

Reconstructing and Revitalizing Japan's Financial Sector: Policy Implications

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Presented at:

“Restructuring Financial Infrastructure to Speed Recovery”

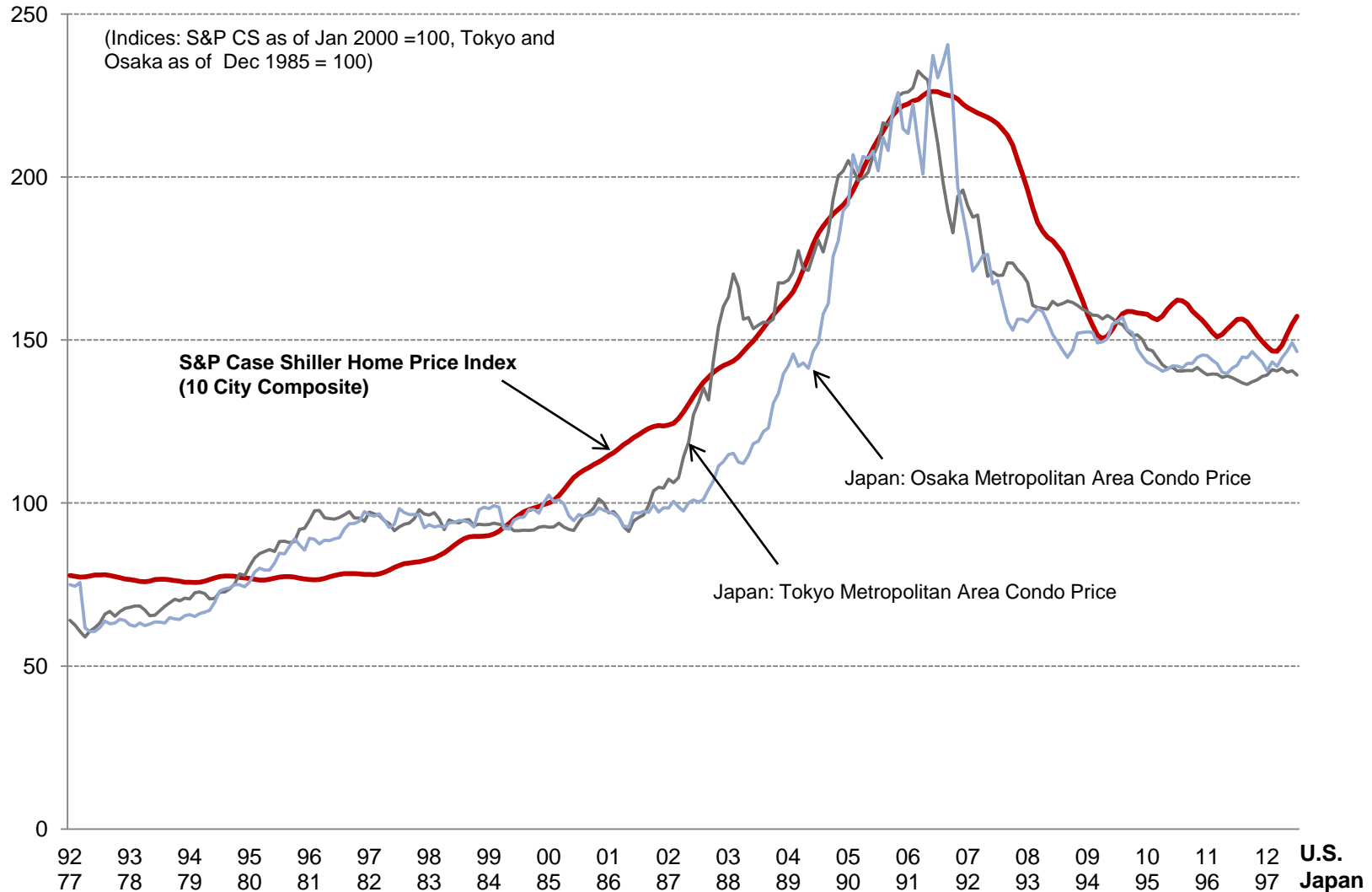
*Brookings-Nomura-Wharton Conference on
Financial Markets 2012*

October 26, 2012

- **Major Concern: Containing System-Wide Shock and Rebuilding Confidence**
- **Japanese Experiences**
 - **Removing Bad Assets Regarded as Critically Important Policy**
 - **Lack of Legal Framework and Practices for Transacting Distressed Assets/Businesses**
 - **Designing “Comprehensive” Policies for Reconstruction**
 - **Balancing Incentives of Senior Managers and Improved Transparency and Governance**
 - **Revitalizing Corporate Sector and Real Estate Market**

U.S. Home Price Index: Bottoming Out?

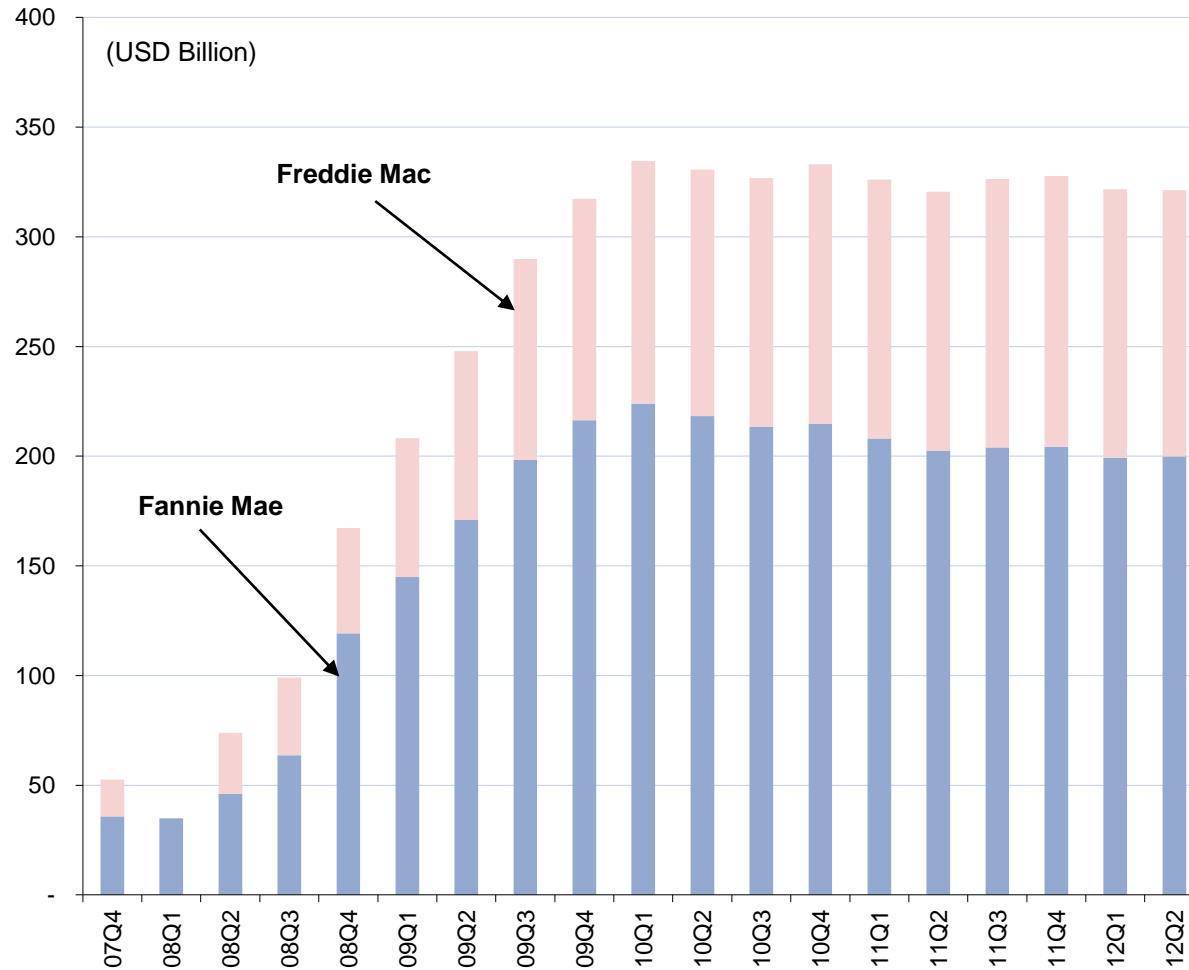
Comparison: U.S. Housing Prices and Condominium Prices in Japan



