

Post-crisis Regulation of Financial Institutions in Japan

Toshihide Endo

Financial Services Agency, Japan

March 8, 2013



** Any views expressed in this presentation are those of the speaker, and do not represent the official views of JFSA.*

Chronology of Events in the 1990's

Japan's Non-Performing Loan Problem in the 1990's

Cause: ① Real Estate Bubble

② Over loan by banks through their non-bank subsidiaries
(housing finance companies)

The 1990's Onset and increasing seriousness of the non-performing loan problem
(The authorities did not get the picture of the size of NPLs and the seriousness)

- 1995 Injection of approximately ¥680 billion in public funds to deal with bankrupt housing finance companies
- 1996 Protection of all deposits (pay-offs frozen)
- 1997 (Jul.) Thailand: Devalued the Baht
(Oct.) Hong Kong: 10% fall in stock market
(Nov.) Japan: Bankruptcies of Hokkaido Takushoku Bank, Yamaichi Securities
Korea: Exchange rate band widened. Won fell sharply.
- 1998 Financial Supervisory Agency established
- *intensive inspections of major banks*
Financial Reconstruction Act implemented
- *a system for dealing with bankruptcies*
Early Strengthening Act implemented
- *capital strengthening via public funds*
Nationalization of the Long Term Credit Bank of Japan
Falling credit ratings, the Japan premium, credit-crunch
- 1999 Financial inspections manual published
Capital injected to 15 major banks and 4 regional banks

