Reconstructing and Revitalizing Japan's Financial Sector: Policy Implications

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Concerns and Issues

- Major Concern: Containing System-Wide Shock and Rebuilding Confidence
- Japanese Experiences
  - Removing Bad Assets Regarded as Critically Important Policy
  - Designing “Comprehensive” Policies for Reconstruction
  - Balancing Incentives of Senior Managers and Improved Transparency and Governance
  - Revitalizing Corporate Sector and Real Estate Market
Comparison: U.S. Housing Prices and Condominium Prices in Japan

Note: Tokyo and Osaka condo prices are based on the price per square meter, 5-month moving average.
Source: NICMR, based on S&P, CME, and Real Estate Economic Institute
Outstanding Nonperforming Loans: Fannie Mae and Freddie Mac

Source: NICMR, based on 10-Q files of Fannie Mae and Freddie Mac
U.S. Commercial Banks: Slowly Declining Noncurrent Loan Ratio

FDIC-Insured Commercial Banks: Noncurrent Loans

FDIC-Insured Commercial Banks: Reserves for Loan Losses

Note: Allowance is level data and provision is flow data. Provision data for 2012 Second Quarter is annualized.
Source: NICMR, based on FDIC
Illiquid Assets on Largest Banks’ Balance Sheets

Level 3 Assets on Largest U.S. Banks’ Balance Sheets

Level 3 Assets to Tier 1 Capital (%)

Source: NICMR, based on 10-Q Files of Each Banks

Source: NICMR, based on 10-Q Files of Each Banks
Confidence on Banking Sector Does Not Return

Largest U.S. Banks: CDS Spread (Senior 5 year)

Largest U.S. Banks: Price-to-Book Value Ratio (Times)

Source: NICMR, based on Bloomberg
Japanese Experience: The 15-Year War on NPL Problem

- 1990-1991  Burst of Bubble Economy
  - December 1989  Peak of Nikkei 225 Index (Equity Market)
  - September 1991  Peak of Land Price

- 1992-1996  Development of Non-Performing Loan Problem
  - December 1995  Recapitalizing the Jusen System (Mortgage Lenders)

- 1997-1998  Emergence of Financial Crisis
  - November 1997  Bankruptcies of Sanyo Securities, Hokkaido Takushoku and Yamaichi Securities
  - October 1998  Long-Term Credit Bank Bankruptcy, Financial Reconstruction Law
  - December 1998  Nippon Credit Bank Bankruptcy

- 1999-2000  Containment of System-Wide Crisis
  (Harsh Criticism on Banks)

- 2001-2005  Removal of NPLs and Reconstruction of Financial Sector
  - April 2001  Junichiro Koizumi Administration
Exit from NPL Problem: Major Concern in 2001-2005

Outstanding Non-Performing Loans (Disclosed Basis)

Non-Performing Loans to Total Assets

Source: NICMR based on Financial Services Agency, Ministry of Finance, etc.

Note: US NPL is Assets past due 30 or more days.
Source: NICMR based on Financial Services Agency and FDIC
Why Japan’s Financial Sector Struggled for So Long?

- “Too Many To Fail”
  - Depressed Macro Economy
  - Disorganization of Industrial Sector
  - “Kicking the Can Down the Road”
    - Painful Secondary Loss by Sales
    - Remote from Fair Value Accounting
    - Lack of Incentives for Bank Management
    - “Extend and Pretend”, “Zombie” Companies
  - Complicated Debtor-Creditor Relationships
    - Recourse Loans
    - Multiple Mortgages on Single Property

- Lack of Market for Distressed Assets
  - No Legal Framework for Corporate Reorganization or Out-of-Court Workouts
  - Debtor-in-Possession (DIP) Financing

- Stagnant Real Estate Market
  - SPC Laws for Securitization (Enacted in 1998)
  - J-REIT Market (Launched in 2001)
Long-Sustained and Significant Depreciation of Asset Prices

Land Prices (Urban Land Price Index)

Stock Index (TOPIX)

Source: NICMR based on Japan Real Estate Institute

Note: End of Month
Source: NICMR based on Bloomberg
Japanese Banks’ Exposure to Asset Devaluation

Loans Secured by Real Estate and Floating Mortgages

Equity Shares Owned by City and Regional Banks (Market Values)

(Trillion Yen)

Note: End of Fiscal Year
Source: NICMR based on Bank of Japan

Note: End of Fiscal Year
Source: NICMR based on Tokyo Stock Exchange
Reconstruction Process: Sequence of Policies