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

Nonperforming Residential Mortgage: Remaining at Plateau

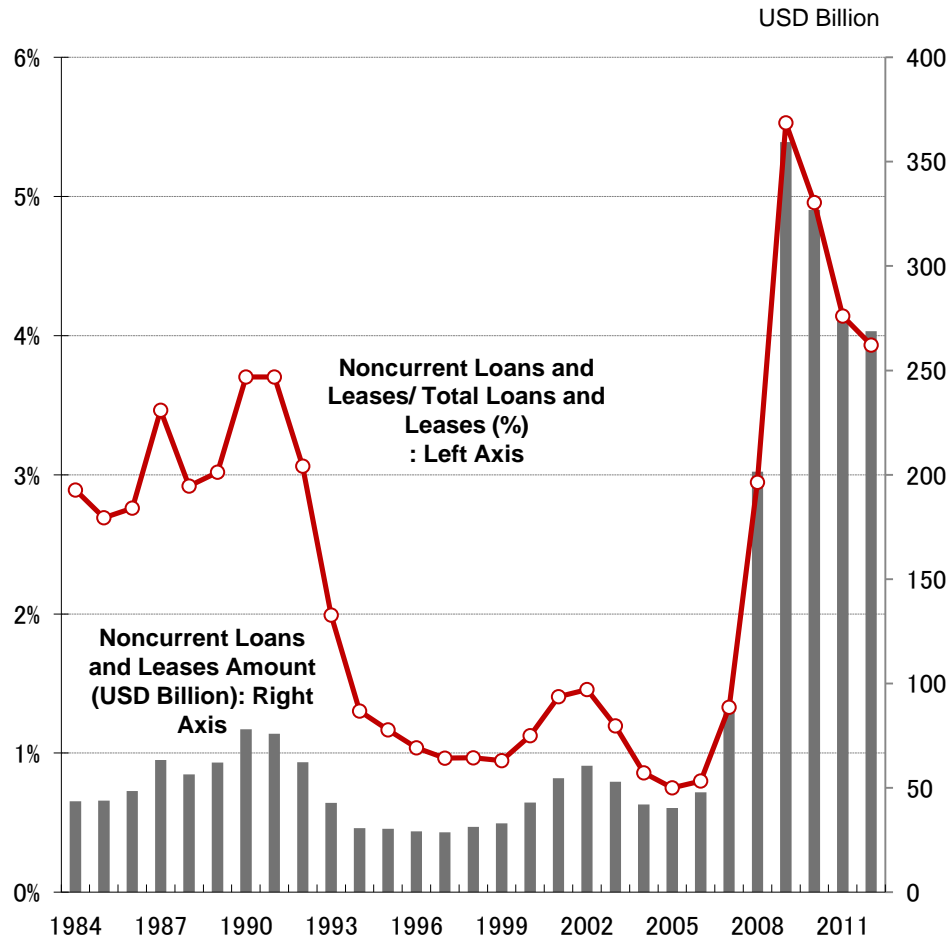
Outstanding Nonperforming Loans: Fannie Mae and Freddie Mac



Source: NICMR, based on 10-Q files of Fannie Mae and Freddie Mac

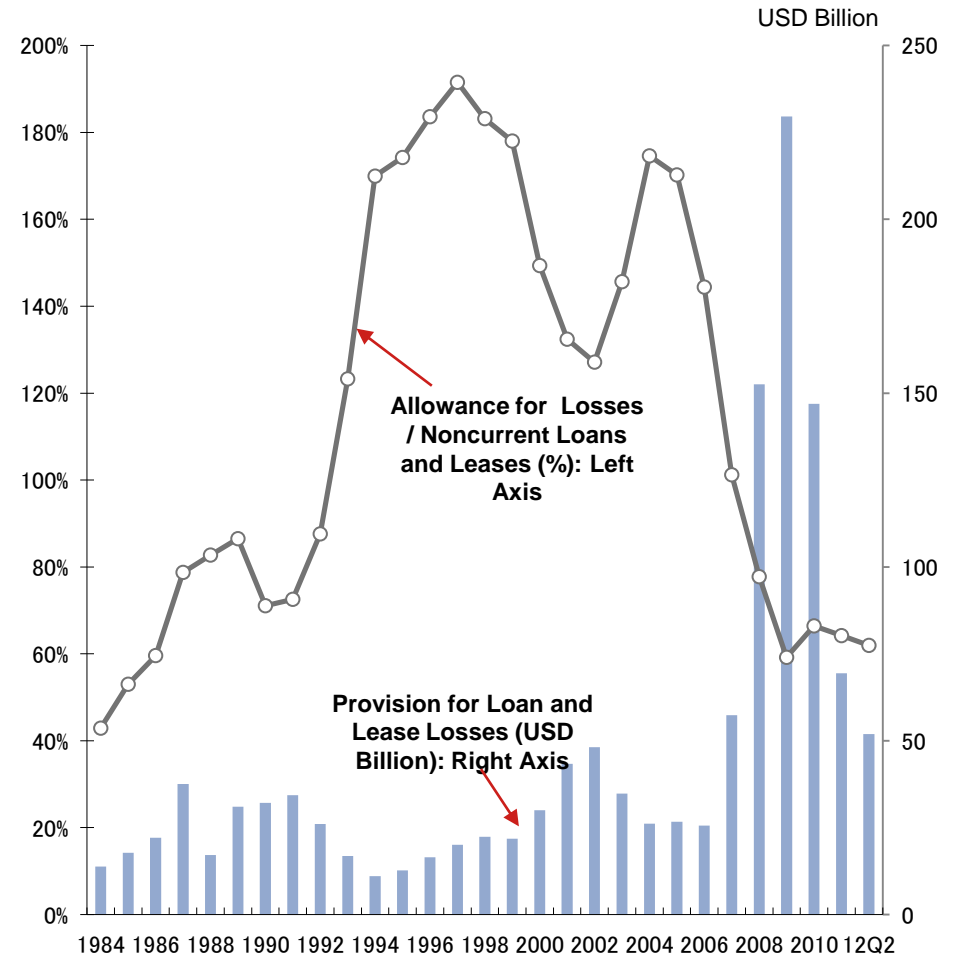
U.S. Commercial Banks: Slowly Declining Noncurrent Loan Ratio

FDIC-Insured Commercial Banks: Noncurrent Loans



Source: NICMR, based on FDIC

FDIC-Insured Commercial Banks: Reserves for Loan Losses

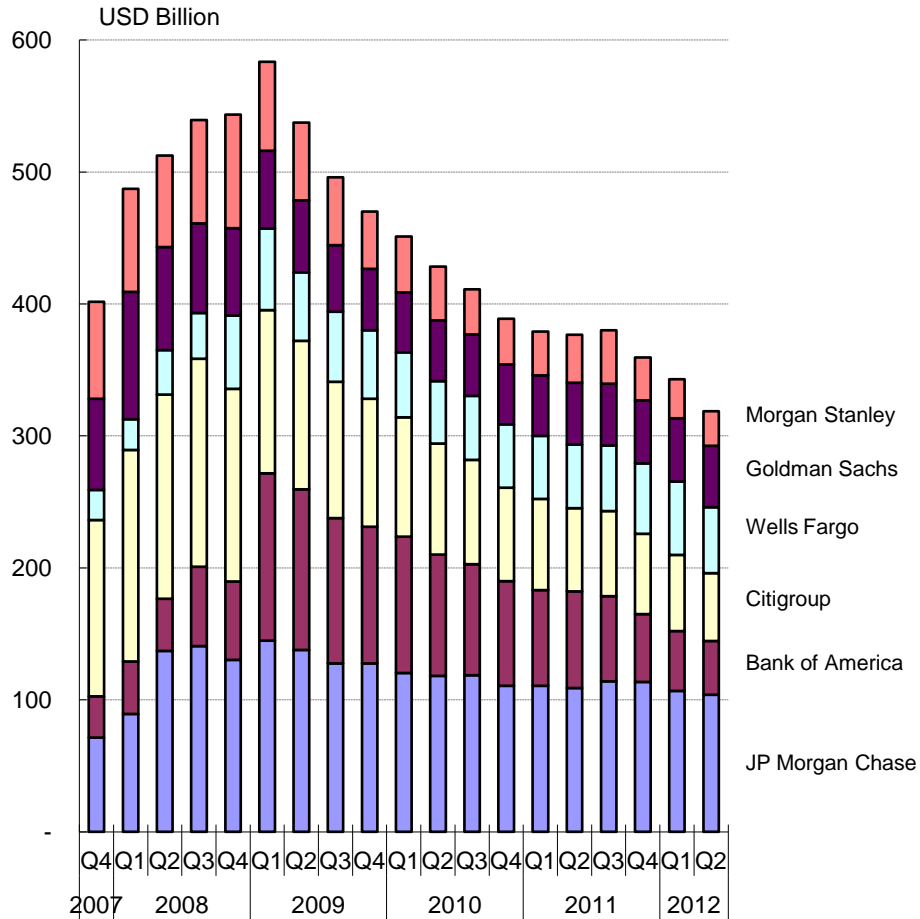


Note: Allowance is level data and provision is flow data. Provision data for 2012 Second Quarter is annualized.

