

**Revitalization after the banking crisis
– Japan's experience and policy responses –**

Keynote address by
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at the International Insolvency Institute's
16th Annual Conference
Tokyo, June 6, 2016

Introduction

It is a great honor to speak to prominent insolvency practitioners from around the world on this occasion of the annual conference of the International Insolvency Institute.

As many of you may know, a great earthquake hit and brought serious damage to Kumamoto and Oita in Japan in April this year. One of the troubles the victims of such a large natural disasters face is difficulty repaying their residential mortgages.

As an example, imagine the case where a victim who got a mortgage for housing lost all the value of his or her house broken down by a quake and left with nothing but the mortgage.

As a remedy for the mounting debt on such victims of natural disasters, Guidelines for Restructuring Debts of Natural Disaster Victims was developed following the Great East Japan Earthquake occurred in 2011. The guidelines are currently being used for the recent Kumamoto Earthquake as well.

By following the procedure in the guidelines, the victims can resolve their debt reserving a part of their assets needed to sustain their lives and without blemishing their credit history, which would facilitate their taking out a new loan. With these benefits, the guidelines are expected to support the rebuilding of lives and businesses of the victims and thereby contribute to the reconstruction and rebuilding of the disaster area.

The guidelines were developed based on the Guidelines for Multi-Creditor Out-of-Court Workouts, which I will touch on later, and could be cited as one of the examples of the wider use of out-of-court reorganization in Japan. In fact, Dr. Shinjiro Takagi was the linchpin who rendered indispensable service to the evolution of out-of-court reorganization in this country.

Now, in the first half of my remarks, I will give an overview on the development of the framework and practice of business turnaround in Japan, many aspects of which I was involved in.

Since increase in enterprise value, which is a product of business turnaround, is of vital concern to Japan's economic revitalization, I would like to present relevant challenges and policy efforts in the latter half of my speech.

Evolution in the framework of business turnaround in Japan

So, let me start with how the framework of business turnaround developed in Japan.

Japan experienced the collapse of real estate bubble in the 1990s and was plagued with the ensuing non-performing loan problems. The crisis can be divided into two phases.

In the first phase of the crisis, real estate prices slumped, followed by the failure of such businesses as real estate and construction.

Concentration risk on the real property was brought to the fore because the banks had increasingly relied on loans secured by real estate since the real estate bubble. Due to the non-performing loans and losses, undercapitalized banks went under and financial intermediary function weakened.

Then in the second stage, the drop of asset prices turned into the deflation in the real economy. Under the deflationary environment, not only real estate-related industry but wider range of businesses including distributors and manufacturers saw drop in their earnings. The first phase was the problem stemming from Balance Sheets and confined in limited

sectors, whereas in the second phase the problem spread to Profit and Loss statements and non-performing loans sprung up in diverse sectors.

During the second phase, borrower companies that are saddled with excessive debts fell into a state of debt-overhang and became unable to invest actively. In order to rejuvenate the debt-burdened companies, it was necessary for lending banks to set aside sufficient provisions and reduce the debt burden of the borrowing companies and thereby restructure their business. However, the banks were short of capital and inclined to procrastinate about taking measures to rejuvenate the borrowing companies to avoid the losses to be realized. In this way, integrated efforts were required toward a fundamental solution to the problem: restructuring of borrowing companies; adequate provisions made by banks; and capital enhancement of banks.

On top of that, in those days we did not have a practice of starting off by working out among interested parties under the party autonomy principle, and file for insolvency proceedings with the court only after creditors failed to reach a voluntary agreement. Meanwhile, legal procedures were time-consuming and bound to detract the corporate value, which was a problem.

To cope with these obstacles, in 2001, the Japanese government propounded the idea of devising guidelines for coordination among related parties in an out-of-court workout. A study group composed of the representatives of financial and industrial circles was established for developing the guidelines. As a product of discussion, and with the leadership of Dr. Takagi and Dr. Sakai, Guidelines for Multi-Creditor Out-of-Court Workouts came out as the rules to facilitate business turnaround and debt forgiveness.

Creditors, who mainly consist of a number of financial institutions, and a company in debt were expected to consult and move into action based on the guidelines. The guidelines were groundbreaking in the sense that they provided for substantive requirements for a turnaround plan including getting out of insolvency and turning profitable within around three years after the plan is worked out.

The guidelines not only contributed to disposing non-performing loans retained in the financial institution but also to enhancing the borrower corporate value. Moreover, it laid foundation to the practice of pursuing early business turnaround in a flexible manner without impairing the business value. Today, in such areas as accounting, taxation, and bank inspection, the plans are treated equally with those with court involvement as long as they are worked out through the procedures based on the guidelines.

