

Issues in the Financial Capital Market and Measures Addressing Them

1. Problem of Non-Performing Loans

(1) Status as of March 2001 [1]

i) Balance of Non-Performing Loans

			(trillion yen)			
			End of March 1998	End of March 1999	End of March 2000	End of March 2001
Non-Performing Loans (all Japanese banks)			26.7	29.6	28.6	30.6 (+2.0)
	Bank category	Major banks	18.9	20.3	18.0	17.4 (-0.6)
		Regional banks	7.8	9.4	10.6	13.2 (+2.6)
	Borrower category	"Special attention"	11.1	9.7	8.1	10.6 (+2.5)
		"In danger of bankruptcy" or below	15.5	19.9	20.5	20.0 (-0.5)

(Note): The figures here show the total amount of the non-performing loans on the standard definition. Those of Shinsei Bank (formerly Long-Time Credit Bank of Japan) and Aozora Bank (formerly Nippon Credit Bank) are not included.

While the balance of non-performing loans decreased in major banks, it increased in regional banks, which resulted in a slight increase in the total amount of non-performing loans of all Japanese banks.

In terms of loan categories, the loans to borrowers classified in or below the 'In danger of bankruptcy' category decreased due to final disposal etc. Thereof, while the loans to those classified in the 'Special attention' category increased as partly a result of stricter Self-assessment of assets reflecting rigorous inspections by the FSA. This was also a main reason for the increase of non-performing loans in regional banks. The composition of non-performing loans was improved.

(Note) Since the Financial Inspection Manual was announced in July 1999, inspections and audits have been conducted according to the Manual, and the method for defining 'restructured loans' has been unified and also improved.

The 'non-performing loan ratio (non-performing loans / total amount of loans)' is 5.72% (average of 16 major banks). This is still beyond the peak figure recorded in the United States (5.47% in 1991).

ii) Loss Resulting from Disposal of Non-Performing Loans (Loss on Disposal of Non-Performing Loans)

(trillion yen / %)

		End of March 1998	End of March 1999	End of March 2000	End of March 2001
Loss on disposal of NPLs	Major banks	9.9	10.4	4.5	4.3
	All Japanese banks	13.3	13.6	6.9	6.1
Credit expense ratio	Major banks	3.0	3.3	1.7	1.4
	All Japanese banks	2.4	2.7	1.4	1.2

(Note) The major banks refer to 16 banks. Shinsei Bank and Aozora Bank are not included.

The amount of loss on disposal of non-performing loans (losses resulting from the use of provisions, write-offs and sell-offs) continued to decrease after passing its peak in FY 1999. This reflected the qualitative of improvement in the composition of non-performing loans.

The 'credit expense ratio (loss on disposal of non-performing loans / total amount of loans)' also decreased after passing its peak in March 1999. The FY2001 figure (1.2% average of all Japanese banks) is already at a level comparable to the United States, but still remains high in relation to profit margin.

(Reference)

Credit expense ratio of US banks	1.2% (1999)
Profit margin of US banks	3.3% (1999)
Profit margin of Japanese banks	0.58% (FY2001)

(2) Assurance of Accuracy in Self-assessment of assets [1]

The Government has decided to fundamentally enhance inspections of major banks in the following manners for the purpose of making each bank improve the accuracy in self-assessments, as a precondition for the removal of non-performing loans. This decision will immediately be put into practice through its application in the basic inspection guidelines for the current administrative year (starting as of July 2001).

1. Implementation of Annual Inspection

The frequency of inspections has been approximately once every two years up to now, but this will be enhanced by changing to annual inspections.

2. Implementation of Follow-up Inspections (checkups during self-assessment operations)

In addition to annual inspections, follow-up inspections will be carried out so as to ensure that the results of latest FSA inspections based on its Financial Inspection Manuals are properly reflected into each bank's self-assessment of assets.

Implementation of the follow-up inspections will be concentrated during the period of self-assessment operations.

3. Disclosure of aggregated Inspection Results (under consideration)

Consideration is currently under way concerning the disclosure of aggregated results of the above-mentioned inspections.