Source: NICMR, based on FDIC

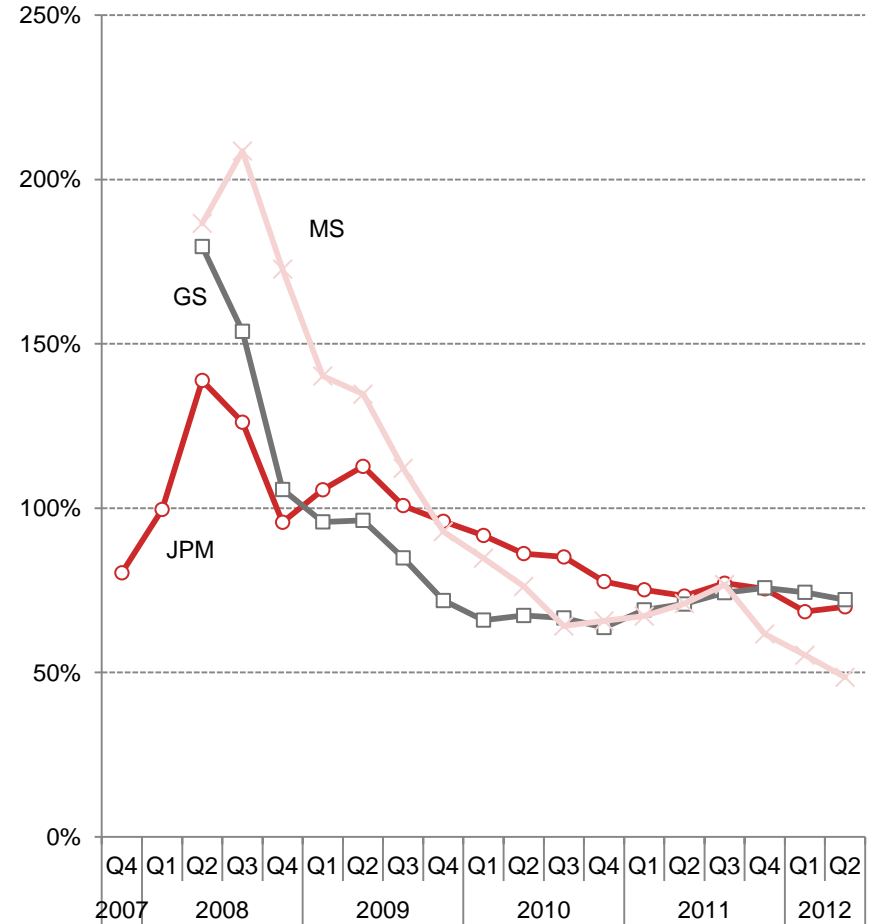
Illiquid Assets on Largest Banks' Balance Sheets

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



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

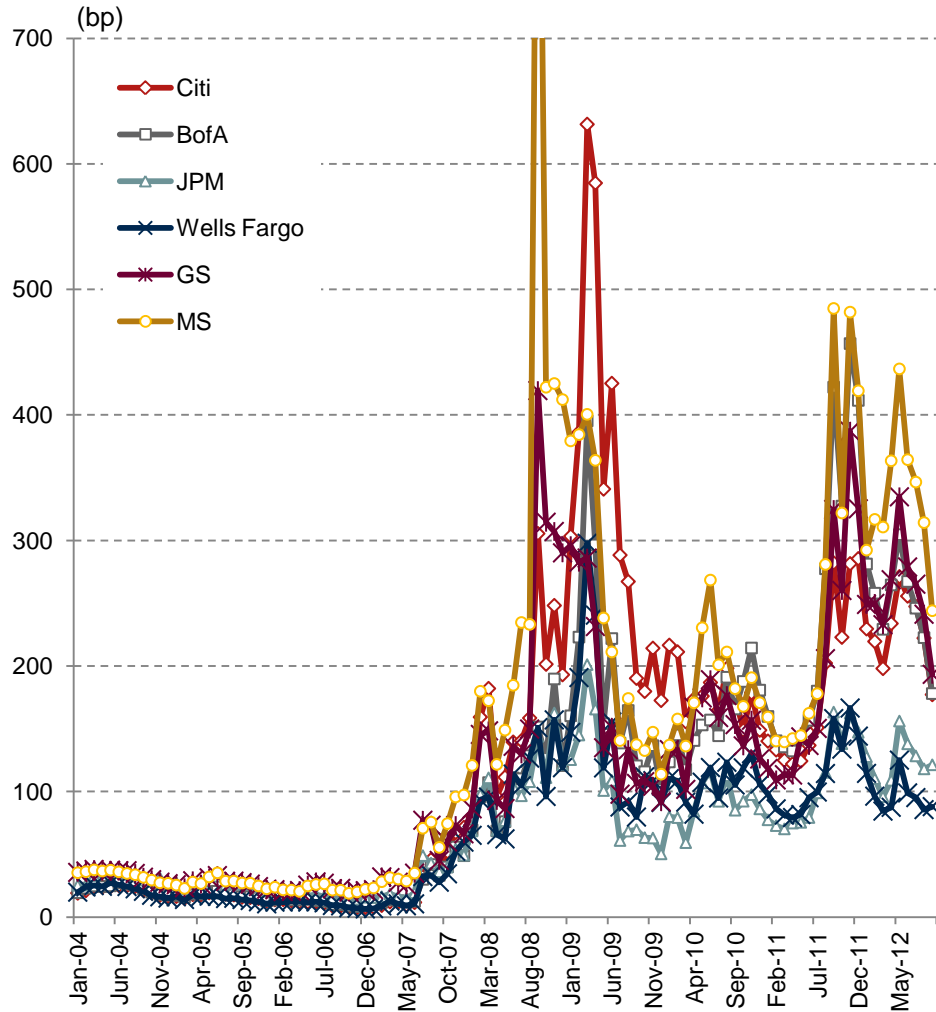
Level 3 Assets to Tier 1 Capital (%)