The guidelines were of huge importance as the model and starting point for the various out-of-court workout mechanisms developed thereafter. Guidelines for Restructuring Debts of Natural Disaster Victims, which I mentioned at the outset, is one of the examples.

The Guidelines for Multi-Creditor Out-of-Court Workouts paved the way for corporate revival based on the initiatives and the autonomy of the parties involved, the so-called main banks, who had taken the leading role in the consensus building among creditors, lost their strength through the long-running disposal of non-performing loans. In the meantime, a new loss-sharing system was not established and the situation was continuing where business turnaround hardly moved forward.

To deal with such a situation, in April 2003, the Industrial Revitalization Corporation of Japan, or IRCJ was established as a public organization and Dr. Takagi assumed the Chairman. In fact, I myself was involved in setting up the IRCJ. It is one of the most valuable experiences during my professional life to have worked with members of the IRCJ who stood up to find a way out of the predicament of the country.

We had the belief that corporate turnaround should ideally be promoted by the private sector. When setting up the IRCJ, we thus tried our best to find the mechanism for out-of-court workouts as practically workable as possible while avoiding the distortion of healthy market competition which public intervention could have brought about.

First of all, the IRCJ was empowered to invest, purchase debts, and propose a business turnaround plan including operational and financial restructuring plans and coordinate among the rights of creditors in its

capacity as an impartial public body. Additionally, as a legal framework to smoothly carry out business turnarounds, the Industrial Revitalization Corporation Act provided for a mechanism to assist business turnaround through out-of-court proceedings. For example, in a case where a company with support from the IRCJ enters into statutory insolvency proceedings, the court was encouraged to respect pre-DIP finance that had been confirmed by the IRCJ.

Second, when operating the IRCJ, it was not considered satisfactory just to restore a company.

In other words, in an environment that an industry is with excess capacity, resurrecting a company that lost in market competition by writing off debts would not rectify the structure of excess capacity, and, even worse, could possibly distort fair market competition. Thus, the IRCJ, for each case it was involved, conducted a rigorous screening from the standpoint of whether the turnaround could produce a positive effect on the economy and society. As for actual turnaround, to take an example of a condominium developer, the company withdrew from condominium construction business that was in excess supply and shifted to businesses mainly consisted of condominium management that had future growth potential. In the case of hot spring inns, regional revitalization was pursued by such measures as reducing the number of inns in the region. Furthermore, at the time of exit from the investment in the cases where a company with support from the IRCJ resurged, industry peers, in principle, were given the opportunity to purchase the shares by bidding.

Third, the IRCJ was established as a five-year life-span stock company based on the understanding that the IRCJ is publicly involved in corporate turnaround that should, in normal conditions, be undertaken by the private sector and thus it should serve a pumping-priming role for the market to function properly.

However, the number of cases brought to the IRCJ immediately after its establishment fell short of expectations. The reason behind this was the fact that banks were not provided with adequate incentive to dispose of non-performing loans they had. Giving banks such incentive was the

role of the Financial Services Agency of Japan, or JFSA in short.

Since its birth in 2000, the JFSA has implemented a wide array of policy measures to deal with the non-performing loans of lenders, in step with the development of a framework of business turnaround.

In the first place, there was a need to get rid of the incentive of the banks to avoid exposing underestimated losses by putting off the resolution of non-performing loans. Thus, in April 2001, the JFSA required that major banks take measures in a time-bound manner to clear from their balance sheets the existing loans to borrowers in danger of bankruptcy or riskier borrowers within two fiscal years, and fresh non-performing loans within three fiscal years, which was called a two-year, three-year rule.

In addition, in October of the same year, the JFSA embarked on special inspection, which was intended to ensure appropriate borrowers' classification as well as write-offs and provisions that reflect the companies' business performance and financial conditions on a real-time basis.

As a result, the losses were adequately recognized and necessary provisions were set aside, and thereby the major banks could move into full gear the disposal of non-performing loans.

Moreover, the JFSA released the Program for Financial Revival in 2002 and committed to reduce major banks' non-performing loan ratio to about half by March of 2005. To that end, the JFSA implemented a package of policy measures on major banks including tightening valuation of assets and applying Discounted Cash Flow approaches for provisioning, thereby induced banks to work with borrowing companies to come up with realistic business restructuring plans.