Source: NICMR
## Goal Setting: Emergency Economic Measures in 2001

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<th>Comprehensive Structural Reform under Koizumi Administration</th>
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<td>Legal Frameworks for Reorganization</td>
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<td>Company Reorganization Law</td>
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<td>Debts Newly Categorized as “In Danger of Bankruptcy” and Below: Complete Sale or Charge Off Within 3 Fiscal Years</td>
<td>Civil Rehabilitation Law</td>
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<td>Enhancement of Corporate Restructuring Procedures</td>
<td>Guidelines for Out-of-Court Workouts</td>
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<td>Making Debt Forgiveness Easier: Setting Rules and Guidelines for DIP Financing and Debt-Equity Swap</td>
<td>Special Inspection: Focusing on Certain Problem Borrowers</td>
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<td>Policies for Asset Liquidation</td>
<td>“In Danger of Bankruptcy” Borrowers: Providing Rehabilitation Plan, Court Reorganization, Sales to RCC, etc.</td>
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<td>“Special Attention” Borrowers: Giving Internal Credit Rating and Monitoring</td>
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### Policies for Asset Liquidation

- Special Inspection: Focusing on Certain Problem Borrowers
  - “In Danger of Bankruptcy” Borrowers: Providing Rehabilitation Plan, Court Reorganization, Sales to RCC, etc.
  - “Special Attention” Borrowers: Giving Internal Credit Rating and Monitoring

### Legal Frameworks for Reorganization

- Company Reorganization Law
- Civil Rehabilitation Law
- Guidelines for Out-of-Court Workouts
- Special Inspection: Focusing on Certain Problem Borrowers
  - “In Danger of Bankruptcy” Borrowers: Providing Rehabilitation Plan, Court Reorganization, Sales to RCC, etc.
  - “Special Attention” Borrowers: Giving Internal Credit Rating and Monitoring

### Emergency Economic Measures under Mori Administration

- April 6, 2001 “Emergency Economic Packages”
- June 26, 2001 “Basic Stance for Structural Reform” (Cabinet)
- October 26, 2001 “Advanced Reform Program -Financial Sector” (JFSA)
- April 8, 2002 “Measures for Developing Stronger Financial System” (JFSA)
Asset & Borrower Classification Standard by Self Assessment

<table>
<thead>
<tr>
<th>Borrower Classification</th>
<th>Classification of Guarantee, Collateral</th>
<th>Collectability</th>
<th>Ordinary Collateral (Real estate etc)</th>
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<tr>
<td></td>
<td>Superior Collateral (Deposit, Government Bond etc) Superior Guarantee (Guarantee by public sector etc)</td>
<td>Estimated Disposal Value of collateral (70% of market value)</td>
<td>Difference between Market Value and Estimated Disposal Value of collateral (30% of market value)</td>
</tr>
<tr>
<td>Bankrupt</td>
<td>I</td>
<td>II</td>
<td>III</td>
</tr>
<tr>
<td>De facto Bankrupt</td>
<td>I</td>
<td>II</td>
<td>III</td>
</tr>
<tr>
<td>In Danger of Bankruptcy</td>
<td>I</td>
<td>II</td>
<td>III</td>
</tr>
<tr>
<td>Special Attention</td>
<td>I</td>
<td>II</td>
<td>II</td>
</tr>
<tr>
<td>Needs Attention</td>
<td>I</td>
<td>II</td>
<td>II</td>
</tr>
<tr>
<td>Normal</td>
<td>I</td>
<td>I</td>
<td>I</td>
</tr>
</tbody>
</table>

Category I: Assets with no problems in terms of repayment risk or loss of value risk
Category II: Assets deemed to include a higher than normal repayment risk
Category III: Assets for which there are serious doubts about collection or value
Category IV: Assets deemed to be uncollectable or without value

Bankrupt: Legally and formally bankrupt, including bankruptcy, liquidation, reorganization, rehabilitation, Composition, and suspension of dealings on the bill exchange

De facto Bankruptcy: Be in serious business difficulties and considered to be impossible to rebuild, though not yet legally and formally bankrupt

In Danger of Bankruptcy: Facing business difficulties and failing to make adequate progress on its business improvement plan, so that there is a possibility of falling into bankruptcy in the future

Special Attention: Within the borrowers classified as "Needs Attention", overduing longer than 3 months or having problems with lending conditions (i.e., waivers, reductions, or deferrals of interest)