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

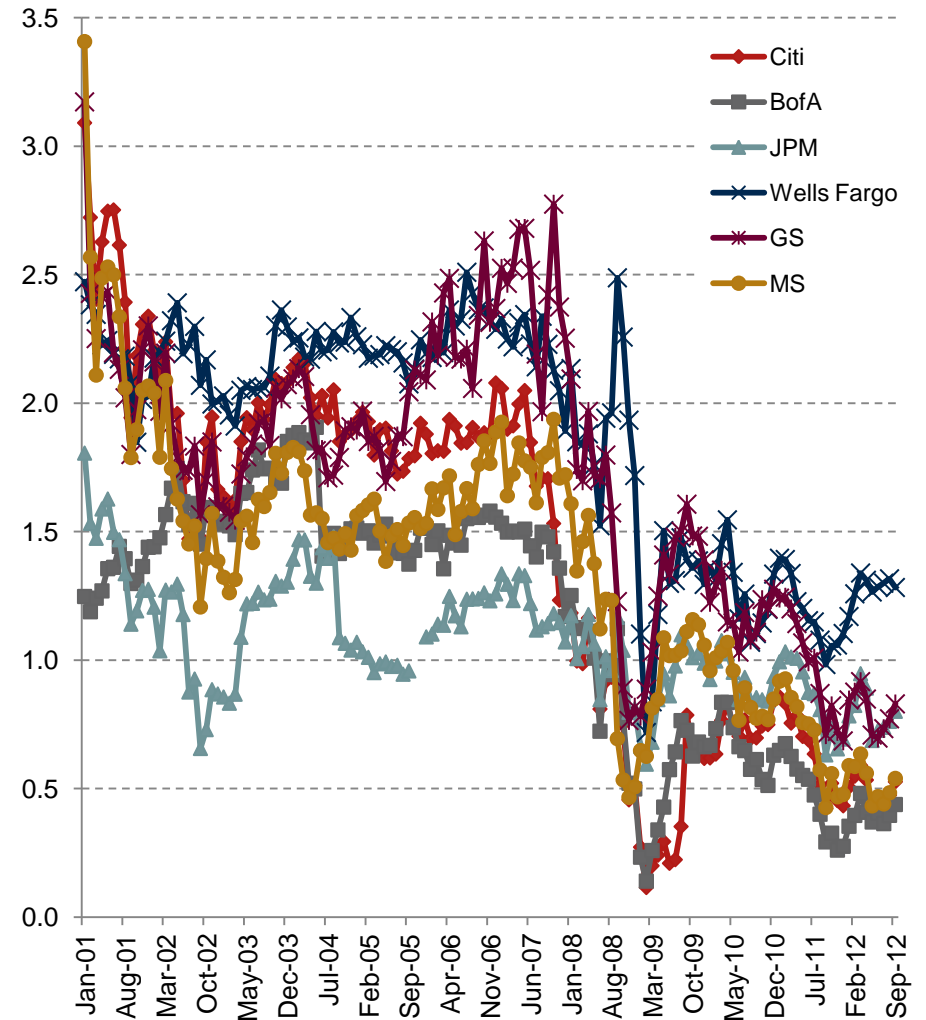
Confidence on Banking Sector Does Not Return

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



Source: NICMR, based on Bloomberg

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



Source: NICMR, based on Bloomberg

- **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)**

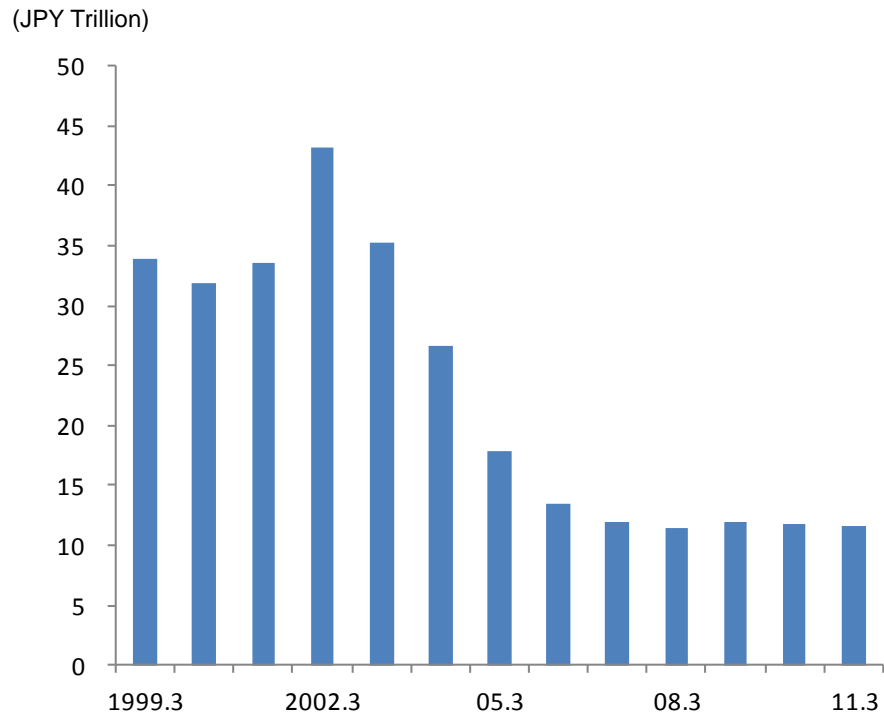
- **1997-1998** **Emergence of Financial Crisis**
 - **November 1997** **Bankruptcies of Sanyo Securities, Hokkaido Takushoku and Yamaichi Securities**
 - **October 1998** **Long-Term Credit Bank Bankruptcy, Financial Reconstruction Law**
 - **December 1998** **Nippon Credit Bank Bankruptcy**

- **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**

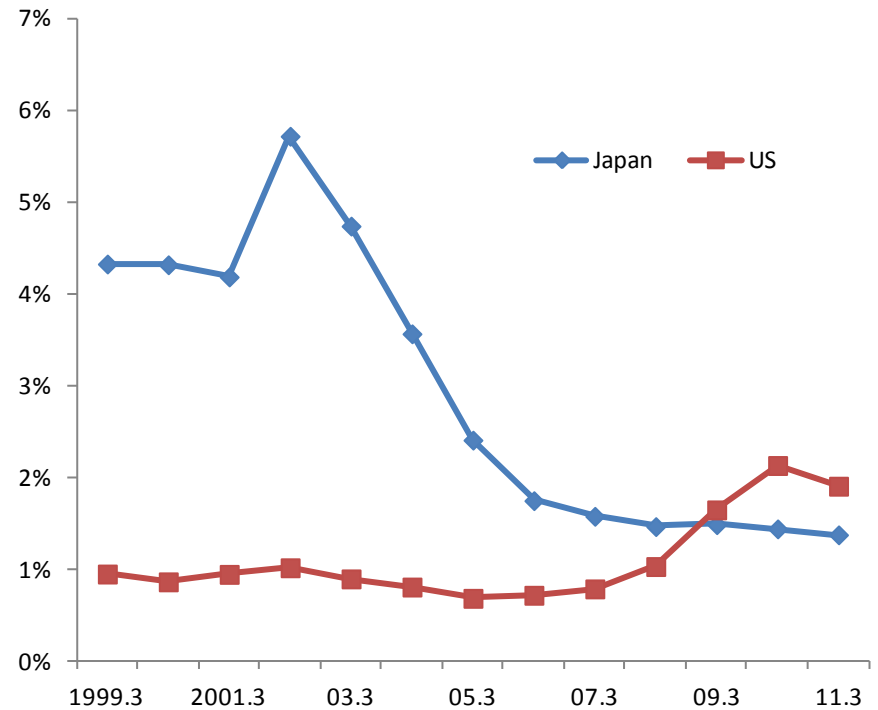
Exit from NPL Problem: Major Concern in 2001-2005

Outstanding Non-Performing Loans (Disclosed Basis)



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

Non-Performing Loans to Total Assets



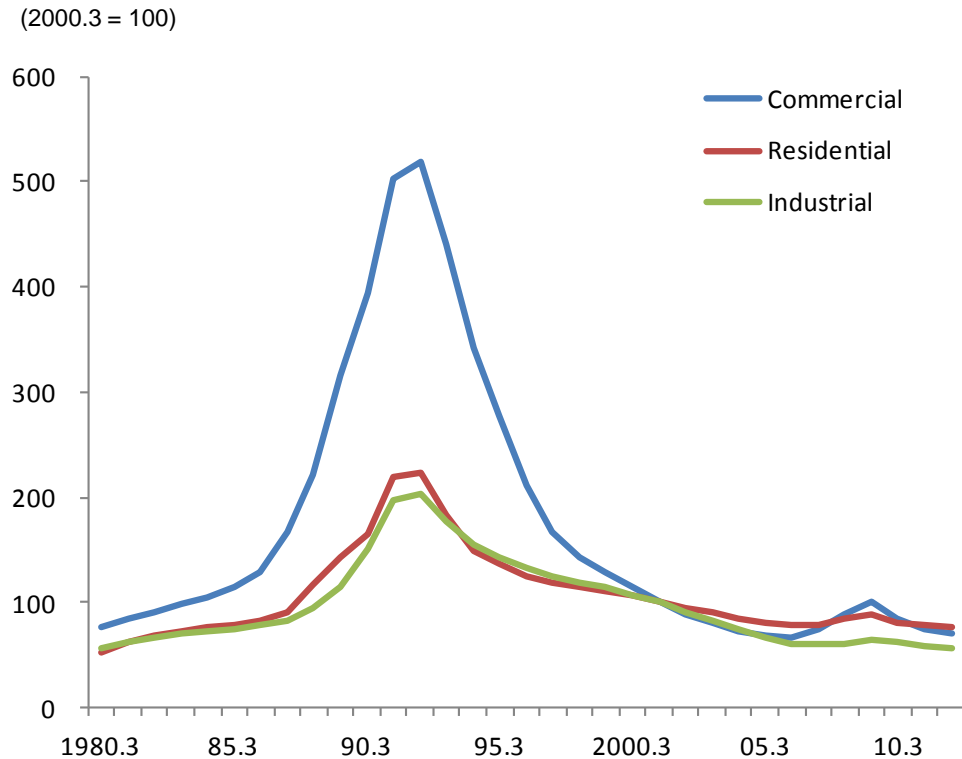
Note: US NPL is Assets past due 30 or more days.
Source: NICMR based on Financial Services Agency and FDIC

