To Improve Corporate Governance of Capital Injected Major Banks with Public Funds (Provisional Translation)
-Tightening application of supervisory actions and clarifying criteria to convert government-held preferred shares-

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Financial Services Agency

Corporate Governance concerning capital injected banks with public funds is ensured by reporting and releasing compliance with the rationalization plan, supervisory actions and conversion of government-held preferred shares to common shares. In particular, basically, the FSA requests capital injected banks to report compliance with their rationalization plans based on the Article 5.4 of the Early Strengthening Law, discloses it, and facilitate self-correction by financial institutions themselves. In case of a worsening of earnings conditions, firstly, the FSA takes supervisory actions including collecting reports and taking business improvement administrative orders based on the Banking Law, in order to ensure compliance with the rationalization plan. Moreover, in case that such financial institutions become significantly undercapitalized, the FSA examines to convert preferred shares.

The principle regarding these actions is defined in "Administrative actions to capital injected banks regarding follow-up" (September 1999, Financial Reconstruction Commission) and "Clarification of concepts of Administrative actions to capital injected banks regarding follow-up" (June 2001, Financial Services Agency), moreover, the principle regarding conversion of preferred shares is defined in "Conversion of convertible preferred shares" (June 1999, Financial Reconstruction Commission).

In the "Program for Financial Revival"(released on October 30, 2002), it is stipulated to strengthen governance of capital injected banks that "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." Also, it is stipulated in this program that "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."

In accordance with this program, from the view to strengthen governance of capital injected banks, the FSA makes strict supervisory actions to the banks which fail to achieve the rationalization plans and clarifies criteria to convert government-held preferred shares, moreover, the FSA administers both measures in a well-organized and integrated manner.

(note1)

The FSA examines a guideline for capital injected banks except major ones based on "Toward enhancing functions of Relationship Banking", the report of Second Subcommittee, Sectional Committee on Financial System, Financial System Council (released on March 27, 2003) and is to develop them by the end of June, 2004.

(note2)

In the following description, "Administrative actions to capital injected banks regarding follow-up" is abbreviated to "30% rule", "Clarification of concepts of Administrative actions to capital injected banks regarding follow-up" is abbreviated to "Clarification of 30% rule" and "Conversion of convertible preferred shares" is abbreviated to "The Guideline for Conversion".

1. Supervisory Actions

(1) Tightening supervisory actions

In "30% rule" and "Clarification of 30% rule", it is stipulated that the FSA takes supervisory actions to capital injected banks in case that their annual income and/or operational profit ROE of the bank fell 30% or more short of its commitment in the rationalization plan. Regarding these rules, based on the "Program for Financial Revival", the FSA rigorously takes such actions through business improvement administrative orders after checking causes and degrees of problems through correction of reports and judging the necessity of orders.

(2) Clarifying management responsibilities

In case that the banks and bank holding companies to which an improvement administrative order was taken cannot improve their businesses in spite of business improvement administrative orders, such that banks' annual income and/or operational profit ROE fell 30% or more short of its commitment in the rationalization plan again in the next fiscal year of this order, the FSA is to take necessary supervisory actions such as examination of business improvement administrative orders which request banks to submit and carry out plans to establish responsible management systems to improve management by the following measures.

(a) Retirement of a representative executive (a bank president) and staffs who have equivalent management responsibilities as a representative executive materially.

(b) Clarifying the segregation of official duties of each board member

(c) Review of a salary system, drastic cost reduction through the limitation of salaries for staffs and the reduction of the number of staffs and board members

(d) Suspension of bonuses to board members

(note)

The FSA asks banks the same measures above in case that it requests them to submit and carry out plans to establish responsible management systems to improve management through business improvement administrative orders in “Clarification of 30% rule” 3.(1) (Actions to cases of non-dividend payouts to preferred shares).

<u>2. Conversion of Government-held Preferred Shares</u>

(1) Response to the failure of management

① In case that banks are in following conditions, it is applied to the banks that “where it is necessary to secure appropriate business operation through management administration including revamping of management with regard to a bank which failed its management judged by its capital adequacy ratio, profit indicators and others” mentioned in “The Guideline for Conversion”, and the conversion is to be considered.

(a) In spite of supervisory actions in “Clarification of 30% rule” 3. (1) [Actions to cases of non-dividend payouts to preferred shares], there is a case of non-dividend payouts to preferred shares for two successive years or practically equivalent to non-dividend payouts to preferred shares for two successive years.

(note 1)

“practically equivalent to non-dividend payouts to preferred shares for two successive years” are the following cases;

- Non-dividend payouts for preferred shares are estimated for two successive years, by cases such as bank’s announcement of possible non-dividend payouts at the midterm account settlement in the second accounting year. (In this case, the FSA takes measures before settlement of accounts for the fiscal year.)
- Earning performances are not improved in the second accounting year, as is the case of reduction of dividend payouts to preferred shares, if there is any dividend.

(note 2)

In judging whether government-held preferred shares are converted concretely, if it is affirmed by examining causes of non-dividend payouts to preferred shares that the management system does not have particular problems and that the earning performance does well, the FSA takes due account of such conditions.

(b) There is a case that the earning performance of a bank is considered to be substantially declined, for example, the revised core operational profit ROA declines

10% or more against the previous fiscal year for two successive years and 30% or more on aggregate, and falls below the average of all banks.