(3) Proper Removal of Non-Performing Loans

i) Indirect Measures [1]

1. How Non-Performing Loans Are Secured

Non-performing loans are secured by collateral, guarantees or provisions, according to the risk of each loan.

<How Non-Performing Loans Are Secured (total of all Japanese banks, FY2001)>

(unit: %)

	Collateral / Guarantees	Provisions	Total
"Special attention"	39.9	13.6	53.6
"In danger of bankruptcy"	50.9	32.7	83.6
"Bankrupt" and " <i>De facto</i> bankrupt"	72.4	27.7	100
Total NPLs	52.1	25.2	77.4

2. Collateral Assessment

Assessment of collateralized real estate should be conducted regularly and properly by each financial institution by way of assessment including by real estate appraisers. According to a sample examination, the actual amount of sales proceeds exceeds the recent appraisal value.

<Sample Examination (total of all Japanese banks)>

(100 million yen)

Recent appraisal value (A)	Actual amount of sales proceeds (B)	(B) - (A)
7,428	8,777	+1,349

3. Normalization of Loans to Borrowers in the 'Needs Attention' Category etc.

Of all the borrowers classified in the 'Needs attention' category at the end of March 2000, 12.8% were moved up to the 'Normal' category within one year. On the other hand, 8.4% thereof were moved down to the 'In danger of bankruptcy' category or below (according to the sample examination of major banks).

Financial authorities have urged financial institution to work towards, normalization of loans to borrowers particularly in the 'Needs attention' category, including by establishing a system to facilitate this process, and also concerning the establishment

of a system for this. Local Finance Bureau Chiefs are currently conducting hearings with regional bank presidents with respect to their specific efforts.

<State of Borrower Categorization Shift between March-end 2000 and March-end 2001 (according to the sample examination of major banks)>

(unit: %)

		End of March 2001		
		"Normal"	"Needs attention"	"In danger of bankruptcy" or below
End of March 2000	"Normal"	92.9	6.5	0.6
	"Needs attention"	12.8	78.8	8.4
	"In danger of bankruptcy" or below	1.0	5.3	93.7

ii) Final Disposal [1]

1. In accordance with the 'Urgent Economic Measures' (April 6) and the 'Basic Guidelines' (June 26), final disposal of non-performing loans (those made to borrowers classified in the 'In danger of bankruptcy' category or below) will be conducted in a steady manner.

End of September 2000

End of March 2001

Removal from balance sheets

Existing NPLs -- 12.7 trillion yen -- reduced by 4.4 trillion yen -- 8.3 trillion yen -- to be disposed of within two years

Newly-generated NPLs -- 3.4 trillion yen -- to be disposed of within three years

(Note) The actual amount of final disposal for FY2001 (full year) was 6.9 trillion yen.

2. Four Final Disposal Types

Statutory liquidation	Winding-up	Bankruptcy Law etc.
	Reorganization	Corporate Rehabilitation Law, Civil Rehabilitation Law etc.
Civil insolvency		Debt forgiveness
Sell-offs (entrustment) etc.		Bulk sale, RCC etc.

3. In order to ensure transparency, fairness and effectiveness in 'civil insolvency', the Japanese Bankers Association, the Japan Federation of Economic Organizations and others have been requested to prepare the 'Guidelines for Civil Insolvency (Japan's equivalent of the INSOL)' based on the 'Urgent Economic Measures'. The research group prepared an interim report on June 29. Further examination is under way with the intention of finalizing the Guidelines by the end of September.

4. Functions of the RCC (Resolution and Collection Corporation) will be fundamentally expanded for the purpose of further removal of non-performing loans.

- Purchasing Operations Examination has already started among relevant parties with respect to revision of conditions and proceedings for purchasing non-performing loans.

- Trust Operations Application for approval of trust operations has already been received and is currently under examination. A working group for trust operation preparations has been set up within the RCC, which is currently examining specific trust schemes etc.