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)**

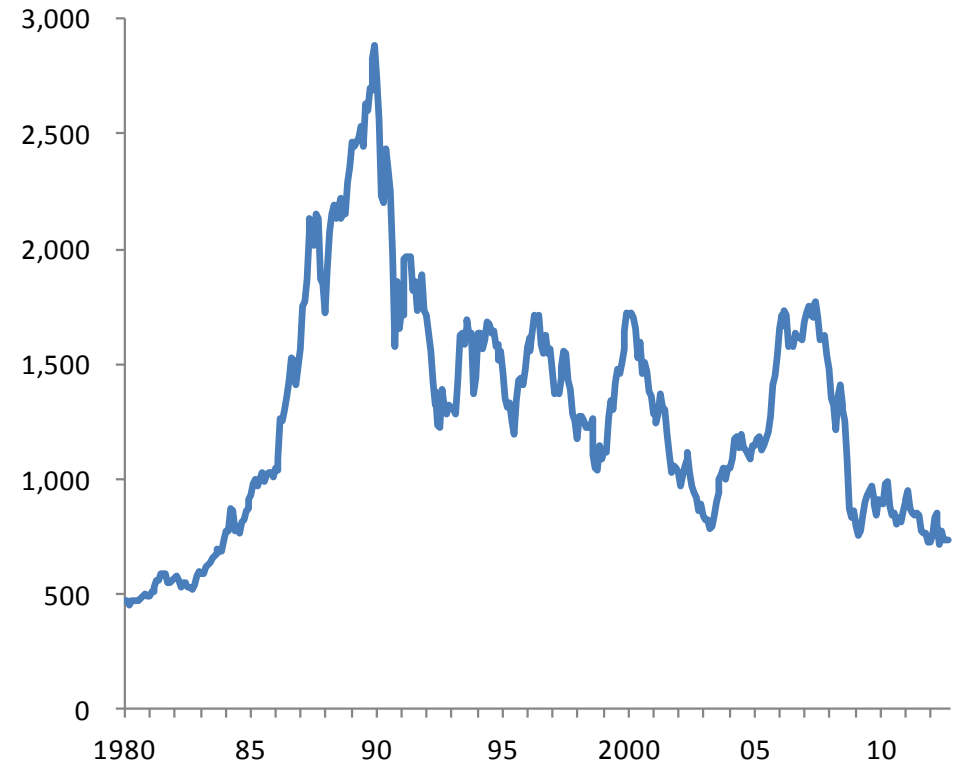
Long-Sustained and Significant Depreciation of Asset Prices

Land Prices (Urban Land Price Index)



Source: NICMR based on Japan Real Estate Institute

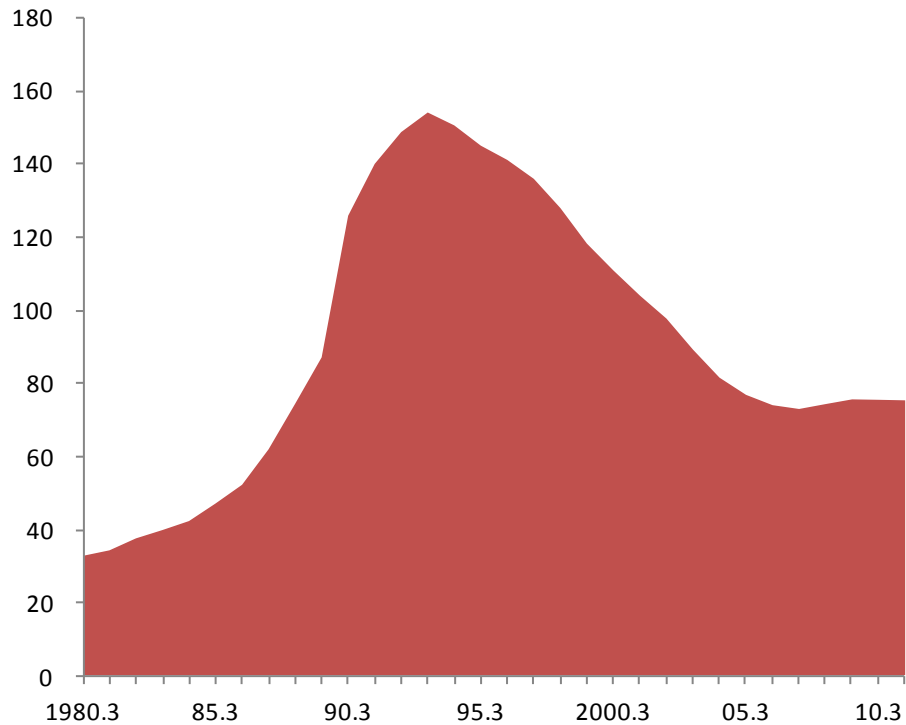
Stock Index (TOPIX)



Note: End of Month
Source: NICMR based on Bloomberg

Loans Secured by Real Estate and Floating Mortgages

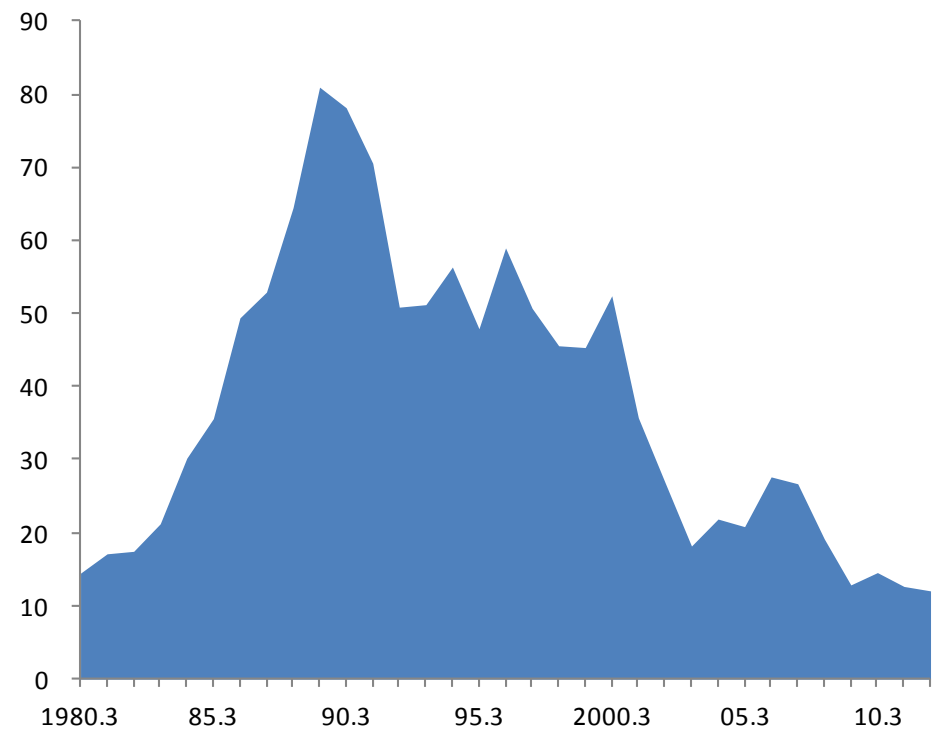
(Trillion Yen)