Needs Attention: Having problems with lending conditions, fulfillment or its financial conditions, etc

Normal: Having strong results and no particular problems with its financial condition

Source: JFSA
Program for Financial Revival ("Takenaka Plan")

Contents of Financial Reconstruction Program (October 30, 2002)

1. A New Framework for the Financial System
   - Constructing a reliable financial system
   - Financial administration for the benefit of the Japanese people
   - Maintaining a stable clearing function
   - Establishing a monitoring system
   - 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 medium-to-small businesses face
   - Maintaining a monitoring system for financing for medium-to-small businesses
   - Establishing a hotline for tight lending practices and retraction of credit
   - Inspection of tight lending practices and retraction of credit

2. A New Framework for Company Reconstruction
   - Company reconstruction via "special support"
   - Shift of off-balance for financial receivables
   - Utilizing self inspections for market-value reference information
   - Guarantee system for DIP financing
   - 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 reconstruction function

3. A New Framework for Financial Administration
   - 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 correction inadequate self-inspections
   - Declaration of the accuracy of financial statements by managers

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

   - Forfiting 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 a 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

Source: JFSA
Removing NPLs: Resolution of NPL Problems By FY 2004

Provisioning Issues
- Introduction of Self Assessment
- No Favorable Tax Treatment: Difference Between Financial Accounting and Tax Accounting
- Arbitrary Classification: Based on Past Default Rates
- “Too Little, Too Late” Provisioning

Governance Issues
- Slow Reform of Management at Financial Institutions that Received “Special Support” (Public Funds)
- Vague Commitment on “Plan for Sound Management”
- Public Funds in the Form of Preferred Shares

Tightened Assessment of Assets
- Uniform Classification of Large Problem Borrowers Among Lenders
- Application of Discounted Cash Flow (DCF) Methods to “Need Special Attention” Borrowers
- Review of the Criteria for Average Remaining Period to Figure Out Provisioning
- Rigorous Examination of Collateral Assessment
- Accelerated Removal of Problem Loans

Strict Monitoring by Government
- Issuance of Business Improvement Order to Banks Not Achieving Profitability Goals
- Accountability of Senior Management: Net Income or Net Business Profit ROE Below 70% of Target Level
  - Replacement or Compensation Limit
- Possible Conversion of Preferred Shares into Common Shares
Expanded Function of Resolution and Collection Corporation (RCC)

- **January 1995**
  - Tokyo Kyodo Bank
  - Receiver for 2 bankrupt credit unions

- **July 1996**
  - Housing Loan Administration Corporation (HLAC)

- **September 1995**
  - Resolution and Collection Bank (RCB)
  - Reformed as servicer for other bankrupt banks

- **April 1999**
  - Resolution and Collection Corporation (RCC)

- **January 2002**
  - Permitted to purchase NPLs at “Market Prices”
  - Allowed to participate a bid for NPL bulk sales
  - Established “Corporate Restructuring” Dept.

- **October 2002** “Financial Revitalization Plan”
  - Strengthened corporate restructuring functions
  - Aimed to partner with private investment funds
  - Accelerating sales of holding assets: Creating loan trading market
  - Enhancing the securitization function

Source: Nishimura (2011)
Industrial Revitalization Corporation of Japan (IRCJ)

- Carried out Revitalization Plans for 41 Companies (Total Debt: Approx. JPY 4 Trillion) During 2003-07
- Performed Financial Restructuring (Consolidation of Bank Loans, Forgiveness and Debt-Equity Swaps)
- Provided Advisory for Business Revitalization

Entry

- Indebted Company
- Main Bank
- Non-Main Banks

Restructuring Plan

Exit

- Revived Company
- Banks
- New Money
- Strategic Sponsors
- Private Equity Fund
- Investment Banks
- Banks

Loan Assets Purchase

Evaluation

Sale

Source: Takagi (2003)
Revitalizing Property Market: Utilization of Market Mechanism

Securitization in Japan: ABS Issuance

Real Estate Investment Trust (J-REIT): Growth in Market Cap

Source: Nomura Securities

Source: Nomura Securities based on Tokyo Stock Exchange
Heterogeneity of Major Banks’ Responses to NPL Problems

Change in Capital Positions of Major Japanese Banks

Source: NICMR based on Japanese Bankers Association
## Resources for Nonperforming Asset Reduction