Furthermore, with an aim to secure effective financial intermediary function in local communities, in 2004, Act on Special Measures for Strengthening Financial Functions, a sunset law, was put into force as a new system that enables injecting public money in an expeditious way. The Act provided a framework to enhance mainly the financial strength of regional financial institutions by way of preventive infusion of public funds.

These efforts incentivized banks to promote the disposal of non-performing loans, and the number of cases brought to the IRCJ gradually increased, including the cases referred to by a bank to which the public fund was injected. Specifically, the IRCJ succeeded in advancing the turnaround of those cases where the settlement were postponed for a long time due to the intractability of interests among creditors by coordinating as a honest broker the interests between a main bank and the other creditors.

At the end, 41 cases were brought to the IRCJ by the time of its liquidation and over 10% of total value of the non-performing loans in Japan was addressed by its assistance.

As a consequence of integrated efforts towards resolving excessive debts problems and non-performing loans problems, the target to slash by half the major banks' NPL ratio was achieved. The IRCJ, in its four-year lifetime, contributed to the objective of spreading the culture of early corporate turnaround by use of out-of-court workouts in which a debtor develop a restructuring plan to change its business model at an early stage and achieve consensus among creditors.

At the same time, it served as a source of experts in a sense that people worked for the IRCJ have played an active role even after it wound up. I believe its greatest achievement was that, as a catalyzer, it formed and developed a distressed market in Japan and brought in many market participants. The IRCJ payed around 43 billion yen of profit to the national coffer after its closure, and accomplished its mission and closed its business one year earlier than had been originally scheduled.

After the IRCJ was resolved, the need arose for establishing a framework to continue promoting effective business reorganization based on private initiative.

With this in mind, the Business Reorganization Alternative Dispute Resolution, or Business Reorganization ADR was introduced in 2007 as a new regime for early business turnaround without public intervention.

The Business Reorganization ADR follows the procedures established by the Guidelines for Multi-Creditor Out-of-Court Workouts, and the same time it contains an enhanced mechanism. For one thing, the court is encouraged to respect pre-DIP finance in statutory insolvency proceedings. This feature makes it easier for a main bank to take up an offer to enter into a workout. For another, impartial third-party experts including lawyers, certified public accountants, and practitioners who worked with the IRCJ carry out coordination between a debtor and creditor financial institutions.

The scheme ensures fairness and credibility, which are the challenges of out-of-court workouts, and encourages a multitude of creditors to sit at the negotiation table.

The Business reorganization ADR is not only flexible and speedy proceedings based on out-of-court workouts but also encapsulates a mechanism to facilitate the coordination of interests and to utilize the knowledge and experience the experts gained through the work at the IRCJ. I hear that a Business Reorganization ADR body was set up by Japanese Association of Turnaround Professionals, and now being used for a number of large-scale projects.

Challenges at present — approaches to companies in between the maturity and decline stage—

Now, I would like to move on to current challenges for Japan and how we address them. As I have said so far, the framework for revitalizing distressed companies has been built up as a result of joint efforts of public and private sectors in the course of overcoming the collapse of the bubble economy and the ensuing financial crisis.

Now, thinking about corporate life cycles, companies needs to deal with different challenges depending on its stage in the cycle: raising finance at the start-up stage; increasing the enterprise value of companies between the maturity and decline stages; and achieving smooth exit and succession of a business of companies that lost competitiveness.

In the Japanese environment, the challenge of raising the enterprise value of companies between the maturity and decline stages is becoming

more relevant.

In other words, in this country, a wide range of business sectors that serve domestic customers are in a state of oversupply due to the continuing population decline. It is necessary for these companies to exit from their non-core business and concentrate managerial resources into businesses with higher potential of growth. However, such reform efforts towards a sustainable business have not been in full bloom yet.

For example, some major companies such as those in electricity industry lost their competitive edge while procrastinating about making decisions towards selection and concentration of businesses.

I think it is necessary to promote constructive dialogue between institutional investors and companies from a mid- to long-term perspective for the sake of making sustainable growth and creating sustainable value in companies.

Based on this view, in Japan, two Codes were introduced.

One is the Corporate Governance Code, which was developed last June to improve corporate governance which is necessary to commit business method changes and improve sustainable corporate value in order to deal with rapid changes in competition environment surrounding companies. The other is the Stewardship Code, which was developed in February two years ago to encourage mid- to long-term investors including a pension fund to constructively contribute to the governance of the invested companies.

These Codes are changing the culture of Japanese companies. First, approximately 80% of all listed companies comply with over 90% of the 73 principles contained in the Code as of the end of last year.

Second, the proportion of the Tokyo Stock Exchange First Section listed companies which have more than two independent directors have increased from roughly 20% in two years ago to over 50%.

