for all major banks (as defined in note 10).
13. The figures *exclude* the Hokkaido Takushoku Bank, Tokuyo City Bank, Kyoto Kyoei Bank, Naniwa Bank, Fukutoku Bank, Midori Bank, and 32 credit companies whose assets and liabilities have been transferred to other institutions.
14. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help, estimated at ¥2,015 billion at end of March 1998 for all Japanese deposit-taking institutions.
15. This figure was provided privately to me by the FSA.
16. The figures *exclude* the Nippon Credit Bank.

Sources: Hall, 2000; Financial Supervisory/Services Agency (various)

EXHIBIT 7 : FURTHER BREAKDOWN OF JAPANESE DEPOSIT-TAKING INSTITUTIONS' CREDIT EXPOSURES AS REVEALED BY THE FSA'S AGGREGATION OF THE INSTITUTIONS' SELF ASSESSMENT OF ASSET QUALITY, AS AT END-MARCH 2001 (¥ billion)[1]

Institutional Grouping	Total Credit Exposure[2]	Category I Exposures	Category II Exposures	Category III Exposures	Category II + Category III Exposures	% Total Credit Exposures
Major Banks	350,121	307,968	40,492	1,660	42,152	12.04
Regional Banks	140,566	123,536	16,369	661	17,030	12.12
Regional Banks II	45,654	39,165	6,257	231	6,488	14.21
All banks total	536,341	470,669	63,118	2,553	65,671	12.24
Co-operative type institutions	134,249	117,174	16,502	573	17,075	12.72
All deposit-takers	670,590	587,843	79,621	3,126	82,747	12.34

Notes:

1. Tokyo Sowa Bank, Niigata Chuo Bank and bankrupted co-operative type institutions are excluded from the data. N.B. Category IV exposures (i.e. those deemed uncollectable or of no value) totalled zero as, by the year end, they had been fully written off or provisioned against. All figures are shown net of estimated collateral collections.
2. Includes loans, discounted bills, securities loaned, foreign exchange, customers' liabilities for acceptances and guarantees, accrued interest and suspense payments.

Source: FSA, 2001

ENDNOTES

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[i] *See* Ministry of Finance, 1998a, for further details.

[ii] This was due to public dissatisfaction with the previous performance of the MoF in these areas and, in particular, to the public outcry at the media revelations concerning the Ministry's involvement in a series of financial scandals (for further details *see* Hall, 1998b, Chapter 2, pp.43-47).

[iii] *See* Hall, 1999a, for a discussion and assessment of the evolution of deposit insurance arrangements in Japan.

[iv] *See* Ministry of Finance, 1998b, for further details.

[v] A body set up in 1996 to facilitate the smooth disposal of failed credit co-operatives - for further details *see* Hall, 1999a.

[vi] A body set up in 1996 to facilitate the resolution of the *jusen* crisis - *see* Hall, 1999a, for further details.

[vii] Measures first used in October 1998 to resolve the problems at the Long-Term Credit Bank and, two months later, to resolve the crisis at Nippon Credit Bank.

[viii] Recapitalisation *via* the purchase of common stock is available only to banks deemed to be "significantly undercapitalised" [i.e. those running a risk-adjusted ratio of under 4% (2% on a non-adjusted basis, for those only operating domestically)] or "critically undercapitalised" [i.e. those running capital ratios of under 2% (1% for domestic operators)]. In each case, it is up to the FRC to decide the terms and conditions (as applicable under an agreed restructuring plan, which is likely to include, *inter alia*, a management reshuffle and suspension of dividend payments - *see* FRC, 1999b) on which funding will be made available. For the former set of institutions, this would normally involve the government in taking a 50% stake; and for the latter, the government assuming full control for a temporary period (ideally, for less than one year, but with the possibility of ownership lasting up to 3 years).

Meanwhile, recapitalisation *via* the purchase of financial institutions' preferred stocks or subordinated bonds, or *via* making subordinated loans, is usually available only to institutions with risk-adjusted capital ratios of at least 4% but less than 8% (2% and 4% respectively, on an unadjusted basis, for those only operating domestically). However, it is available to those institutions with risk-adjusted capital ratios of 8% or above (4% or above for domestic-only operators, on an unadjusted basis) if: (i) such institutions have taken over failed institutions or merged with other financial institutions that have incurred operating difficulties; or (ii) such recapitalisation is deemed essential to avoid "an abrupt and substantial credit crunch".

