In order to recover confidence in the Japanese financial system and the financial administration, and to create a financial market that is valued from around the world, it is imperative to solve the non-performing loans (NPLs) problems of major banks in the first place. Hereafter, the Financial Services Agency (FSA) strives to normalize the NPLs problems in FY 2004 by reducing major banks’ NPL ratio to about half, and aims to create a stronger financial system that can support the structural reform. Therefore, in terms of tightening assessment of assets, enhancing capital adequacy and strengthening governance of major banks, the FSA is to strengthen its policy in accordance with the following measures.

1. Framework for a new financial system

The FSA is to take the following measures for developing a new financial system to accelerate the structural reform.

(1) Developing a financial system which the people can rely on without anxiety

The FSA is to develop a more solid financial system in order to enable one to lead a life without anxiety about financial institutions.

(a) Financial administration for the people
It is confirmed that the objects which the financial administration protects are people and entities, such as depositors, investors, borrower companies and individuals.

(b) Securing the stability of the payment and settlement functions
In order to secure the stability of the payment and settlement functions, the full protection of the payment and settlement deposits will be introduced from April 2005. While the government is strengthening measures for the structural reform such as
acceleration of disposal of NPLs, the complete abolition of the blanket deposit guarantee will be postponed until the end of March 2005 not to give anxiety to depositors.

(c) Enhancing the monitoring system of the FSA
“Task Force on Financial Issues” will be established within the FSA. The Task Force will monitor the progress of issues, towards attaining the objective of terminating the NPLs problems in FY2004.

(2) Due consideration to loans to small- and medium-sized enterprises (SMEs)

The FSA is to strengthen the safety net as follows, in order to prevent any marked deterioration of financing environment for SMEs that constitute a large majority of Japanese corporations, due to the disposal of NPLs by major banks.

(a) Entry of new lenders to SMEs
In order to facilitate the entry of new lenders into business which have enough managerial and behavioral abilities to meet SMEs’ financial needs, measures will be examined aggressively to expedite the approval of banking license and promote the establishment of “Small-and Medium-Sized Enterprises Loan Trust Companies (J loan)”

(b) Developing financial schemes to support revival of SMEs
To support revival of SMEs in a manner best fit for the actual conditions of SMEs, development of financial schemes, including through utilizing trust and debt equity swaps, will be examined.

(c) Issuing a “Business Improvement Administrative Order” to a financial institution which has not achieved its plan for lending to SMEs
To a financial institution who has failed to achieve its plan for lending to SMEs in its plan for sound management in a serious degree, a “Business Improvement Administrative Order” will be issued. In case that the financial institution cannot attain its plan in a slight degree, the FSA orders the financial institution to immediately report its improvement plan.

(d) Ensuring inspections which take account of SMEs’ actual conditions
The FSA will make it sure that inspections will be conducted properly in a way to fully
take account of SMEs’ actual conditions. In addition, the intent and the contents of the “Supplement to the Financial Inspection Manual: Treatment of Classifications regarding Credits to Small- and Medium-Sized Enterprises” are to be made more well-known to borrower companies.

(e) Strengthening the monitoring system on financing to SMEs
The FSA will strengthen its monitoring system over financing to SMEs in order to prevent unjustified “credit withdrawal” and other actions taken by financial institutions. If necessary, effective inspections would be also implemented.

Creation of a “Hotline for credit crunch and credit withdrawal”
A hotline for receiving fax and e-mail is set within the FSA so that SMEs can inform the FSA of such problems in cases they encounter unjust treatment by financial institutions such as credit crunch or credit withdrawal, on the pretext of this Program or the Inspection Manuals.

Implementation of “Inspections on credit crunch and credit withdrawal”
Where the FSA identifies serious problems after scrutinizing information provided through the “Hotline for credit crunch and credit withdrawal”, the agency will order the financial institution in question to submit reports and take appropriate administrative measures. If necessary, inspections would be also implemented.

(3) Termination of Non-Performing Loans Problems towards FY 2004
From the point of view that the Government actively engages in resolving NPLs problems of financial institutions, the FSA is to take measures as follows:

(a) Strengthening the support system in full cooperation between the Government and the Bank of Japan
If and when a financial institution falls into distress, capital shortage or similar situations, the Government will apply the following framework of the “Special Support” immediately. The Government and the Bank of Japan (BOJ) together will take every necessary measure to prevent a systemic risk from arising and the economy from plummeting further.

