July 28, 2003
Financial Services Agency

Report of the Second Sub-Committee regarding the Use of Public Funds for Financial Institutions (Outline)
[Provisional Translation]

1. Situation surrounding financial institutions in Japan and issues

(1) In recent years, the capital base of financial institutions in Japan has been weakening mainly as a result of large amounts of bad-loan disposal and valuation losses on their shareholdings. Looking ahead, financial institutions face a risk of further decline in their capital base.

(2) It is necessary for the Japanese banking sector not only to enhance corporate governance and improve the profitability of banks, but also to make further efforts in early bad-loan disposal and support industrial revitalization. The basic condition for solving financial sector problems is to enhance the retained earnings of financial institutions in a sustainable manner. It is necessary to enhance their capital adequacy since efforts to strengthen the profitability of financial institutions increases new risk.

2. Possible framework for capital injection using public funds

(1) One can take the view that the case of Resona Bank demonstrated that the framework for recapitalizing financial institutions using public funds under Article 102 of the Deposit Insurance Law* is robust enough for the purpose of stabilizing the financial system under the threat of a financial crisis.

* *When it is recognized that there is a risk of serious threat to the maintenance of orderly functioning of the financial markets, the Government can take measures such as recapitalization, financial assistance for protection of deposits above pay-off costs, or special crisis administration.*

(2) However, for the following reasons, it is possible to conceive a framework of recapitalization using public funds for financial institutions that can reform their management for strengthening their profitability and that can perform their financial functions in a sound and proper manner.

① Due to the current issues facing bank management and the continuation of deflationary conditions, it is difficult for the banking sector to provide their intermediary functions properly. With the decline in their capital adequacy ratios, financial institutions are required to be strongly mindful of the capital adequacy requirements. If such conditions persist, the financial functions of those institutions may be weakened substantially.

② The banking sector is required to perform its functions in a sound and proper manner, by calling for a drastic disposal of bad loans and strengthening support for corporate revitalization. It is an important issue for the national economy to secure a sufficient level of capital in measure with the increase of risks (economic capital).

③ Self-financing of capital is limited under the current abnormal market conditions.

(3) Some different views were expressed in the Working Group, as follows.

- According to past examples, recapitalization using public funds do not easily lead to fundamental reform in the management of banks. Any attempt to create a new scheme for recapitalizing banks using public funds should be carefully considered, as serious side-effects may arise.
- There is little need to enhance the capital base of banks under the current deflationary environment, as it is difficult to develop new businesses, and financial institutions should refrain from risk-taking to the extent possible. Refund of corporate income tax, calculated on the basis of loss carry-back resulting from taxable provisioning constituting deferred tax assets, would be preferable to recapitalization using public funds.

3. Individual issues concerning recapitalization using public funds

In order to minimize the side-effects and to secure maximum results from recapitalization using public funds, the Sub-Committee discussed the following individual issues.

(a) Governance by the Government and the type of shares to be held by the Government

(1) General speaking, it should be possible for the Government to impose proper governance by holding preferred shares with voting rights for the appointment and dismissal of board members, on the basis of exercising its supervisory powers.

(2) However, when governance based on voting rights is required to ensure management reform, it is appropriate for the Government to hold common shares.

(3) With regard to the termination of recapitalization using public funds, the Government should have various options, including the cancellation of shares through planned accumulation of profits, or the sell-off of shares in the market.

(b) Management responsibility

(1) In order to prevent moral hazard on the part of management, it is appropriate to require proper steps for taking management responsibility, on the basis of capital adequacy at the time of recapitalization.

(Note)

In the Financial System Early Strengthening Law, different measures for clarifying management responsibility are required, in accordance with the capital adequacy of the institutions, such as " well-capitalized" or" undercapitalized", under the Capital Adequacy Requirements.

(2) It is important to secure improved profitability through management reform. For this purpose, it is appropriate to create a framework for realizing management reform, by making management responsible for the achievement of a business plan ensuring enhanced profitability, including a set of numerical targets.

(c) Shareholder responsibility

(1) Shareholder rights for control of management are diluted by capital injection using public funds.