[ix] In the event, ¥7.5 trillion was injected through this route into 15 major banks in March 1999 (*see* Nakaso, 1999), with additional sums being injected into 9 regional banks plus the Long-Term Credit Bank during the following 18 months. This followed the injection of ¥1.8 trillion into 21 banks in March 1998 under the Financial Stabilization Law (*see* DIC, 2000, p.79). And, in June 2000, the Law for the Early Strengthening of Financial Functions was revised to allow for the recapitalisation of credit co-operatives through this route.

[x] For a discussion of the MoF's further emasculation under the Civil Service reforms implemented in December 2000 *see* Euromoney, 2001.

[xi] A full cost-benefit analysis of the creation of a single regulator (outside the central bank) is provided in Hall, 2001a.

[xii] This was called into question following a number of scandals which dogged the chair of the FRC. For example, Mr. Michio Ochi was forced to resign in February 2000 after promising to be "lenient" to Japanese banks; and a subsequent head, Mr. Kimita Kuze, was similarly forced out of office following an

alleged bribery scandal. And finally, the last head, Mr. Hideyuki Aizawa, earnt a reputation for being lukewarm on reform (e.g. in November 2000 he urged banks, contrary to official policy, to refrain from unwinding their cross-shareholdings for fear of damaging the stock market recovery; and he also advised inspectors to take a soft line towards troubled credit co-operatives for fear of damaging the regional economy).

[xiii] For details of the UK arrangements *see* Bank of England, 1998.

[xiv] These and other supervisory reforms were first proposed in Hall, 1999b.

[xv] Investor concerns had earlier led the Bank of Tokyo Mitsubishi to employ a widely-respected firm of western accountants to carry out its audits in the late nineties. More clearly needs to be done to enhance the training and skills of local auditors if the integrity of external audit is to be restored; and a greater willingness - as evidenced by the actions of the receivers of Yamaichi Securities, the bankrupt Japanese broking house, to sue the firm's auditors, Chuo Audit, for allegedly failing to spot off-balance-sheet losses - to seek financial compensation from negligent auditors should certainly serve to focus minds!

[xvi] Removal of the MoF from the scene has already helped as the agency's prior concern for both regulation and accounting standards had led it to slow down the move towards the adoption of internationally-accepted accounting standards. [Such so-called "accounting forbearance" is discussed in Hall, 2000.] However, the banks' successful lobbying for a delay - until at least April 2002 - in the adoption of 'marked-to-market' accounting treatment (which requires marketable securities to be booked at market value if they have dropped by more than 30% of book value, with any unrealised losses being fully deducted from Tier 1 capital) for derivative portfolios indicates that the old ways die hard.

[xvii] The Japanese scheme, which is clearly modelled on the US form of PCA introduced under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 - *see* Hall, 1993 - was introduced in April 1998 (April 1999 for domestic-only operators) under the Government's "Big Bang" package of reforms (*see* Hall, 1998c).

[xviii] The 1998 candidates for nationalisation, the Long-Term Credit Bank and the Nippon Credit Bank, were subsequently bought by the US-based Ripplewood Financial Services Group and a consortium led by the Japanese Softbank Group respectively. Banks subsequently reprivatised following public management, which include the Kofuku Bank (May 1999), the Kokumin Bank (April 1999), the Tokyo Sowa Bank (June 1999), the Namihaya Bank (August 1999) and the Niigata Chuo Bank (October 1999), were eventually acquired, respectively, by the US-based Wilbur Ross-led Fund, Yachiyo Bank, the US-based Lone Star Fund, Kinki Osaka Bank and, in the case of the Niigata Chuo Bank, by six Japanese regional banks. [For the reprivatisation of shinkin banks and credit co-operatives *see* DIC, 2000, p.69.]

[xix] For full details on the type of DIC assistance provided to failed banks up until 8 June 2000 *see* DIC, 2000, pp.62-67. [N.B. 20 banking institutions failed in fiscal 1999 following the 30 cases in fiscal 1998, leading to ¥5.9 trillion of financial assistance being provided by the DIC (¥5.4 trillion in fiscal 1998).]

[xx] The imposition of a "tough" restructuring plan can, however, mitigate this to a degree, although toughness has to be balanced against the need to induce a take-up of the new funding mechanism, given the voluntary nature of the scheme.

[xxi] Some critics of the initial disbursements made by the FRC in March 1998 (*see* FRC, 1999b) argued that they were a device to allow the banks to comply with the Basel Capital Accord's minimum risk asset ratio requirement of 8 per cent at the end of fiscal 1998 and/or to revive bank lending and hence demand in Japan (*see* Bank of England, 1999).

[xxii] The official reason given for the delay was to allow time for the FSA to conduct financial inspections of smaller financial institutions previously supervised by local government.