Provision of liquidity through special loans by the BOJ
If a threat of financial crisis arises, the FSA is to take appropriate measures responsibly and request the BOJ for necessary measures including provision of special loans (last resort financing), thereby the FSA and the BOJ together make assurance to secure a reliable crisis management system.

- **Injection of public funds based on Deposit Insurance Law**
  If needed, the Government will promptly inject necessary public funds based on the current Deposit Insurance Law.

- **Dispatch of de facto resident inspectors**
  The FSA will examine a system that allows inspectors to sit at the board of directors’ meetings and the management committee of a financial institution under the “Special Support” (“Special Support Financial Institution”).

(b) **Managerial reform of ‘Special Support Financial Institutions’**
A “Special Support Financial Institution” must reform its management and promptly restore its soundness.

- **Pursuit of responsibilities of the management**
  The management representing financial institutions which receive “Special Support” is severely urged to clarify their responsibilities.

- **Appropriate management of accounts**
  A financial institution which receives “Special Support” is to divide its account into a “New Account” and a “Revival Account” for the purpose of the accounting management and administrate them properly.

- **Monitoring of business plans**
  “Task Force on Financial Issues” will strictly check a business plan of a “Special Support Financial Institution” submitted to the FSA by the new management and give advice to the Minister for Financial Services as to whether the plan is appropriate. Moreover, the Task Force will monitor the progress of implementation of the plan and report it to the Minister. The Task Force will also be able to advise the Minister to take appropriate actions, if considered necessary in such a case where the ‘Special Support Financial Institution’ will not become profitable even after adopting the proper way of management mentioned above.
(c) Establishment of a new public funds scheme
In order to make assurance doubly sure on the stability of the financial system and to terminate the NPLs problems, the FSA will examine the necessity of establishing a new framework which enables the Government to promptly inject public funds into a financial institution. Where appropriate, it will make a legislative proposal.

2. New framework for corporate revival

In order to further accelerate the structural reform, the FSA is to implement a new framework for corporate revival as mentioned below as soon as possible.

(1) Corporate revival through “Special Support”
“Special Support Financial Institutions” are to devote every managerial effort with regard to the following points in order to revive corporate debtors through utilizing wisdom and innovative ideas under the new management.

(a) Promoting removal of loans from balance sheets
The FSA will accelerate the process of corporate revival through sales of loans including those to borrowers classified as “in danger of bankruptcy” or below to the Resolution and Collection Corporation (RCC), corporate reconstruction funds and others. As for the purchase of loans by the RCC, financial measures will be examined, where necessary.

(b) Utilization of self-assessments as reference information in judging fair value
In sales of loans to borrowers classified as “in danger of bankruptcy” or below to the RCC, the FSA will consider using self-assessments as reference information judging fair value which is the RCC’s purchase price, provided that the self-assessments by a “Special Support Financial Institutions” are accompanied by adequate provisioning under the framework of “Special Support”.

(c) Credit Guarantee system for DIP Finance
The FSA will consider introducing a credit guarantee system, for the purpose of reviving the viable portion of a corporation in a legal liquidation process, in case a “Special Support Financial Institution” provides Debtor-in-Possession (DIP) finance to the corporation.
(2) Further utilization of the RCC and corporate revival

The FSA is to expeditiously enhance and utilize the framework to facilitate corporate revival, including promotion of sales of NPLs to the RCC, utilization of corporate reconstruction funds (deleveraging funds), and support for companies to be revived by Government affiliated financial institutions, while taking account of the following points.

(a) Strengthening corporate revival function
In order to strengthen corporate revival function, the FSA will consider strengthening the RCC’s corporate revival section and other measures. For that purpose, the RCC will act aggressively such as in securing adequate human resources, expanding corporate reconstruction funds utilizing the Development Bank of Japan or the Japan Bank for International Cooperation, and strengthening cooperation with other entities such as the Shoko Chukin Bank, which have know-how for corporate revival.

(b) Enhancing the cooperation with corporate reconstruction funds
The RCC will accelerate collections and sales of loans purchased, and perform as a bridge to the activities of corporate reconstruction funds and others. The Corporation will also maximize the collection of loans purchased. From this point of view, the RCC will expeditiously consider selling loans in principle which can not be collected in the short-term after purchase.

(c) Developing a market for loans
The RCC and Government affiliated financial institutions will make every effort to develop a market of loans in Japan through accelerating the sales of loans acquired by the Corporation. At the same time, the ways for the RCC to make more flexible actions to the profitability of each loan are to be comprehensively examined.