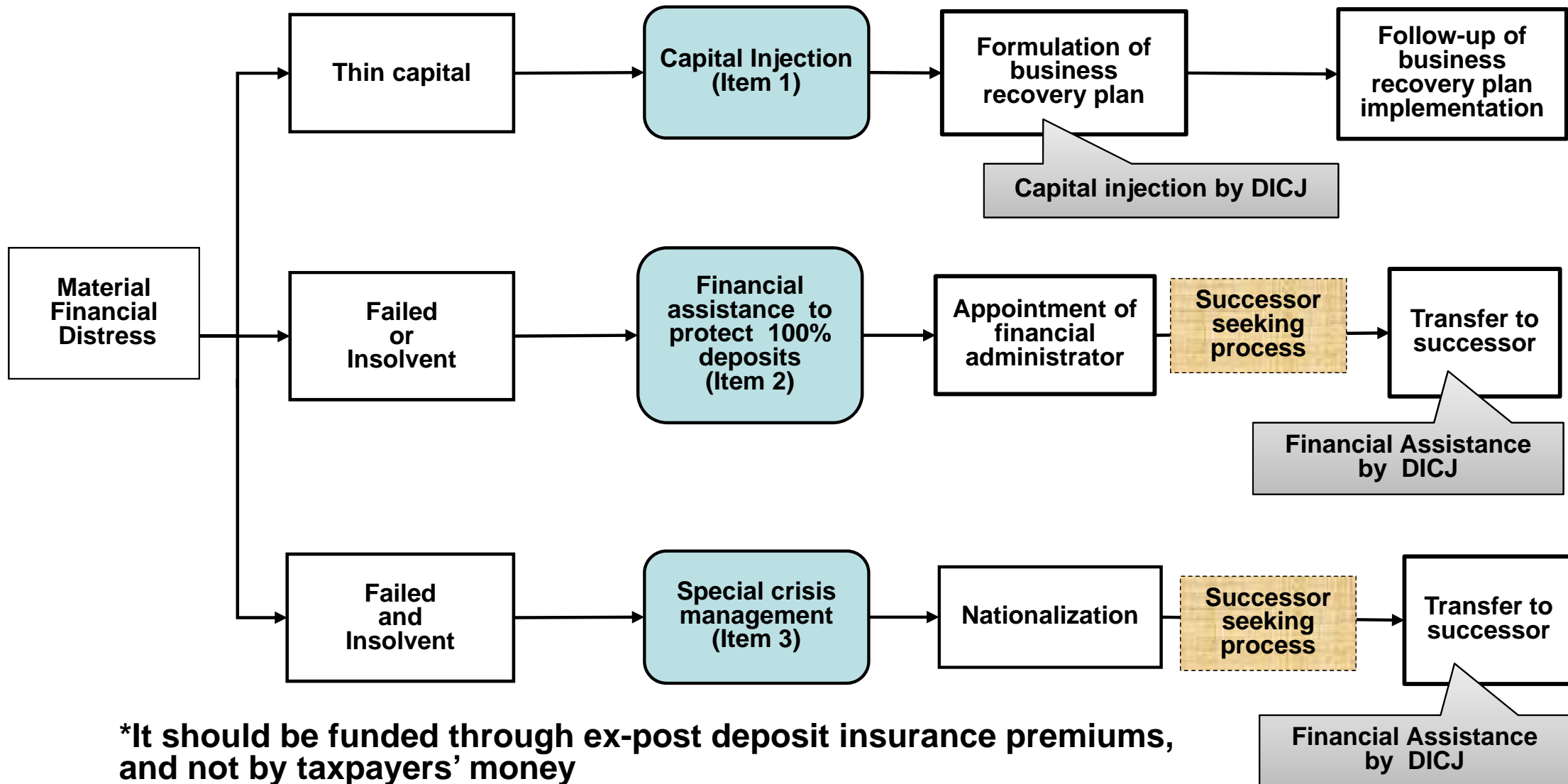
Chronology of Events in the 2000's

Japan's Non-Performing Loan Problem in the 2000's

<u>The 2000's</u>	Normalization of the non-performing loan problem
2000	<u>Financial Services Agency (FSA) was established</u> (Good supervision!) Amendment of the Deposit Insurance Law - <u>introduction of permanent measures against financial crises (Article 102.)</u>
2001	<u>Write down of non-performing loans promoted</u> <u>Special inspections were implemented</u> (major banks)
2002	Announcement of the Financial Reconstruction Program
2003	Capital strengthening for a major bank (Resona Bank) Temporary nationalization of a major regional bank (Ashikaga Bank)
2004	Announcement of the Financial Reform Program
2005	Temporary protection of all deposits ended Target of reducing non-performing loan ratios to half at major banks achieved (end of March 2002, 8.4% ⇒ end of March 2005, 2.9%)
2007	FSA launched an initiative toward "<u>Better Regulation</u>"

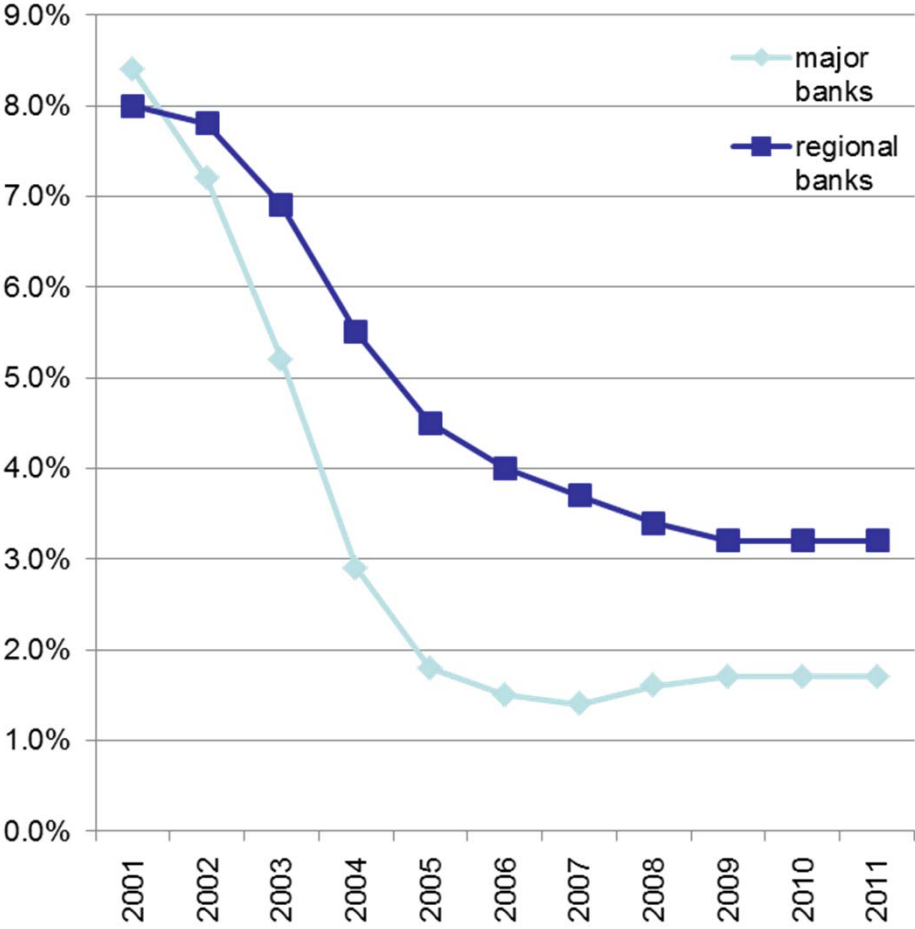
Deposit Insurance Law (Article 102.)

◆ The measures stipulated in the Deposit Insurance Law, Article 102 can be taken when an extremely serious threat is posed to the maintenance of the credit system in Japan or region where financial institutions are conducting operations.