(note 1)

“revised core operational profit” is defined as follows, from the perspective of focusing on profits and losses based on the earning capacity of bank’s original operations.

“revised core operational profit” = {operational profit + cost provided for general provisions for loan losses and provisions for trust accounts - (profits/losses incurred bonds + dividends from subsidiaries)}

“revised core operational profit ROA” is defined as “revised core operational profit” divided by “total assets”.

(note 2)

With regard to cases of institutional reorganizations such as merger/consolidation and separation (it is only the case that a corporation which issued preferred shares held by the government is a capital injected bank after the reorganization (in cases that the status of legal entities of capital injected banks is dissolved through such reorganization, the bank which inherit their capital by the merger/consolidation is included.)), the FSA determines treatment in accordance with the following lines in principle, even though it considers each actual condition.

(i) In case of merger/consolidation and taking business, the FSA compares the revised core operational profit ROA after reorganization with that before reorganization in principle.

(ii) In case of separation and business transfer,

(a) In case that capital injected banks transfers assets and liabilities to consolidated subsidiaries such as banks and corporations (in case that there is a parent corporation of the capital injected bank, subsidiaries of the parent corporation are included.), figures of the consolidated subsidiaries are to be added together in calculating “revised core operational profit ROA”. In this case, debts and credits (those defined in 4-6 of the principles on consolidated financial statement), and volumes of transactions (items of transactions defined in 5-2 of the same principles mentioned above) between the capital injected bank and its subsidiaries are to be cancelled out. Also, in case that subsidiaries are corporations except banks, the ordinary profit is substituted for the operational profit.

(b) In case that capital injected banks transfer assets and liabilities to corporations except consolidated subsidiaries mentioned in (a), the FSA treats in the same way as the case mentioned in (i).

(note 3)

In case (except for the case mentioned in note 2) that a capital injected bank becomes a different corporation which issued preferred shares that Government holds by exchanging shares between a capital injected bank and its parent corporation such as a bank-holding corporation and there are plural capital injected banks (except for banks whose preferred shares held by the Government) under the corporation, revised core operational profit ROA is to be calculated by adding figures of these plural capital injected banks (if the corporation is a capital injected bank, the corporation is to be included). In adding figures of those banks, the same correction as (Note 2) (ii) (a) is to be done.

(note 4)

When a revised core operational profit ROA fluctuates as the result of changes in accounting principles, the FSA compares the revised core operational profit ROAs after correcting this fluctuation.

(note 5)

In judging the conversion of government-held preferred shares concretely, the FSA takes due account of particular factors to the revised core operational profit ROA, such as an impact from the change of outside circumstances like interest rate trend.

(c) In case that adequate improvements are not be recognized, as actual achievement of current profit or operational profit ROE underperforms 30% or more against the rationalization plan, regardless business improvement administrative order in (2) of 1. “supervisory actions”.

(d) In case that banks cannot achieve an adequate improvement and it is impossible to expect it hereafter in spite of a prompt corrective action related to the capital adequacy ratio.

② In case that the FSA converts government-held preferred shares, as a result of examination regarding ①, the FSA requests the bank to take following actions in principle, in order to ensure appropriate business operations through management administration including reforming the management system, in accordance with “The Guideline for Conversion”.

(a) Thorough clarification of management responsibilities such as resignation of board members who have rights of representation and pursuit of their responsibilities corresponding to the sharing of responsibilities classified in 1.(supervisory actions) (2) (b),

(b) Drastic reform of management through review of organizations and operations including reduction of the number of branches, and establishment of businesses contributing to the enhancement of the profitability of the bank.(including disposal of the equity of subsidiaries and review of businesses of the other subsidiaries)

(c) Suspension or reduction of dividends

If above actions are taken before the conversion of government-held preferred shares and it is affirmed that the appropriate measures to improve management have been taken, the FSA assesses the need of conversion of government-held preferred shares through taking another period, while taking supervisory measures as needed.

(note)

In case that the FSA converts government-held preferred shares as a result of examinations in case that requirements of approval to underwrite common shares stipulated in Early Strengthening Law, mentioned in “The Guideline for Conversion”, are satisfied, the FSA requests the bank to take the same actions mentioned above.

(2) Response to management crises of individual banks (Emergency Responses)

Regarding banks which cannot avoid a management crisis in spite of supervisory actions including business improvement administrative orders, based on the comprehensive consideration in trends of deposits, cash management, financing in inter-bank market, status of international transactions of derivatives and others, the FSA considers such banks fall into the cases that confidence of banks substantially declines and recovery of it is needed , and the FSA examines measures not only emergency finance of the BOJ and/or capital injection based on the article 102.1(1) of the Deposit Insurance Law but to convert government-held preferred shares.

(note)

In case that the FSA converts government-held preferred shares based on examination of cases corresponding to above, the FSA requests the bank to take equivalent actions to those in (1)2 as needed.

(Remarks)

(1) In case that the FSA decides to convert government-held preferred shares, in consequence of examinations of converting government-held preferred shares based on 2 (Conversion of Government-held Preferred Shares), the FSA determines the timing of conversion, while watching the trend in stock markets and taking due account of appropriate management of public assets.

(2) The guideline is applied from the end of March, 2003. (the guideline for capital injected banks except major ones, which will be created by the end of June 2003, is to be applied from the end of March, 2004)