Third, last year, Japan's three major banking groups have unveiled their

plans to unwind cross-shareholdings by 30% within the next three to five years. This unwinding of cross-shareholdings is steadily progressing, sometimes coupled with share buybacks by companies.

Regarding Japan's Stewardship Code, 207 domestic and foreign investors in total have subscribed to it and almost all major institutional investors in Japan have already accepted it. However, we have no time to be complacent with these initial outcomes. To achieve sustainable economic growth, these codes must function like two wheels of a cart and result in real enhancement in the effectiveness of Corporate Governance Practices, not just in statements or in form. To make this happen, we established the follow up council for the two Codes last August.

And in February this year, the follow-up council published an opinion statement following six rounds of discussions. In the statement, issues related to the selection and dismissal of CEO and the function of the board of directors were especially emphasized. The council is currently discussing the effectiveness of dialogue between institutional investors and invested companies, particularly from the viewpoint of the fiduciary duties of institutional investors. The council is going to publish another opinion statement regarding the dialogue between institutional investors and invested companies.

In addition to the equity governance, debt governance by main banks has to be enhanced as Japanese companies broaden the scope of their global activities. As for local SMEs, debt governance occupies even a larger role.

The service industry plays a vital role in Japanese economy, accounting for approximately 70% of its GDP and employment. When comparing the labor productivity of OECD countries in 2014, the Japanese manufacturing industry ranked 10th among 34 countries, but the overall industry ended up 21st. These figures demonstrate that improving productivity of the service industry is a key task for Japan. Local SMEs account for the large part of the service industry, and thus they need to transform their business models in keeping with the change in economic and business environment.

Unlike global companies that are involved in a worldwide competition, many local service industries have significant rooms to raise their productivity.

A friend of mine who served as the COO of the IRCJ runs a local bus companies' group that has the top-ranking rate of earnings leaving behind many other bus companies in Japan. According to him, what he does is nothing special, but the company achieves high productivity by sticking to the basics including accurately grasping the moves of passengers and changing the number of running busses according to the demand. When it comes to a retail business, it would be more beneficial for the productivity growth to retreat from products or areas with low profitability and focus on profit-earning products rather than to increase the number of stores or variety of goods in an attempt to maintain or boost sales figures.

The majority of these local SMEs are unlisted companies that rely on financing from banks or other financial institutions. Thus, as distinct from global major companies, it is of vital importance for debt providers to encourage and help them achieve sustainable growth and the mid-term improvement of the enterprise value. Financial institutions are expected to play a crucial role.

However, many financial institutions remain to focus on lending that relies on collateral and guarantees, not necessarily fulfilling their expected functions. Therefore, it is important for those financial institutions to understand business challenges of their borrowing companies, hold a discussion with them to find a solution, and collaborate with outside experts of corporate revival as necessary. In making these efforts, it is equally important for the financial institutions to provide funds to the companies that undertake a makeover of their business plan.

I do not go into details today, but the JFSA has been working to encourage financial institutions to perform such a role.

Japan had long been plagued with deflation against the background of the decline of working-age population and the progress of aging. Such a phenomenon is not just an issue of Japan but also a common challenge

for developed countries. As a result of drawn-out deflation, interest rates remain low, yield curves are flattened, and earnings of commercial banks appear structurally repressed around the world. In this situation, banks are expected to carry out evaluation of their customers companies' business potentials, give business advices to them, and adequately provide them with finance based on the evaluation and advice. These efforts will lead to the business growth of the customer companies and stabilize the banks' own profits, and thereby contribute not only to sustainable development of the customer companies but to sustainability of the bank's own business model.

It is an urgent issue in Japan to increase productivity of companies, especially of the service industry, given that a labor shortage is becoming conspicuous due to the decrease in the working-age population. The increase in productivity is conducive to the wage increase of corporate workers. The Japanese industry structure is in the midst of shift from the manufacturing to the service industry. Such a change in industrial structure tends to give rise to income inequality, but if the middle-income class could be sustained through the improved productivity and consequential stable wage growth, that should also lead to social and political stability.

Toward that end, it is of vital importance to continue business reorganization and restructuring, responding to the changing business environments.

Conclusion

The JFSA was established in July 2000, and it is going to reach its 16th birthday in the next month. Incidentally, today is the 16th annual conference of the International Insolvency Institute, meaning that the two institutions have lived the same age. It is important for the public and private sector to continue to join forces in advancing the efforts that I mentioned today, and the JFSA is hoping to work together with everyone here.

Thank you very much for your kind attention.