(2) In addition, it is appropriate to restrain the payout of dividends (prevention of the outflow of profits to outsiders)

(3) Capital reduction does not change net shareholder value, and does not have the effect of imposing losses on existing stockholders. However, capital reduction for the purpose of offsetting losses in the capital account may be viewed positively, since it enables future payout of dividends. Meanwhile, a view was expressed that the reverse split of shares may have a negative effect, since it tends to cause a decline in share prices and may undermine the stability of the financial system.

(d) Requirement for management including strengthened governance

(1) It is necessary to strengthen corporate governance in order to fulfill the following two requirements.
- Strict monitoring of management by the Government
- Enhancement of profitability through allowing discretion of management

(2) Although it is anticipated that financial intermediary functions are performed fully upon recapitalization using public funds, it is not justifiable to focus on the amount of outstanding loans, and to impose a numerical target to increase the amount of lending.

4. Conceivable framework

As a possible option, the Sub-Committee has put together a conceivable framework for the introduction of a new scheme to inject capital using public funds, as below.

(a) Targeted financial institutions

(1) The scope of the financial institutions which may be covered by a new framework is those institutions which are capable of developing highly-profitable businesses on a sustainable basis, based on its business plan.

(2) The management of the financial institution shall create a business plan and set numerical targets. If management fails to achieve the targets, it must take responsibility. The business plan is to be developed based on an accurate recognition of the asset conditions, managerial resources and risks. Based on the plan, the financial institution must recognize the level of capital required in order to pursue its management strategy.

(3) In order not to allow unprofitable financial institutions to survive, it is necessary for the Government to closely examine the validity of the numerical targets and the appropriateness of the commitment of management to the targets.

(4) A precondition for recapitalization using public funds is to exercise a rigorous self-assessment of asset quality by the financial institution and undergo an audit by certified public auditors. The authorities shall confirm the point.

(5) In relation to the emergency framework stipulated in the Article 102 of the Deposit Insurance Law, the use of the Article 102 framework is possible if there is a threat of a serious disruption in the maintenance of the orderly functioning of the financial system, regardless of whether the financial institution is eligible for application of the new framework.

(b) Steady implementation of management reform through enhanced corporate governance

(1) In order to ensure steady implementation of management reforms, it is important to strengthen corporate governance.

• Examination by private sector experts from the drafting stage of the new business plan and the setting of numerical targets.

- In order to ensure steady implementation of the business plan, a system to ensure proper governance should be developed, including the introduction of an appropriate management regime, recruitment of new human resources such as external board members and auditors, establishment of an advisory board, strengthening of the powers of auditors, and introduction of corporate governance committees.
- Thorough recognition of the status of the company making use of managerial accounting and the enhancement of disclosure.
- Rigorous monitoring including appropriate follow-up (ex-post review) by the Government.

(2) With regard to management reforms, in order to ensure the achievement of the management's commitments, management reforms are to be implemented prior to capital injection using public funds, to the extent possible.

(c) Modalities of recapitalization

(1) In principle, preferred shares with voting rights for appointment and dismissal of board members. If there is a particular need for the Government to exercise governance on the financial institution, common shares may be chosen.

(2) The amount of capital injection is to be determined by taking into account the level of capital required in pursuing the management strategy of the institution (economic capital).

(d) Other issues concerning the basic framework

(1) There were two distinct views regarding the treatment of loss arising from recapitalization using public funds.

- A view is that it is not appropriate to put the burden on other financial institutions and thereby increasing contingent liabilities when the aim is to strengthen the financial functions of the institutions. If losses are incurred, the Government should bear the burden.
- An opposing view is that financial institutions should bear the burden in principle, based on the principle that financial resources to solve problems in the financial system should be provided by the financial system itself. Only when the orderly functioning of the financial system is impaired by implementing this principle should the Government provide financial assistance.

(2) The decision to inject capital using public funds should be discussed and made carefully by the relevant ministers. In the decision process, the knowledge and expertise of private sector experts should be exploited.

(e) Point to be noted

There is a risk that recapitalization using public funds, when poorly implemented, may allow unprofitable financial institutions to survive, and carries the risk of not leading to a strengthening of the financial system. Therefore, it is crucial that the evaluation of the future prospects of the targeted financial institutions and the judgment of whether management reforms are implemented properly are made in an appropriate manner. There was a view that the introduction of a new scheme requires caution unless proper implementation of the business plan and management reforms is not secured.