(d) Enhancement of the securitization function
The RCC will strengthen its function to securitize its huge loan portfolio and continue its efforts to further sell asset-backed securities.

(3) Developing favorable environments for corporate revival
Recognizing that the Government is aiming at reviving corporations, the FSA is to further strengthen the collaboration with relevant ministries such as Ministry of Economy, Trade and Industry (METI) and Ministry of Land, Infrastructure and Transport (MLIT), and take the following measures in order to develop favorable environments for corporate revival.

(a) Developing favorable environment for supporting corporate revival
In order to support final disposal of NPLs and early corporate revival and to facilitate finance to SMEs, the FSA will request relevant ministries to take appropriate tax measures, investment and loan schemes and special treatment under the Commercial code as soon as possible, beginning with feasible ones.

(b) Responding to the excess-supply problem
In order to tackle straightforwardly the problems of excess-supply and debt overhang, the FSA will request related ministries to develop guidelines and views of the Government as to whether specific industries or sectors are in a state of excess-supply and to set proper criteria in order to avoid giving a favorable blessing of the Government to an easygoing corporate restructuring plan.

(c) Developing Guidelines on Prompt Business Revival
The FSA will request related ministries to work together in striving to draw up expeditiously “Guidelines on Prompt Business Revival” and thereby reach a consensus among parties concerned, so that corporations can embark on their revival by their own initiatives. The FSA will participate in the efforts to draw up guidelines.

(d) Measures to deal with the stock price volatility risk
Since the stock price volatility risk is a large destabilizing factor for the management of financial institutions and can give an unexpected effect on the process of corporate revival, we look forward to BOJ’s smooth purchase of stocks held by financial institutions.

(e) Expectation of further monetary easing
In order to support the process of corporate revival, we look forward to further monetary easing to be carried out by the BOJ.

(4) New framework for corporate and industrial revival
In order to tackle corporate and industrial revival, it is necessary to establish a new organization and to pursue corporate revival by purchasing loans to corporations judged as viable at its judgment from financial institutions with an eye to industrial reorganization. To this end, the FSA requests the entire Government to collectively make necessary preparatory work expeditiously.

3. Framework of the New Financial Administration

In order to develop a new framework of the new financial administration to facilitate the structural reform, the FSA is to take the following measures.

(1) Tightening assessment of assets

In order to further tighten assessment of assets by financial institutions, the FSA is to take the following measures.

(a) Review of assessment standards on assets

The following measures are to be taken on assessment standards on assets, in order to match with market evaluations.

- Acceptance of DCF type methods on provisioning
  In major banks, regarding large borrowers who are classified as “need special attention”, provisioning should be assessed individually based on Discounted Cash Flow (DCF) type methods in principle. The FSA will examine concrete methods as soon as possible.

- Review of the criteria of average remaining period of loans to figure out provisioning
  As for major banks, the temporarily adopted criteria i.e. both one-year and three-years criteria for calculating expected losses to figure out provisioning will be examined taking account of the treatment in this respect in the U.S. and other countries.

- Harmonized classification of large borrowers among banks
  As for major banks, the FSA will introduce a concrete mechanism, in order that the
levels of classification of large borrowers classified as other than “normal” should be harmonized with the level of the classification which is made by financial institutions implementing appropriate asset assessments.

- Evaluation of Debt Equity Swaps (DESs) at fair value
  The FSA will examine the application of fair value in evaluating DESs, regardless of the timing of transactions, with respect to large borrowers whose stock prices can be reasonably assessed such as in the cases of listed stocks.

- Rigorous examination of reconstruction plans
  The FSA will establish a special team which includes experts for examining rigorously and continuously the progress and appropriateness of reconstruction plans.

- Rigorous examination of assessment of collateral
  The FSA will consider a scheme to ensure that independent real estate appraisers conduct legal appraisals in principle, where appraisals by real estate appraisers have been used by banks to assess values of collaterals.

(b) Conducting another round of special inspections
Towards the settlement of account at the end of March 2003, the FSA will in practice conduct another round of special inspections, in the form of continuing rigorous examination of accuracy of borrowers’ classification on a real-time basis.

(c) Disclosure of the gap between major banks’ self-assessments and the results of FSA’s inspections
The FSA will disclose the gap between self-assessments by major banks and the result of the FSA’s inspections on an aggregate basis, based on the result of the FSA’s inspections to date. The FSA will continue to disclose the gap periodically and ask each financial institution to narrow the gap.