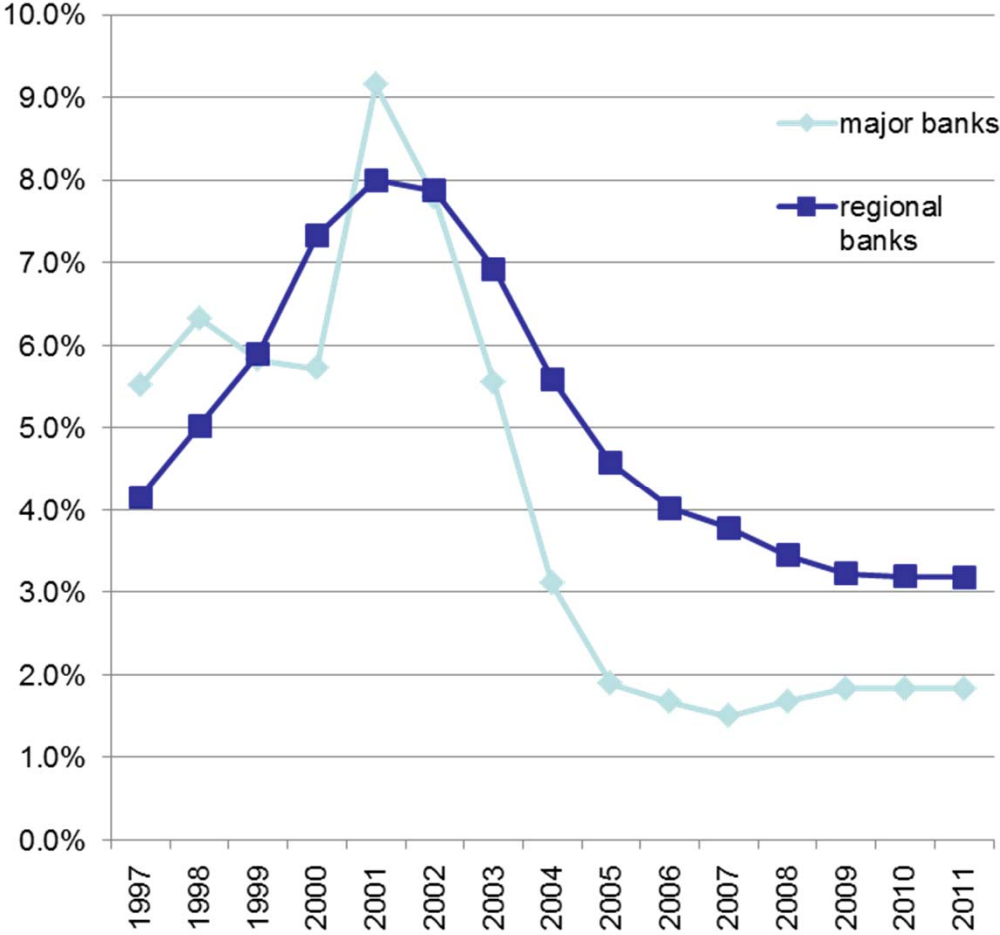


Japanese Banks' Non-performing Loan Rate

Non-performing loan rate disclosed based on the Financial Reconstruction Act

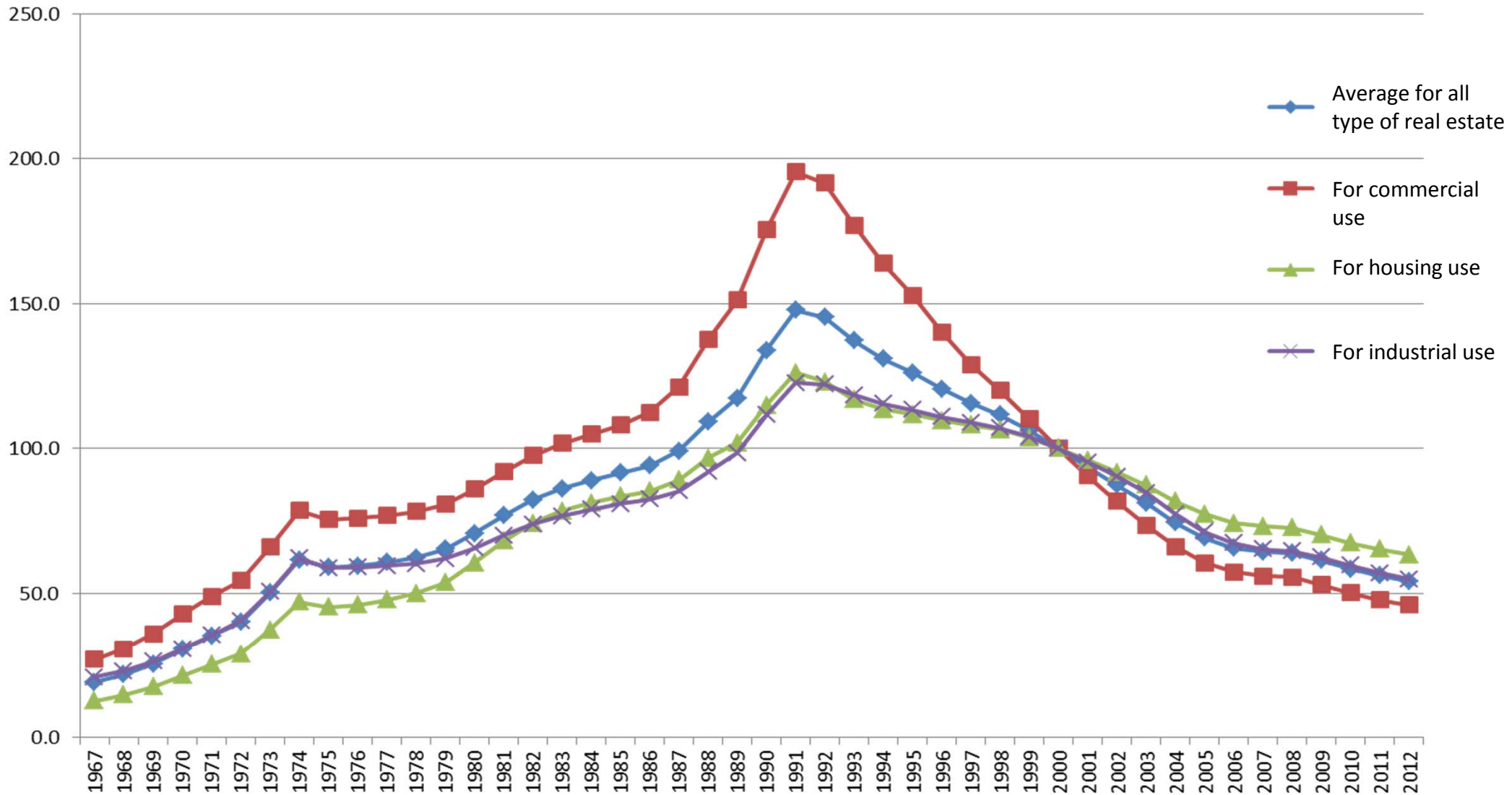


Non-performing loan rate disclosed based on the Banking Act

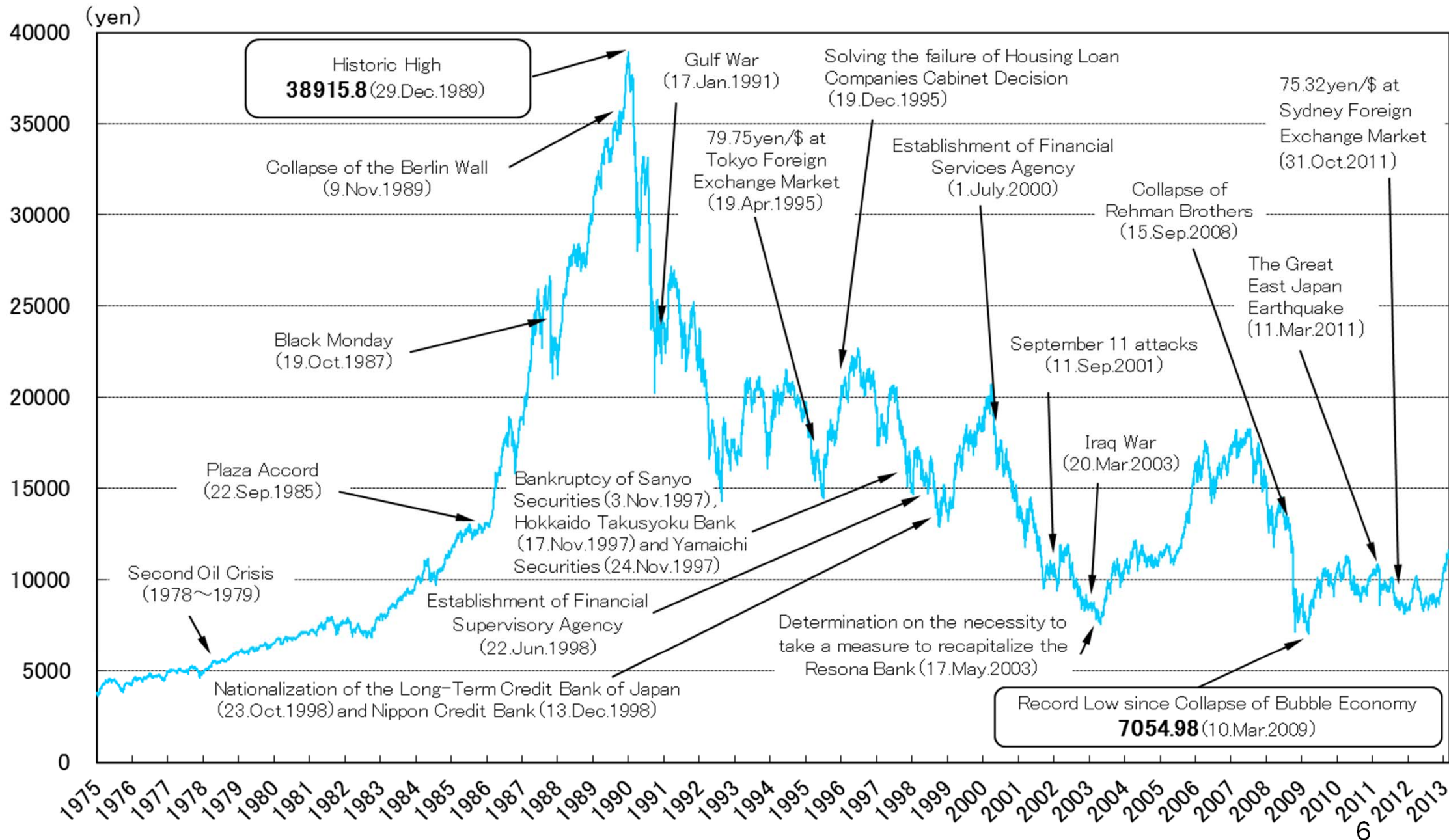


Real Estate Prices

Real estate prices (indices with prices in 2000 as 100)



1. Stock Price (Nikkei Average)



Number of Bank Failures

Number of bank failures

Number of cases

FY	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Total	0	1	1	2	4	6	5	17	30	44	14	56	0	1	0	0	181
Banks	0	1	0	0	0	2	1	3	5	5	0	2	0	1	0	0	20
<i>Shinkin</i> Banks	0	0	1	1	0	0	0	0	0	10	2	13	0	0	0	0	27
Credit Cooperatives	0	0	0	1	4	4	4	14	25	29	12	41	0	0	0	0	134