- Corporate Rehabilitation A working group for corporate rehabilitation measures has been set up within the RCC, which has already started examination of this issue with the intention of materializing measures shortly.

- Securitization Securitization of the building of the former main office of Long-Term Credit Bank of Japan is currently under way (according to the plan, securities will be issued in September). More active measures will follow in the future.

- Collaboration with the Headquarters for Urban Rehabilitation

To promote measures with respect to urban rehabilitation such as effective land utilization, the list of real estate retained by the RCC has been provided to the Headquarters for Urban Rehabilitation.

(Reference)

Scenario – Solution of the Non-Performing Loan Problem

(1) Preconditions

1. During the Focused Adjustment Period (from FY2001 to FY2003)

While the fundamental structural reform of the Japanese economy progresses, low growth continues and a large amount of non-performing loans are newly generated. Land values decline considerably.

2. After the Focused Adjustment Period (from FY2004 to FY2007)

If the structural reform of the economy bears fruit and the revival of the Japanese economy is realized, the state of non-performing loan generation revert to normal. The decline in land values also subsides.

(2) Expected Scenario for Each Period (Estimates)

1. During the Focused Adjustment Period (from FY2001 to FY2003)

As a large amount of non-performing loans constantly are generated and land values continue to decline, the balance of non-performing loans and the loss on disposal of non-performing loans will remain in high numbers.

2. After the Focused Adjustment Period (from FY2004 to FY2007)

- If the state of non-performing loan generation reverts to normal and the decline in land values subsides, the loss on disposal of non-performing loans will first revert to normal.

- Furthermore, the state of final disposal of non-performing loans newly generated during the Focused Adjustment Period (final disposal herein means removal from balance sheets within three years from the generation) will subside by approximately FY2007, and the balance of non-performing loans will also revert to normal.

<Estimates (15 Major Banks)>

Fiscal Year	2000 (Actual results)	2001 to 2003	2004 to 2007
Balance of NPLs	17.4 trillion yen	Remain mostly unchanged	Gradually decline to 7 to 10 trillion yen
NPL ratio	5.72%	5 to 6%	Gradually decline to 2 to 3%
Loss on disposal of NPLs	4.3 trillion yen	Approximately 3 trillion yen	0.6 to 1.0 trillion yen
Credit expense ratio	1.4%	Approximately 1%	0.2 to 0.3%

2. Restriction of Stock Holdings by Banks etc. and the Establishment of the Bank's Shareholding Acquisition Corporation (provisional name)

(1) In order to limit stock price fluctuation risks, stock holdings by banks etc. will be limited within the amount of proprietary capital.

Stocks (43 trillion yen) 14 trillion yen 29 trillion yen (in 2001)

(Sell-offs)

Amount of proprietary capital

Stocks (in 2004)

(Note 1) For certain cases, application of the restriction would be postponed for one to two years.

(Note2) Separate treatment will apply to stocks of subsidiaries and venture companies.

(Note 3) If the new Basel rules are introduced concerning risk evaluation of stock holdings, measures will be taken as appropriate to maintain compliance.

(2) With the implementation of the restriction of stock holdings, the 'Bank's Shareholding Acquisition Corporation (provisional name)' will be established as a provider of a safety net to complement sell-offs of stock holdings in the market.

1. Initial Contribution
2. Financing funds to be used for stock purchasing
3. Purchased
4. Contribution (8% of the amount sold will be reserved)
5. 2 trillion yen as government guarantee

Banks etc. Stocks
Sold in the market when so desired
Market

Organization General account Special account
Financial institutions Government

Stock buyback Sold in the market etc.
Company A

Securities companies Investment trusts / ETF
Additional purchasing Sold
Sold Investors

(3) Bills that propose the measures described in (1) and (2) above will be submitted to the next Diet session with the intention of establishing the Organization in January of next year. [2]

3. Structural Reform of the Securities Market

(1) Basis of the Reform

It is essential to shift from the practice in which only banks bear risks to a new practice in which risks are diversified broadly among individual investors as primary and ultimate risk bearers.