(d) Strengthening administrative measures against inadequate correction of self-assessments
The FSA will clarify its policy to issue a business improvement administrative order to a bank, where the gap between its self-assessments and the results of FSA’s inspection has not been narrowed by the financial institution without due reasons.
(e) Declaration by the management regarding the accuracy of financial statements
The FSA will examine asking representative directors to sign for the accuracy of their institutions’ financial statements including asset assessment.

(2) Enhancing capital adequacy

The FSA is to take measures as follows to improve capital adequacy of financial institutions, while assessing the current status of the quality of capital.

(a) Tax reform for enhancing capital adequacy
In order to enhance capital adequacy of financial institutions, the FSA will strongly request the following measures to relevant ministries and governmental offices.

☐ Introduction of a new tax measure which enables provisioning to be recognized as tax-losses

The FSA will request a tax treatment that enables provisioning to be recognized as tax-losses, with regard to provisioning to the borrowers classified as “in danger of bankruptcy” or below as a result of banks’ self-assessments under the supervision and inspection by the FSA. The FSA will also request to recognize tax-losses in the case of partial write-off, where accounting losses are confirmed, even in cases, for example, the collaterals are not disposed yet.

☐ Removal of the freeze on the refund carry-back system

Regarding to the carry-back of tax deficit, the FSA will request the removal of the freeze on the carry-back system and also the extension of the period.

☐ Consideration of the extension of carry-over period for tax deficit

The FSA will request the extension of carry-over period for tax deficit, currently defined up to five years.

(b) Proper calculation of deferred tax assets
Since capital corresponding to deferred tax assets are less solid component of capital,
the FSA will strictly evaluate the treatment of deferred tax assets rigorously under the regulation on capital adequacy according to accounting guidelines and promptly examine also the upper limit of deferred tax assets to be included in regulatory capital.

(c) Verification that deferred tax assets are reasonably assessed
While recognizing large uncertainty surrounding the management of major banks and understanding the great difficulty to estimate the future taxable income beyond the next accounting year, the FSA will request external auditors to rigorously audit deferred tax assets, and strictly check whether such assets of major banks are adequately booked on the occasion of inspections.

(d) Review of increased capital through the allocation of new stocks to debtors
The FSA will carefully examine the eligibility of increased capital through the allocation of new stocks to a third party (debtors) as capital and, see to it that it is not de-facto self financing.

(e) Review of the issues on capital adequacy of banks
The FSA will further examine the issues which have not been fully dealt with in this program. The examination will lead to a review of the capital adequacy regulation at a later stage.

(f) Introduction of external auditing of capital adequacy ratio
The FSA will examine the possibility to make the calculation of adequacy ratio of regulatory capital subject to external audit, including the possible legislative measures.

(3) Strengthening governance
In order to strengthen governance in the management of financial institutions, the FSA is to take the following measures.

(a) Function of external auditors
External auditors strictly audit the correctness of asset assessment, provisioning and write-off and the assessment about going-concern with grave responsibility.

(b) Conversion of preferred stocks into common stocks
With regard to the conversion of banks’ preferred stocks held by the Government into
common stocks, the FSA will improve the operational guidelines as quickly as possible aiming at converting them when they meet such conditions as advent of due date and significant deterioration of business conditions.

(c) Issuance of a business improvement administrative order to a bank which has not achieved its plan for sound management
Where a bank has not achieved its plan for sound management submitted to the FSA, the FSA is to take appropriate administrative measures, judging the necessity depending on causes and extent of failure of its achievements. If the bank can not show an improvement in its performance, the FSA will take rigorous measures including clarifying the responsibility of the management.

(d) Rigorous review of prompt corrective action framework
The FSA will rigorously review prompt corrective actions stipulated for each category. The review will include the current framework of categorization.

(e) Utilization of the “Early Warning System”
The FSA will enhance its supervisory framework to monitor indicators such as profitability and liquidity, which are not reflected in capital adequacy ratio but warn any deterioration of the management of banks.

4. Future Steps

The FSA aims to draw up and publicize a “work schedule” in November this year in order to implement measures in this Program promptly, which target at major banks. In addition, the FSA will strive to put in place necessary legal and regulatory frameworks. As to the disposal of NPLs of small- and medium-sized and regional financial institutions, the FSA aims to develop an “Action Program” within FY 2002, after studying various aspects of “Relationship Oriented Banking”, which has different features from those of major banks.