Achievements of Industrial Revitalization Corporation of Japan

Corporate Overview

Name: Industrial Revitalization Corporation of Japan (IRCJ)

Capital: 50.507 billion yen

Number of Employees: 214 (as of the end of February 2005)

President: Atsushi Saito (Director & Representative Executive Officer, Group CEO of Japan Exchange Group, former Executive Vice President of Nomura Securities)

- ✓ Industrial Revitalization Corporation Act (the "Act") was enacted and came into force in April 2003 for the purpose of establishment of IRCJ.
- ✓ IRCJ was established on April 16, 2003, began operations in May, and disbanded on March 15, 2007.
- ✓ Since its establishment, IRCJ made decisions to support 41 projects (19 involving large corporations) including Daiei and Kanebo before the deadline for credit purchase application on March 31, 2005.
- ✓ Completed support for all projects, and contributed to securing employment.
 - ❖ Total number of employees for the 41 projects at the time of support decision exceeded 70,000.
- ✓ Japanese public did not incur any resulting debts.

Programs for Final Disposal of Non-performing Loans (1)

1. **Emergency Economic Measures** (April 6, 2001)

- Allowing off-balance-sheet treatment for major banks for credit extended to borrowers in danger of bankruptcy or below; within 2 years for existing loans and 3 years for new loans. (the 2-and-3-year rule)
- Requesting an institutional arrangement for normalizing special attention loans and doubtful loans.
- Formulation and announcement of a guideline regarding out-of-courts workouts.

2. **Basic Policy for Fiscal and Economic Management and for Economic and Social Structural Reform** (June 26, 2001)

- Disposal of non-performing loans and corporate turnaround through the Resolution and Collection Corporation (RCC) based on drastic enhancement of functions of the RCC
- Adequate grasp of the overall non-performing loan problem, referring to such new indices as non-performing loan ratio and credit cost ratio

3. **Advanced-Reform Program** (October 26, 2001)

- Conducting special inspections of major banks
- Flexible pricing method for RCC's purchasing of non-performing loans (purchase at market values)
- Promotion of establishment of corporate turnaround funds
- To overcome the non-performing loan problem within 3 years or by the end of the intensive adjustment period at the latest by concurrently promoting structural reforms in other areas

Programs for Final Disposal of Non-performing Loans (2)

4. Measures against deflation to be promptly implemented (February 27, 2002)

- Rigorous implementation of special inspections and announcement of their results
- Proactive purchase of non-performing loans by RCC

5. Policy measures for establishing a further robust financial system (April 12, 2002)

- For credits extended by major banks to borrowers likely in danger of bankruptcy or with lower creditworthiness, off-balance-sheet treatment was further accelerated with specific disposal targets (in principle 50% to be disposed within a year and most of them—about 80%—within two years (the 50/80% rule)) and with proactive utilization of RCC functions including trust.
- Introduction of year-round inspection of major banking groups by specialized inspectors in charge of each group
- Measures for promoting mergers of financial institutions

6. Financial Reconstruction program (October 2002)

- As a framework for establishing a further robust financial system, the following measures were taken:
 - 1) Tightening of asset assessment at major banks including the revision of asset assessment standards, implementation of special inspections and strengthening the administrative penalty for inadequate correction of self-assessments
 - 2) Improvement of capital bases through tax reforms to strengthen equity capital and the confirmation of rationality of deferred tax assets
 - 3) Enhancement of governance including the conversion of government-held preferred stocks to common stocks

Financial Reconstruction Program

Financial Reconstruction Program

—Economic Reconstruction Through Solving the Major Banks' Non-Performing Loan Problem—

Economic reconstruction by solving the major banks' non-performing loan problem
– key elements are solving the major bank non-performing loan problem and progressing structural reforms
Forcibly reinvigorating the economy while attempting to minimizing hardship
– implementing an integrated policy combining measures for employment and also for medium-to-small businesses

《1. A New Framework for the Financial System》

(1) Constructing a reliable financial system

- Financial administration for the benefit of the Japanese people
- Maintaining a stable clearing function
- Establishing a monitoring system

(2) Sufficient consideration given to lending for medium-to-small businesses

- Increasing number of lenders for medium-to-small businesses
- Maintaining a framework to support reconstruction for medium-to-small businesses
- Issuing business improvement orders for financial institutions failing to meet lending targets for medium-to-small businesses
- Carrying-out inspections that capture the actual situation of medium-to-small businesses
- Maintaining a monitoring system for financing for medium-to-small businesses
- Establishing a hot-line for tight lending practices and retraction of credit
- Inspection of tight lending practices and retraction of credit

(3) End of non-performing loan problems by FY2004

- Development of an integrated support system provided jointly by the government and the Bank of Japan
- Management reforms at Special Support Financial Institutions
- Foundation of a new public funding system

《2. A New Framework for Company Reconstruction》

(1) Company reconstruction via “special support”

- Shift to off-balance for financial receivables
- Utilizing self-inspections for market-value reference information
- Guarantee system for DIP financing

(2) Increased use of RCC and company reconstruction

- Strengthening the company reconstruction function
- Bolstering collaboration with the Company Reconstruction Fund etc.
- Establishing a transaction market for financial receivables
- Enhancing the securitization function