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

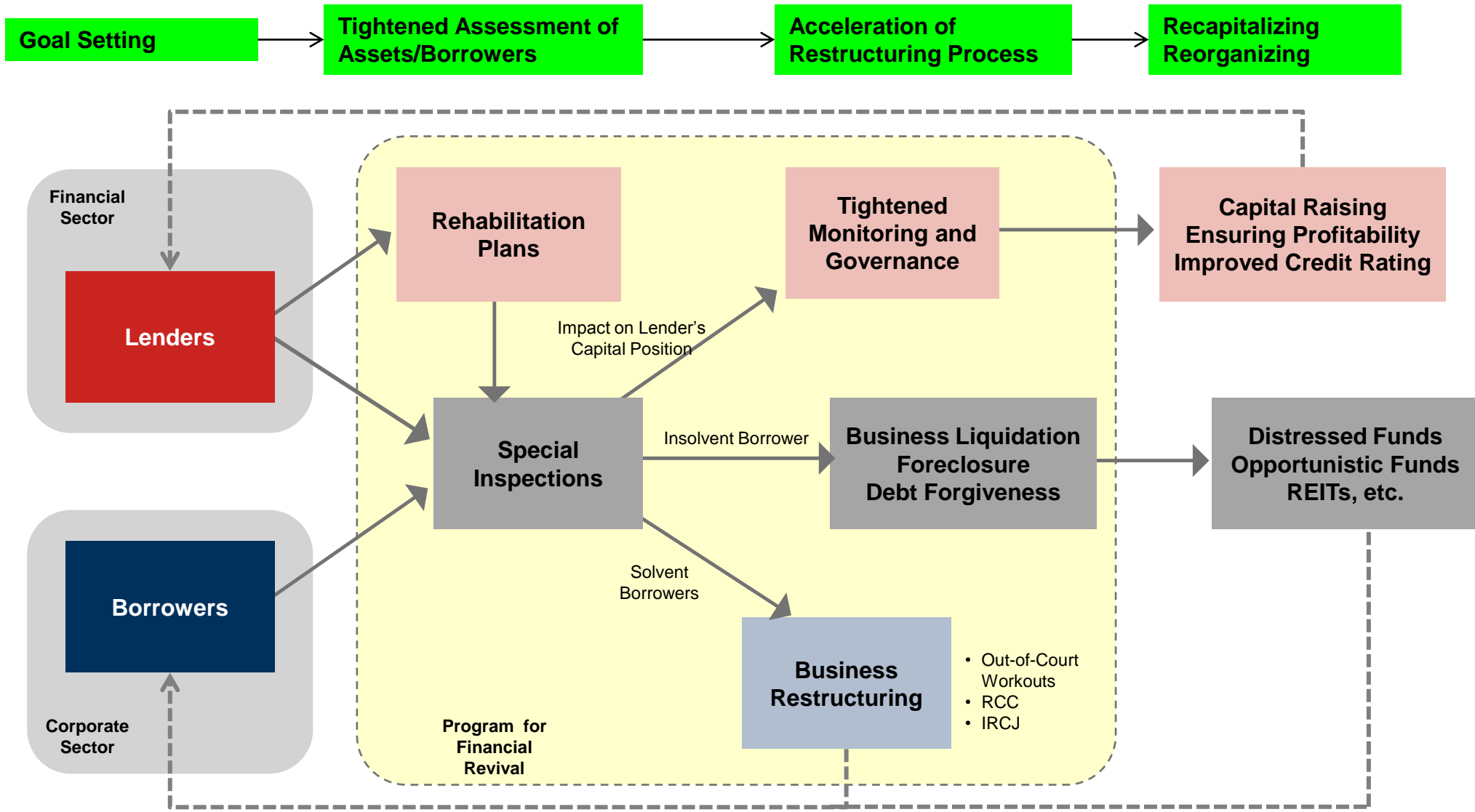
Equity Shares Owned by City and Regional Banks (Market Values)

(Trillion Yen)



Note: End of Fiscal Year
Source: NICMR based on Tokyo Stock Exchange

Reconstruction Process: Sequence of Policies



Emergency Economic Measures under Mori Administration

April 6, 2001 “Emergency Economic Packages”

- **Removal of NPL from Banks’ Balance Sheets : “2-years, 3-years Rule”**
 - **Debts Categorized as “In Danger of Bankruptcy” and Below: Complete Sale or Charge Off Within 2 Fiscal Years**
 - **Debts Newly Categorized as “In Danger of Bankruptcy” and Below: Complete Sale or Charge Off Within 3 Fiscal Years**
- **Enhancement of Corporate Restructuring Procedures**
- **Making Debt Forgiveness Easier: Setting Rules and Guidelines for DIP Financing and Debt-Equity Swap**
- **Policies for Asset Liquidation**

Comprehensive Structural Reform under Koizumi Administration

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)

- **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**

Asset & Borrower Classification Standard by Self Assessment

Solvent
↓
Financial Condition
↑
Insolvent

Borrower Classification	Classification of Guarantee, Collateral (Deposit, Government Bond etc) Superior Guarantee (Guarantee by public sector etc)	Collectability		No Collateral, Guarantee
		Large ←	→ Small	
		Ordinary Collateral (Real estate etc)		
		Estimated Disposal Value of collateral (70% of market value)	Difference between Market Value and Estimated Disposal Value of collateral (30% of market value)	
Bankrupt	I	II	III	IV
<i>De facto</i> Bankrupt	I	II	III	IV
In Danger of Bankruptcy	I	II	III	III
Special Attention	I	II	II	II
Needs Attention	I	II	II	II
Normal	I	I	I	I

- 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

Program for Financial Revival (“Takenaka Plan”)

Contents of Financial Reconstruction Program (October 30, 2002)

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 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 medium-to-small businesses face
 - 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

《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 correction 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