[xxiii] By October 2001, it was clear that Japan was slipping back into ("double dip") recession with official figures showing declining industrial production, declining exports and a deterioration in the trade balance, declining bank lending (it had fallen for 45 consecutive months), declining corporate profitability, rising corporate bankruptcies (and associated debts - the collapse of the Sogo department store in July 2000, with debts of around ¥2 trillion, has more recently been followed by the collapse of Mycal, Japan's fourth largest retailer, with debts of around ¥1.4 trillion), rising unemployment (a post-war high of 5.3% was reached in the official figures in September 2001, with the real level being much higher because of unrecorded unemployment) and continuing deflation (the core consumer price index fell by 0.8% in the year to September 2001, the 24th consecutive monthly decline, and it is expected to continue to fall for at least another 2 years; and the GDP deflator fell by 2.2 per cent in the year to end-June 2001). And the latest figures confirm these trends, with unemployment rising to a new record high of 5.6% in December 2001, the trade surplus falling by over 32% during 2001, industrial production declining by over 13% in the year to November 2001, and consumer prices falling throughout 2001.

[xxiv] Despite the recent announcement of yet another supplementary budget (for ¥3 trillion), in an attempt to boost the flagging economy, fiscal expansion is constrained by both the parlous state of the public finances [the general government's net debt (excluding contingent liabilities) already exceeds 130% of GDP and its fiscal deficit is well in excess of 14% of GDP] and by the government's self-imposed cap of ¥30 trillion on the annual net issuance of central government bonds. At the same time, monetary policy has, for years, resulted in nominal interest rates being held at around 0%, with banks refusing to extend credit even when enjoying an enhanced lending capacity as a result of improved reserve ratios. And adoption of an inflation target, assuming the BoJ were to bow to pressure to introduce it, would do little to improve things in the short run, even if it proved practicable. Moreover, it would inflict losses on banks' bold holdings [which, at end-March 2001, stood at over ¥73 trillion] as a result of increased nominal interest rates, thereby compounding the problems caused by the rating agencies' downgrades of Japanese sovereign debt as a result of the deteriorating fiscal position.

[xxv] Land prices fell for the eighth consecutive year in 1999.

[xxvi] The Nikkei 225 closed below the 10,000 mark (compared with an historic high of around 40,000) at the end of the first half of fiscal 2001 (i.e. at end-September 2001), in the process eradicating any unrealised gains on securities held (including bonds) for most banks [Bank of Tokyo Mitsubishi alone revealed losses of ¥400 billion on its equity portfolio, while the industry reported aggregate unrealised losses on investment securities of ¥3.1 trillion], thereby depleting capital ratios yet further under the new mark-to-market accounting rules – *see* Bank of England, 2001b, p.55. [Earlier declines in stock prices, which saw the Topix index fall by 13% over the 6-month period to end-March 2001, had reduced collective unrealised gains on securities holdings from ¥2.8 trillion to ¥0.8 trillion.] At the close of business on the last trading day of fiscal 2001 the Nikkei 225 stood at 11,025, with the broader Topix index standing at 1,060, foreshadowing further valuation losses for the banks.

[xxvii] "Back of the envelope" calculations strongly suggest the need for an external injection of funds. If one assumes that, firstly, the "true" scale of the bad debts existing at end-March 2001 was ¥43 trillion, the figure given in Exhibit 5, and, secondly, that a realistic collateral coverage ratio for these debts is 25%, then the deposit-taking industry's "bad debts to be disposed of" amount to around ¥22 trillion, given specific provisioning of ¥10 trillion (*see* Exhibit 6). If one further assumes that stock prices will not rise sufficiently (estimated to be around the 13,000 level for the Nikkei 225, and around 1,300 for the Topix index) to generate unrealised gains on securities holdings, and that profitability does not improve (thereby constraining internally-generated capital to around ¥0.5 trillion per year, the level of net operating profits recorded for fiscal 2000) then, over a 3-year horizon, banks would need to raise around ¥20 trillion of external capital to fully dispose of their *existing* bad debts (assuming risk asset ratios were held at current levels). Over a 6-year horizon, the figure still amounts to around ¥18 trillion. Thus, if the capital markets do not supply the volume of funds required – the major banks are only talking about raising perhaps ¥200 billion to ¥300 billion each through preference share issues – the DIC will have to step in and recapitalise the banks using the ¥15 trillion still available at the Early Function Strengthening Account if the government's commitment to resolving the banks' bad debts problems by end-2004 is to be

met. And, the greater the emergence of *new* bad debts, the greater the need for the external injection of capital.

[xxviii] The problem arises because loan collateral provided by a business borrower generally is not attached exclusively to a particular loan but, rather, to all its loans from all its lenders.