(3) Maintaining an appropriate environment for company reconstruction

- Maintaining an environment that assists company reconstruction
- Responding to problems such as excessive lending etc.
- Establishing guidelines for early company reconstruction
- Dealing with share-value fluctuation risk
- Planning for further deregulation for companies

(4) A new framework for the reconstruction of business and industry

《3. A New Framework for Financial Administration》

(1) Raising standards for asset valuation

- Raising standards for asset valuation
- Review of standards for asset valuation
- Adoption of DCF methods for reserve funds
- Review of time period for calculation of reserve funds
- Thorough verification of rebuilding plans and collateral valuations
- Re-implementation of special inspections
- Difference between self-inspection evaluations and FSA inspection evaluations published
- Bolstering administration to correct inadequate self-inspections
- Declaration of the accuracy of financial statements by managers

(2) Supplementing equity capital

- Revising tax system to strengthen equity capital
- Checking rationality of deferred tax-assets
- Introducing external audits to verify equity ratio

(3) Fortifying Governance

- Changing preferential stocks to common stocks
- Issuing business improvement orders for companies failing to achieve financial soundness targets
- Increasing severity of early correction measures
- Utilizing an early warning system etc.

Early implementation (targeting November of the current year to create and announce an action timetable)

* An action plan for the disposal of non-performing loans for medium to small sized and regional financial institutions was targeted for implementation within 2002

Basic philosophy

Restoring trust in the Japanese financial system and financial administration, realizing financial markets highly regarded around the world



Reducing the non-performing loan ratio of major banks in-half by 2004, then aiming to normalize the problem
Targeting the creation of a strong financial system with the support of structural reforms

Lessons (1)

1. Early identification of and early responses to problems

- ✓ Implementation of asset assessment based on rigorous standards, early recognition of (reserve for) losses and timely disclosure are indispensable
- ✓ Framework that enable supervisory authorities to make objective judgment is effective for ensuring early identification and early responses.

2. Prompt measures dealing with financial institutions' undercapitalization; and implementation of smooth failure resolution and crisis management

- ✓ In case recognition of losses from non-performing loans makes the financial institution undercapitalized, a prompt and sufficient increase in capital is needed.
- ✓ In case private-sector's efforts for increasing capital have limitations, a mechanism for increasing capital with public funds is effective as the ultimate safety net.
- ✓ It is important to establish a system for smooth failure resolution and crisis management of financial institutions taking systemic risks into consideration.

3. Use of public funds requires public understanding

- ✓ To promote public understanding (1) strong pressure for normalizing the business management, (2) actions to call to bring the managers and the shareholders responsible to account, and (3) securing of taxpayers' benefits, are necessary.

4. Fundamental resolution of the non-performing loan problem requires the off-balance-sheet treatment, corporate turnaround and recovery of the economy

- ✓ Banks' accounting recognition of losses alone would not restore market confidence. It is necessary to remove the non-performing loans from the balance sheet through the use of purchase of credits by public institutions.
- ✓ Concurrently, measures for corporate turnaround with public institutions involved would contribute to decreasing non-performing loans and to recovery of the economy.
- ✓ Recovery of the economy is indispensable for fundamental resolution of the non-performing loan problem, which requires smooth supply of funds to corporations —i.e., maintenance and expansion of banks' function of extending credit.

5. Reinforcement of banks' self-discipline for preventing recurrence of the non-performing loan problem

- ✓ Reinforcement of banks' credit examination is needed. Especially enhancement of internal control and governance to prevent loose lending is important.

Act on Special Measures for Strengthening Financial Functions

Act on Special Measures for Strengthening Financial Functions (August 1, 2004)

In an environment where financial institutions had difficulty in securing financing on their own, provide sufficient funding through capital participation via public fund injection so that the financial sector can voluntarily commit to risk taking and function as financial intermediaries in the regional economy.

(Temporary measure expired at the end of March 2008)

September 15, 2008 Lehman Brothers bankruptcy

Amended Act (December 17, 2008)

With the external factors such as disruption of global financial market potentially becoming significant obstacles to financial sector's function as intermediary by impacting their capital adequacy, the Act was to be utilized to enhance their intermediary functions and provide support to regional economy as well as small and medium enterprises that face severe conditions. (extended until the end of March 2012)

March 11, 2011 Great East Japan Earthquake

Special earthquake-related provisions (July 27, 2011)

With concerns over various effects from the Great East Japan Earthquake on the financial sector, special earthquake-related provisions for the Act was established to maintain and enhance financial functions in the affected areas and provide comfort to the depositors.
(re-extended until the end of March 2017)

Act on Special Measures for Strengthening Financial Functions (Amended Act enacted on December 17, 2008)

Summary of the Act on Special Measures for Strengthening Financial Functions

Purpose: revitalizations of regional economies by strengthening financial functions through central government's capital participation to the financial sector.

Application (*Deadline: End of March 2012)

Prepare and submit management enhancement plan with the statement;

- 1) Plan period (maximum of 3 years)
- 2) Profitability and efficiency targets, and schemes to achieve such targets
- 3) Establishment of a responsible management system including revision of the previous management system
- 4) Measures to contribute to revitalizations of regional economies, such as facilitating credit granting to SMEs.
- 5) Amount and contents of underwriting of stocks, etc.