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



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

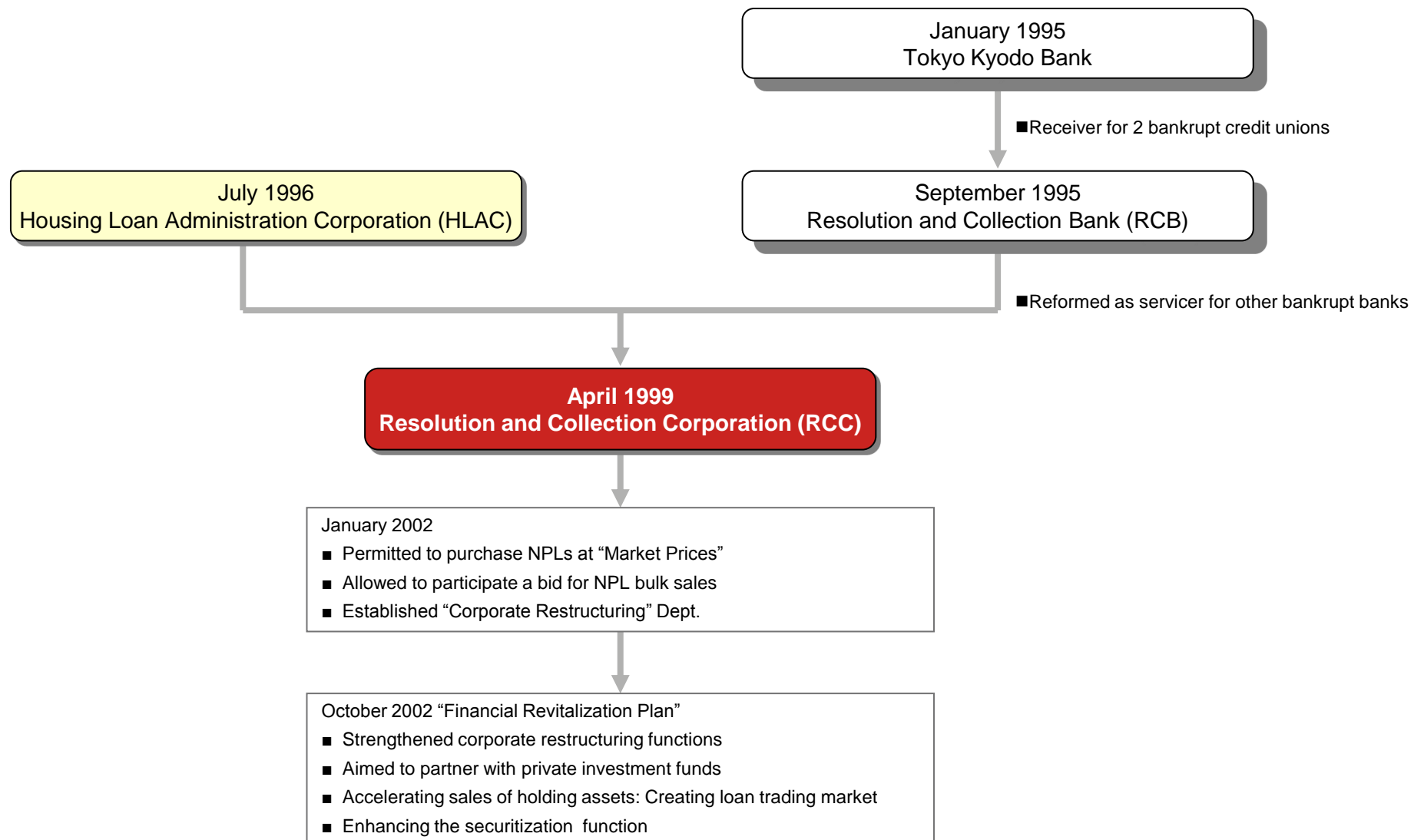
Governance Issues

- 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

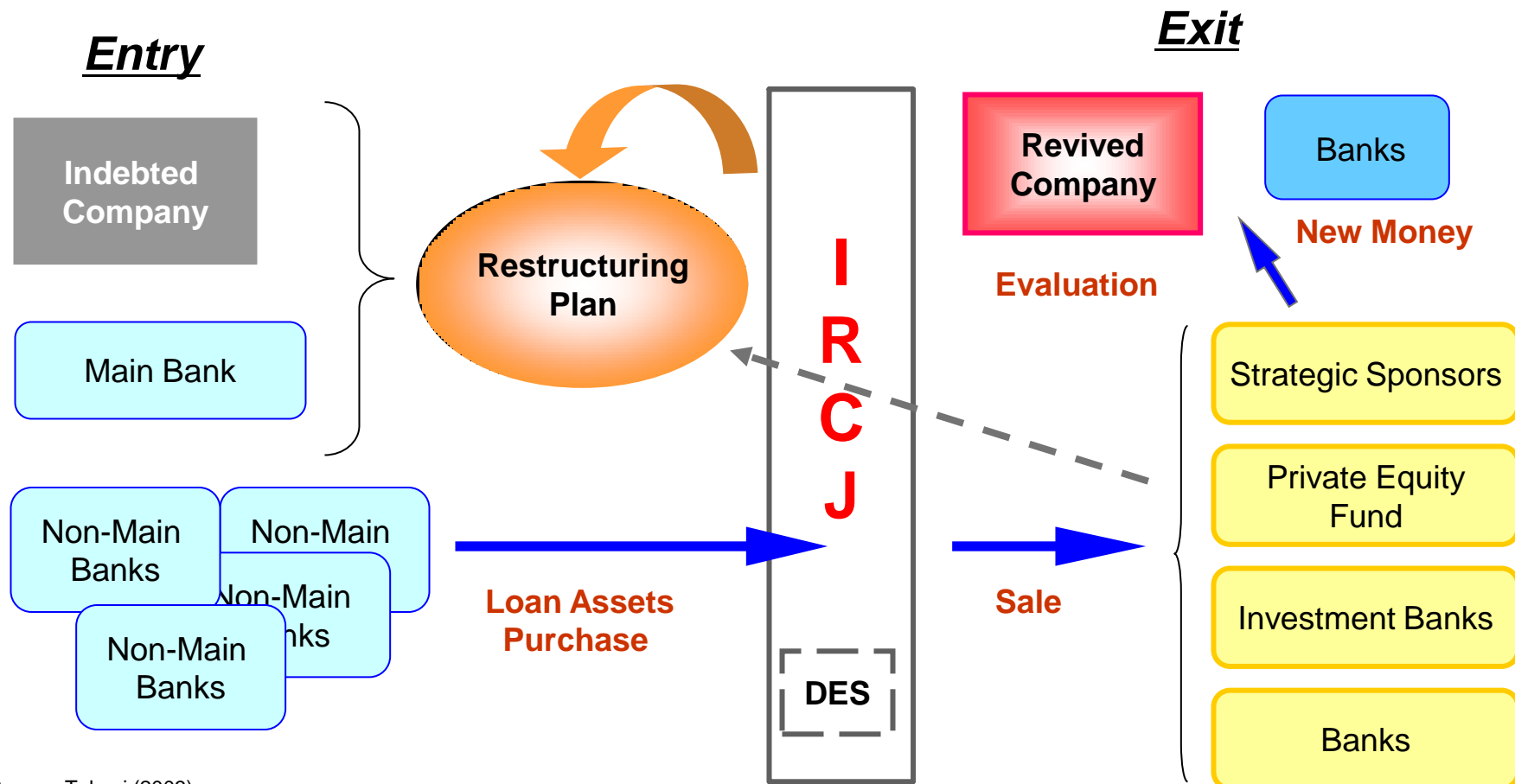


Strict Monitoring by Government

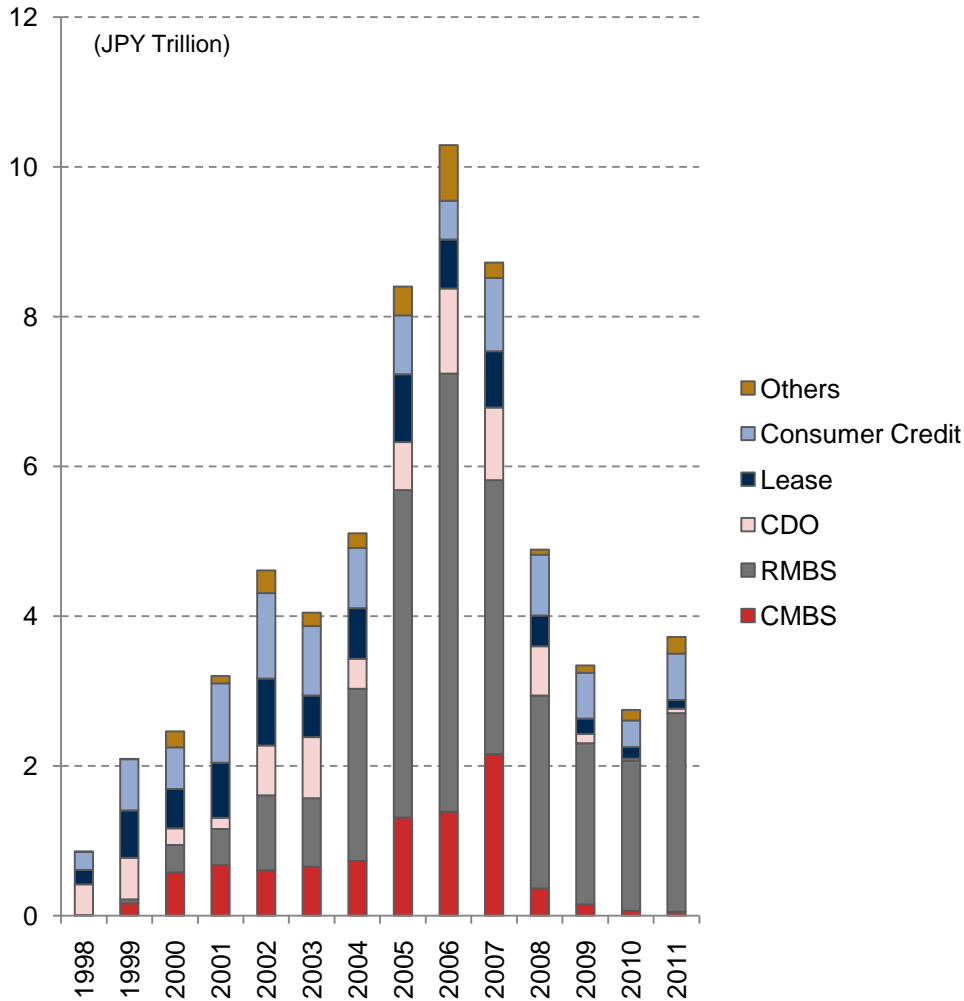
- Issuance of Business Improvement Order to Banks Not Achieving Profitability Goals
- Accountability of Senior Management : Net Income or Net Business Profit ROE Below 70% of Target Level
 - Replacement or Compensation Limit
- Possible Conversion of Preferred Shares into Common Shares