1. Companies: from borrowing to equity financing
2. Individuals: from saving to investment
3. Government: from encouragement of saving to promoting investment
4. Financing method: indirect financing to direct financing

(2) Specific Measures

i) Improvement of the Securities Market's Reliability for Private Investors

1. Measures Intended for the Change in Business Practice of Securities Companies

Disclosure of all the administrative measures taken against regulatory violations [1]

Encouragement of business model construction focused on personal investors [1]

Introduction of a system to regularly check the quality of securities company salespersons [1]

2. Enhancement of Market Surveillance by Government

Personnel enhancement etc. for private investor-oriented administrative supervision by the Securities and Exchange Surveillance Commission [1]

Implementation of strict administrative measures to protect private investors [1]

Enhancement of collaboration between the Inspection Bureau and the Securities and Exchange Surveillance Commission in response to conglomeratization etc. [1]

3. Establishment of Market Infrastructure

Promotion of electronic transmission of prospectuses [1]

Application of smaller minimum unit of trading [1]

4. Enhancement of Market Surveillance by Self-Regulating Organizations

Disclosure of dispositions against securities company salespersons etc. [1]

Voluntary disclosure of the content of complaint management and dispute solutions [1]

5. Establishment of Shareholder-Oriented Business Practice by Issuing Companies

Establishment of target values for ROE (return on equity) etc. in statements of accounts of stock-issuing companies / Disclosure of specific measures intended for the improvement thereof [1]

Promotion of corporate management information disclosure by stock-issuing companies through quarterly statements of accounts [1]

ii) Realization of 'Attractive Equity Investment Environment' for Private Investors

1. Adjustment for the Realization of Attractive Equity Investment Environment

Improvement of prospectus content for easier understanding on the part of investors [3]

Revision of prospectus description methods in response to the reduction of commission fees in securities investment trusts etc. [3]

Expansion of Scope of ETFs (exchange-traded funds)

Promotion of popularization of ETFs (exchange-traded funds) [3]

2. Tax Reform for Stock Investment Trusts (to be described later)

3. Promotion of Investor Relations Activities [1]

iii) Tax Reform to Encourage Private Investors to Invest in Risk Capital (to be requested)

1. Fundamental Reform of Capital Gain Taxation

Improvement of Separate Tax Declaration Process

Creation of capital loss carry-over system, lowering of tax rates, expansion and permanent application of preferential treatment (special deduction) for long-term-held traded stocks etc.

Simplification of Taxation System for Investors (Creation of Tax-Filing-Free System)

Interim Measures for Smooth System Shift

Interim measures for stocks whose acquisition prices are unknown

The option of separate withholding taxation at source will be continuously allowed for the time being with the application of a higher tax rate on capital gains (from the current rate of 1.05% to, for example, approximately 2%).

2. Improvement of Taxation on Dividend Income

Higher tax threshold for the Declaration Exemption for Small-Sum Dividend Income (currently 100,000 yen annually per stock) etc.

3. Tax Reform for Stock Investment Trusts

With the option of withholding taxation at source maintained, investors who file a tax return will be able to aggregate profits and losses, carry over losses, and benefit from preferential treatment for long-term investments.

4. As An Economic Stimulus Measure, the Creation of a Special Treatment for Gift Taxation That Would Encourage Senior Citizens to Use Savings for Investment

Creation of special treatment in taxation for parent-to-child gifts provided that they are implemented through long-term investment in stock etc.

iv) Investor Education

Launch of a new site addressing school education assistance programs, within the Financial Services Agency's homepage [1]

Expansion of FAQ-based support for personal investors [1]

(Note) [Period of Implementation] -- indicated at the end of each item.