[xxix] According to the DIC (DIC, 2000, p.72), the RCB Account's "collection ratio" [i.e. the ratio of the (cumulative) total collected from asset disposals to the book price of credits bought from the banks] was only 8.9% at end-fiscal 1996. By end-fiscal 1999 the figure had risen to 27.6%, which compares with a collection ratio of 42.5% achieved by the HLAC Account at the same point in time.

[xxx] Private bank sales to mainly foreign institutions, of non-performing loans are estimated to have reached over ¥10 trillion during fiscal 1999. All were sold at huge discounts to book value.

[xxxi] By way of indicating how seriously the FSA takes the new initiative, it announced in October 2001 that it would start the inspection of the major banks' bad loans (and classifications adopted) immediately rather than waiting until January 2002, as previously announced. It also plans to take a more "forward looking" approach than hitherto.

[xxxii] This appears to have been triggered by the recent failure of the retailer Mycal and revelations that the banks had only set aside minimal provisions to cover their liabilities as they did not regard such loans as being at high risk [i.e. they were classified as either Category I or Category II (rather than Category III) loans]. The same is true in respect of the Daiei group – *see* footnote 36 – yet the FSA is yet to act in this case!

[xxxiii] Currently, the RCC is only permitted to purchase the banks' "bad" loans, and, even then, does so at a steep discount (96%, on average) to book value, thereby reducing the banks' incentive to sell. "Subsidies", therefore, may have to be provided to encourage voluntary sales of "doubtful" loans.

[xxxiv] Including FSA opposition to an independent assessment by the IMF.

[xxxv] As evidenced by the recent revelations surrounding the collapse of Wakashio Bank, which revealed that the true value of its loan collateral was only ¥4 billion and not the ¥39 billion previously claimed.

[xxxvi] As evidenced by its refusal to forgive the debt of the Sogo department store, which sought protection from creditors in June 2000, and of Aoki Construction, which collapsed in November 2001. Contrariwise, debt forgiveness did play a part in the ¥420 billion package of assistance provided to the supermarket group Daiei in January 2002 as the main creditor banks – UFJ, Sumitomo Mitsui and Fuji – fought shy of booking ¥1.6 trillion of additional losses. The scale of the banks' exposure, the size of Daiei's workforce and the extent of its supply network all combined to render the retail Group "too-big-to-fail".

[xxxvii] Which, in the six months to end-March 2001, contributed to the appearance of ¥3.4 trillion of new bad loans for the sixteen major banks, almost wiping out the benefits of the ¥4.4 trillion of disposals made over the same period.

[xxxviii] A view reinforced by the statistics which show that, for the last eight years, loan loss charges have exceeded core operating profits for the banking industry as a whole. Moreover, the banks have promised to repay some of the earlier capital injections made by the DIC (for details of the terms on which DIC assistance was given *see* DIC, 2000, pp.77-80), the Bank of Tokyo Mitsubishi having become the first to do so when it repaid ¥100 billion of perpetual subordinated bonds in February 2000.

[xxxix] They would also facilitate more radical restructuring by short-circuiting the problem arising from banks' reluctance to offend long-standing clients by being heavy-handed with weak borrowers.

[xl] The first securitisation of bad loans was announced by the RCC in January 2002 when ¥100 billion of such loans was placed by Goldman Sachs and Mitsubishi Trust Bank with private investors at a discount of around 90 per cent on their face value. Securitisation of a further ¥230 billion of bad loans is planned by the RCC for March 2002.

[xli] They should provide a useful stimulus to this process as they would overcome the banks' traditional reluctance to sell the shares of affiliates, *keiretsu* members, and long-standing customers.

[xlii] Mr. Yanagisawa, the financial services Minister and head of the FSA, announced in August 2001 that it might take the major banks until 2007 to reduce their bad loans to "acceptable" levels, although Prime Minister Koizumi has since reconfirmed the original timetable.

[xliii] The major banking groups announced in November 2001, perhaps partly as a way of pre-empting the outcome of the current deliberations of the FSA in respect of its review of the major banks' loans to large corporations, major (sometimes in excess of 200% of previous forecasts) increases in loan loss charges for fiscal 2001. The result was that only the Mitsubishi Tokyo Financial Group, of the four mega banking groups in Japan, was able to forecast a full year profit for fiscal 2001, even though, like the majority, it reported an interim net loss. It is also worth noting that the collapse of Ishikawa Bank, a second-tier regional bank, in December 2001 – the first since October 1999 – was precipitated by a FSA inspection which revealed inadequate provisions being held against non-performing loans.

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