### Changes in Nonperforming Loans (Based on the Financial Reconstruction Law)

<table>
<thead>
<tr>
<th>Breakdown of Factors</th>
<th>Change in Apr 2002- Mar 2005 (JPY Trillion)</th>
<th>Change in Apr 2002- Mar 2007 (JPY Trillion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in Nonperforming Loans (Based on the FRL)</td>
<td>-25.3</td>
<td>-31.2</td>
</tr>
<tr>
<td>Newly Generated NPLs Due to Weakened Business Activities</td>
<td>20.2</td>
<td>27.3</td>
</tr>
<tr>
<td>Upgrade From Lower Categories</td>
<td>2</td>
<td>2.6</td>
</tr>
<tr>
<td>Return to Normal Claims</td>
<td>-9.5</td>
<td>-12.1</td>
</tr>
<tr>
<td>Repayment, etc.</td>
<td>-4.3</td>
<td>-5.2</td>
</tr>
<tr>
<td><strong>Removal from Balance Sheet, etc.</strong></td>
<td><strong>-33.8</strong></td>
<td><strong>-44.1</strong></td>
</tr>
</tbody>
</table>

### Bankruptcy Process (Liquidation)

<table>
<thead>
<tr>
<th>Change in Apr 2002- Mar 2005 (JPY Trillion)</th>
<th>Change in Apr 2002- Mar 2007 (JPY Trillion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankruptcy Process (Liquidation)</td>
<td>-2.6</td>
</tr>
<tr>
<td>Bankruptcy Process (Reorganization)</td>
<td>-4.2</td>
</tr>
<tr>
<td>Business Improvement by Reorganization</td>
<td>-1.8</td>
</tr>
<tr>
<td>Asset Liquidation</td>
<td>-13.5</td>
</tr>
<tr>
<td>Charge off</td>
<td>4.5</td>
</tr>
<tr>
<td><strong>Total (A)</strong></td>
<td><strong>-17.6</strong></td>
</tr>
<tr>
<td>Collection and Repayment</td>
<td>-12.1</td>
</tr>
<tr>
<td>Business Improvement</td>
<td>-4.1</td>
</tr>
<tr>
<td><strong>Total (B)</strong></td>
<td><strong>-16.3</strong></td>
</tr>
<tr>
<td><strong>Total (A)+(B)</strong></td>
<td><strong>-33.8</strong></td>
</tr>
</tbody>
</table>

Source: Nishimura (2011)
Consideration for Financial Stability During 2001-2005

- Introduction of Deposit Protection Limits
  - Partially in Force in April 2002

- Protection Limits on Savings Account:
  - Effective until April 2005 (initially scheduled to end in April 2003, extended on October 8, 2002)

- Resona Bank

- Ashikaga Bank

 Depository Institution Resolutions in Japan

<table>
<thead>
<tr>
<th>Year</th>
<th>Bank</th>
<th>Shinkin Bank (Credit Association)</th>
<th>Credit Union</th>
<th>Total</th>
</tr>
</thead>
<tbody>
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<td>0</td>
<td>0</td>
<td>1</td>
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<tr>
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<td>5</td>
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<td>17</td>
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<td>2001</td>
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<td>13</td>
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<td>2004</td>
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<td>2005</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</tbody>
</table>

Source: NICMR based on Deposit Insurance Corporation of Japan
Credit Ratings Trends for Japanese Banks

Historical Credit Ratings in Major Banks

Note: Long-term issuer ratings. The present rating is in parenthesis.
Source: NICMR based on Moody’s
Remaining Issues (1) : Capital Raising and Profitability

Capital Raising by Japanese Banks

Profitability of Japanese Banks

Source: Thomson, Deposit Insurance Corporation of Japan

Source: NICMR based on Japanese Bankers Association
Amount of JGB and Loan in Japanese Banks Assets

Loan-to-Deposit Ratio (%, Right Axis)

Note: End of Month
Source: NICMR based on BOJ
Lessons from Japanese Experience

- Removal of Bad Assets: Speedy Policy Implementation by Political Leadership
- “Convoy System” to “Segregation Policy”
- Sequence of Policies: Appropriate Timing of Capital Raising?
- Consideration for Borrowers: “Simultaneous” Reconstruction Needed?
- Use of Market Mechanism: Benefit of Securitization
- Implications for Asian Countries
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(http://www.fsa.go.jp/news/newse/e20011026-1.html)


Takagi, Shinjiro (2003b) “Industrial Revitalization Corporation of Japan”, Presentation on Forum for Asian Insolvency Reform, November 2003