1 Matters that can be dealt with immediately (by the end of September)

2. Matters that can be dealt with through the legislative revision during the extraordinary Diet session

3. Matters to be dealt with after October

Issues in the Financial Capital Market and "Work Process" of Measures Addressing Them

1. Matters that Can Be Dealt with Immediately (by the End of September)

(1) Problem of Non-Performing Loans

State as of March 2001

- SEC-defined outstanding non-performing loans existing as of March 2001 were disclosed
- The status of 'Non-performing loan ratio (non-performing loans / total amount of loans)' and 'Credit expense ratio (amount of loss on disposal of non-performing loans / total amount of loans)' were grasped

Assurance of Accuracy in Self-assessment of assets

- Implementation of annual inspection
- Intensive implementation of follow-up examinations (checkups during self-assessment operations)

Proper Removal of Non-Performing Loans

- Each financial institution has already been requested to normalize loans made to 'Needs Attention'-categorized borrowers etc. and to establish an appropriate system for that purpose. Local Finance Bureau Chiefs are currently conducting hearings with regional bank presidents with respect to their specific efforts.

Final Disposal of Non-Performing Loans (those made to borrowers in or below the 'In Danger of Bankruptcy' category)

- Non-performing loans were removed from balance sheets during the Term ending in March 2001 for the final disposal of these loans
- With respect to 'civil insolvency', a research group is currently studying this issue with the intention of finalizing a draft of the 'Guidelines for Civil Insolvency (Japan's equivalent of the INSOL)' by the end of September.

Fundamental Expansion of the Functions of the RCC (Resolution and Collection Corporation)

- Purchasing Operations Examination has already started among relevant parties with respect to revision of conditions and

proceedings for purchasing non-performing loans.

- Trust Operations Approval of trust operations has been granted to the RCC on August 31, 2001. A working group for trust operation preparations has been set up within the RCC, which is currently examining specific trust schemes etc.
- Corporate Rehabilitation A working group for corporate rehabilitation measures has been set up within the RCC, which has already started examination of this issue with the intention of materializing measures shortly.
- Securitization Securitization of the former Long-Term Credit Bank of Japan building is currently under way (according to the plan, securities will be issued in September). More active measures will follow in the future.
- Collaboration with the Headquarters for Urban Rehabilitation

To promote measures with respect to urban rehabilitation such as effective land utilization, the list of real estate retained by the RCC has been provided to the Headquarters for Urban Rehabilitation.

(2) Structural Reform of the Securities Market

Improvement of the Securities Market's Reliability for Private Investors

- Disclosure of all the administrative measures taken against regulatory violations
- Encouragement of business model construction focused on private investors
- Introduction of a system to regularly check the quality of securities company salespersons
- Personnel enhancement etc. for personal investor-oriented administrative supervision by the Securities and Exchange Surveillance Commission
- Implementation of strict administrative measures to protect private investors
- Enhancement of collaboration between the Inspection Bureau and the Securities and Exchange Surveillance Commission in response to conglomeratization etc.

- Promotion of electronic transmission of prospectuses
- Application of smaller minimum unit of trading
- Disclosure of dispositions against securities company salespersons etc.
- Voluntary disclosure of the content of complaint management and dispute solutions
- Establishment of target values for ROE (return on equity) etc. in statements of accounts of stock-issuing companies / Disclosure of specific measures intended for the improvement thereof
- Promotion of corporate management information disclosure by stock-issuing companies through quarterly statements of accounts

Realization of 'Attractive Equity Investment Environment' for Personal Investors

- Promotion of investor relations activities

Investor Education

- Launch of a new site addressing school education assistance programs, within the Financial Services Agency's homepage
- Expansion of FAQ- based support for private investors

2. Matters that Can Be Dealt with through Legislative Revision During the Extraordinary Diet Session

Bills that propose the restriction of stock holdings by banks etc. and the establishment of the Bank's Shareholding Acquisition Corporation(tentative name) will be submitted to the next Diet session with the intention of establishing the Corporation in January of next year.

3. Matters to Be Dealt with After October

Structural Reform of the Securities Market

- Improvement of prospectus content for easier understanding on the part of investors
- Revision of prospectus description methods in response to the reduction of commission fees in securities investment trusts, etc.
- Promotion and popularization of ETFs (exchange-traded funds)

4. Miscellaneous

Structural Reform of the Securities Market

- Tax reform to encourage private investors to invest in risk capital (to be requested)