Examination

Government will inject capital if the following criteria are met:

- 1) Improvement of profitability and efficiency is expected;
- 2) Facilitating finances for SMEs in the region, etc. is expected;
- 3) Collecting public funds is not difficult;
- 4) Assets are properly evaluated;
- 5) The financial institution is not in bankruptcy or insolvency; and
- 6) Certain share in the region, etc. for Cooperative Structured Financial Institution, etc.

Ex Post Facto Check:

- (i) Financial institutions report progress of the plan to the authority semi-annually
- (ii) FSA publishes the progress report and follow up (take supervisory measures as necessary)

***Government guarantee amount:12 trillion yen**

Background (Circumstances after the Financial Crisis in Japan)

Non-performing loan problem substantially overcome by 2005...

- Downsizing a front office in the context of business restructuring
- More conservative lending attitude to prevent non-performing loans from increasing.

Credit Crunch

SMEs...struggled with refunding their debt
 Large enterprises... with sufficient self-funds, less dependent on banks

Exhausted Regional economy

1. Development of Better Regulation(2007.7~)

Crisis Period: late 1990s – early 2000s

- Establishment of legislation to tackle financial crisis
- Need of strong financial supervision (active on-site inspection) to mitigate market concerns

Publication of a new initiative “Better Regulation” by FSA in 2007

- Highlight of cooperation with financial institutions in the financial inspection
- Increase in transparency and foreseeability of the authority through more extensive information sharing and dialogue with financial institutions
- Respect of exerting self-initiative of financial institution

2. Act concerning Temporary Measures to Facilitate Financing for SMEs (2009.12~)

Point of the Act...

- The obligation was prescribed to prompt financial institutions to review the loan terms when requested by SMEs to ease debt service burden

Expiry of the Act...

- Expiry of the Act, which was originally set in March 2011, was extended one year twice. **FSA announced that FY 2012 was the final year.**

Application so far

- Among total 4 million SMEs,
 SMEs allowed to ease debt service burden: 300~400 thousand
 SMEs needed fundamental revitalization of business/change of business: 50~60 thousand

Statement by Minister...

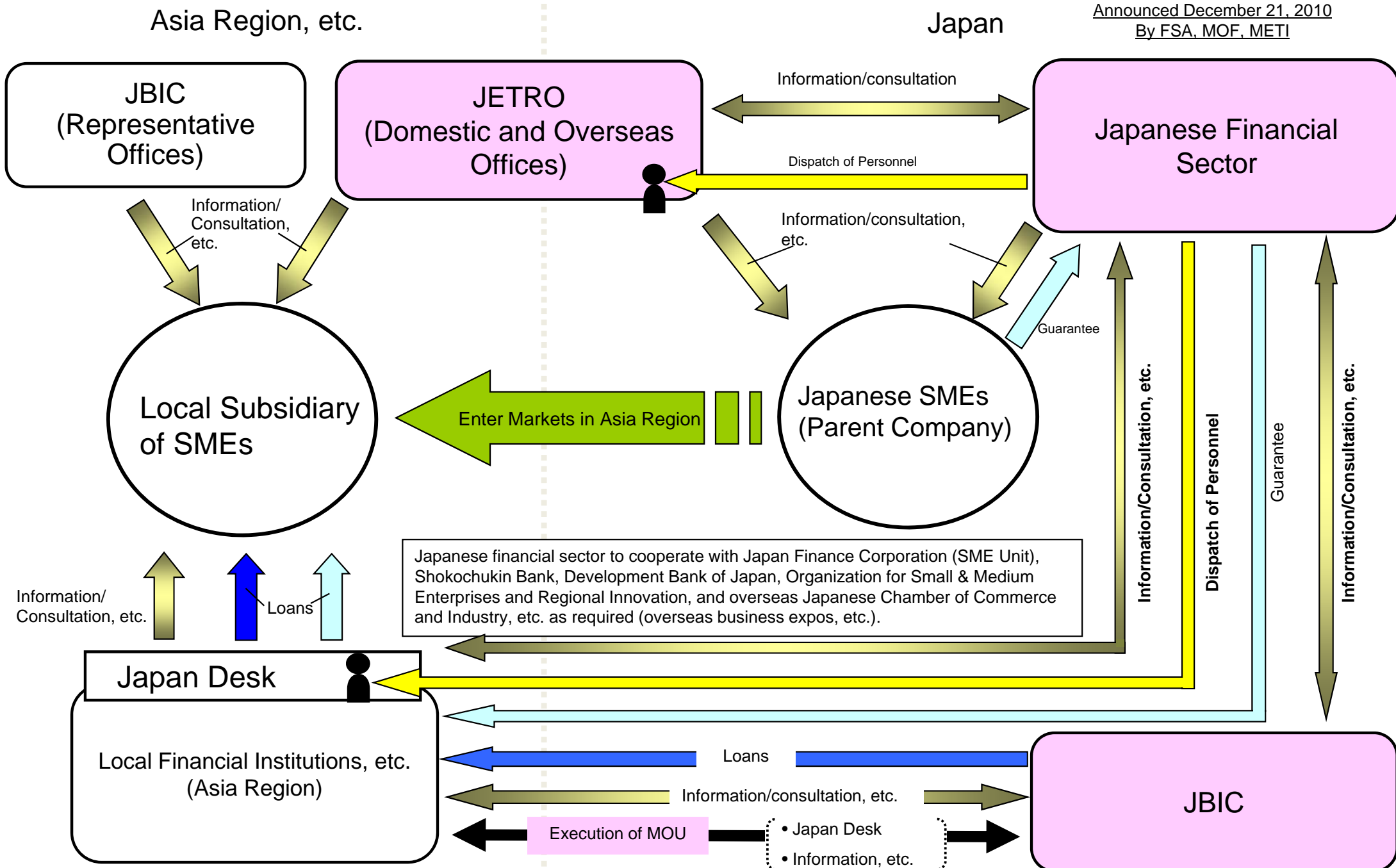
- Policies for inspection and supervision after the expiry of the SME Financing Act was released in November 2012.
 - The FSA will continue to encourage financial institutions, through inspection and supervisory processes to make efforts to modify the terms of the loans and ensure the smooth provision of funds

Ongoing work (as of March 2013)

- The FSA has shifted emphasis to the business rehabilitation of SMEs and is implementing measures included in the “Emergency Economic Measures for The Revitalization of the Japanese Economy(Jan, 2013)”

Develop/Enhance A Support System through Cooperation among Japanese Financial Sector, JBIC, JETRO, etc. for SMEs to Enter Markets in Asia Region

Announced December 21, 2010
By FSA, MOF, METI



Note: Further review on details including financing (loan, guarantee, etc.) methods.

Note: JBIC loan (two-step loan) shall be syndicated loans with interested Japanese financial institutions (regional financial institutions, megabanks, etc.) in principle.

Issues for Regional Banks' Entry into Asia

- Securing profitability from business alliance with local banks against competition with Japanese megabanks that have local branch offices and other regional banks with similar strategies.

1. Competition with Other Banks

- Competition with megabanks that have local branch offices (local currency loans)
 - Competition among regional banks (cost of issuing letters of credit/quality of information provided)
- ⇒ If a customer is snatched by another bank in an overseas market, the same may happen in Japan

2. Securing Profitability for Business Alliance with Local Banks

- Business expos have become one of the established and stable overseas business support models, but it remains a support tool, and is yet to produce profits through business matching (customers do not feel obligated to pay fees).
- Overseas business support through representative offices have limitations in terms of acquiring information and building profit models, and are positioned as career development opportunity and/or a service tool.

*based on interview with Regional Banks Association of Japan

Support of Financial Infrastructure Development in Asia (1)

Restriction on Activities by Japanese Corporation in Asia

- Lack of financial infrastructure (legal and settlement systems, etc.) that form the foundation of funding, settlement and investment in local currency.
- Regulations on transactions/loans in local currency under market conditions with inadequate financial infrastructure.

Support of Financial Infrastructure Development in Asia:

Provide technical support to Asian countries for development of financial infrastructure (legal and settlement systems, etc.) to secure smooth funding for overseas activities by Japanese corporations.

1. Support development of financial infrastructure together with request for deregulation.

2. Make a national commitment, with cooperation among related government authorities and private sector

⇒ **Support activities of Japanese corporations in Asia zone financially, and contribute to economic development.**

Key examples (see details on the next page)

- ◆ **Myanmar:** Establishment of Securities Exchange Act (cooperation with Ministry of Finance, Policy Research Institute ("PRI")), support for the development of securities supervision system (cooperation with JICA), etc.
- ◆ **Vietnam:** Knowledge-based support for non-performing loan administration (cooperation with JICA), support for the establishment of securities market (improving quality of securities companies), etc.

Support of Financial Infrastructure Development in Asia (2)

◆ Myanmar

- **Establishment of Securities Exchange Act (cooperation with PRI)**
 - PRI executed MOU with Bank of Myanmar concerning support for the establishment of the Securities Exchange Act.
 - Government of Myanmar is aiming to establish the stock exchange within 2015.
 - Working group including PRI, FSA, JICA, academics, law firm and Daiwa Institute of Research discussed comments on the bill prepared by Myanmar.
 - Lecture offered on the Japanese legal and supervisory system to Myanmar authorities.
- **Support for the development of securities supervision system (cooperation with JICA)**
 - Preliminary research and dispatch of public-and-private sector mission to support securities supervision in conjunction with the establishment of the Securities Exchange Act.
 - In response to request by Bank of Myanmar, long-term secondment of FSA staff is scheduled to begin from summer of 2013 to advise on financial supervision and enhancement of financial administration capacities

◆ Vietnam

- **Knowledge-based support for non-performing loan administration (cooperation with JICA)**
 - JICA project, in cooperation with Ministry of Finance, Daiwa Institute of Research, law firm, etc.
 - Lecture offered on related legal system to Ministry of Finance and central bank authorities.
- **Support for the establishment of securities market**
 - In response to request for knowledge-based support from Vietnam, performed research to identify specific needs.
 - Improvement of quality of securities companies (licensing, evaluation criteria, supervision method) was identified as priority issue.
 - Training for the Securities Commission of Vietnam and Ministry of Finance authorities is being planned.