- 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

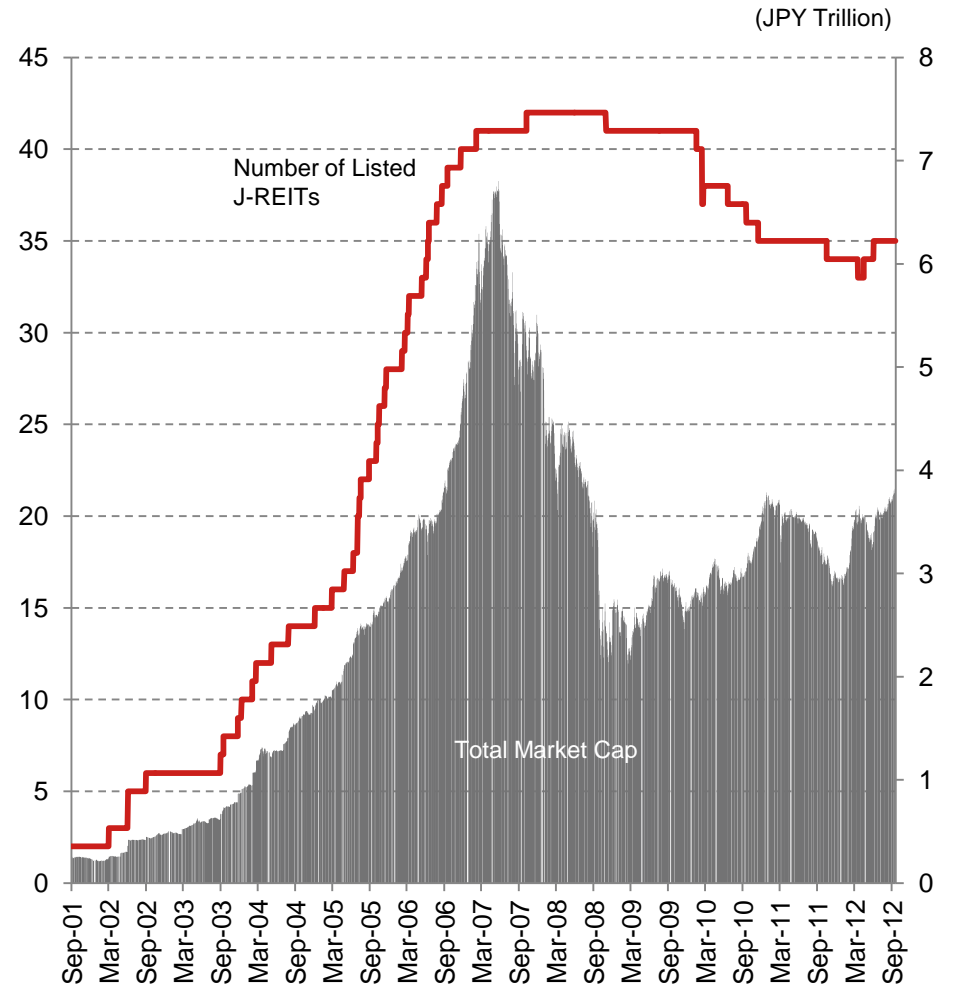


Securitization in Japan: ABS Issuance



Source: Nomura Securities

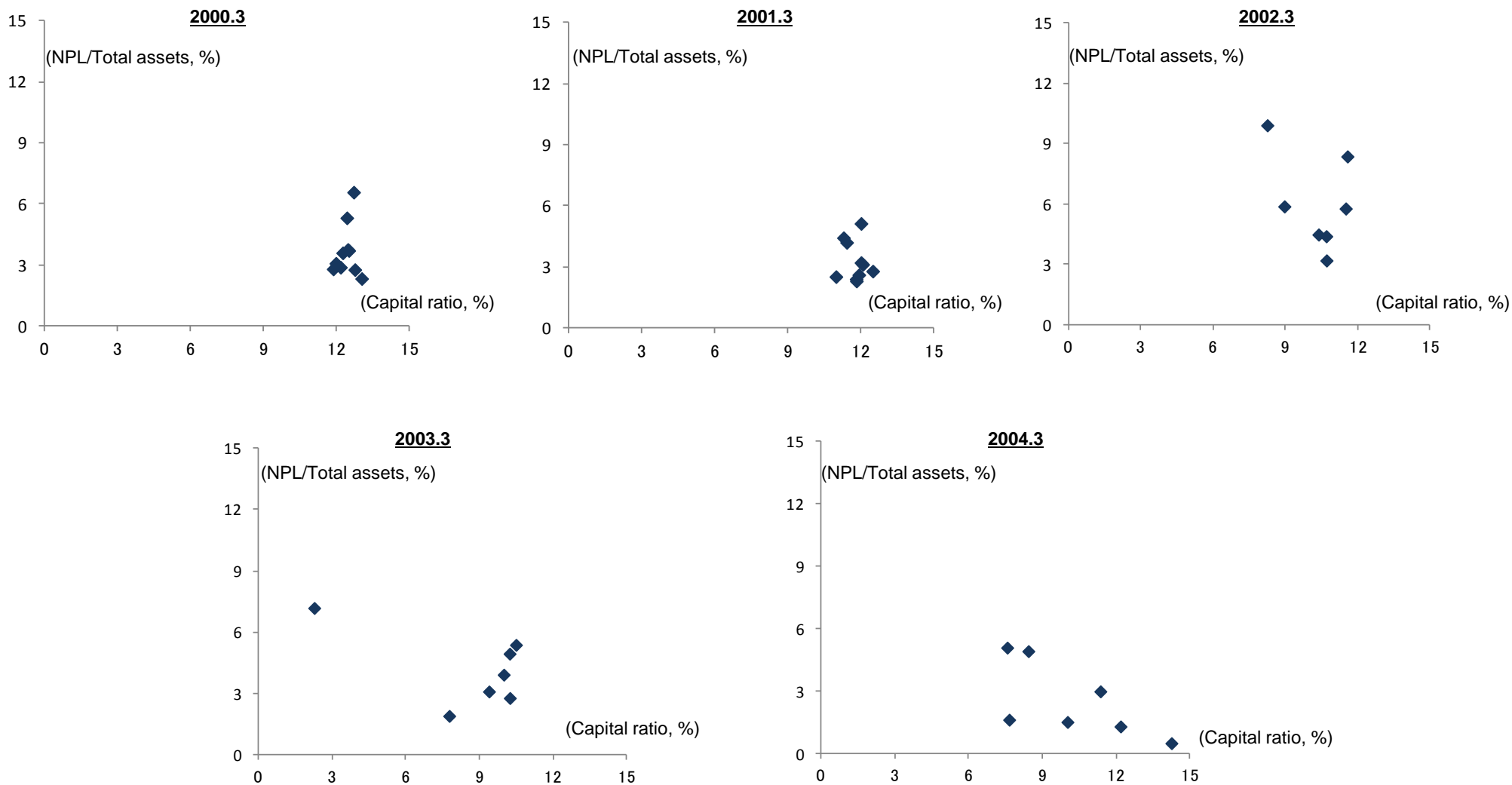
Real Estate Investment Trust (J-REIT): Growth in Market Cap



Source: Nomura Securities based on Tokyo Stock Exchange

Heterogeneity of Major Banks' Responses to NPL Problems

Change in Capital Positions of Major Japanese Banks



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

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

		(JPY Trillion)	
		Change in Apr 2002- Mar 2005	Change in Apr 2002- Mar 2007
Bankruptcy Process (Liquidation)		-2.6	-3.4
Bankruptcy Process (Reorganization)		-4.2	-5.6
Business Improvement by Reorganization		-1.8	-2
Asset Liquidation		-13.5	-17.4
Charge off		4.5	6.8
----- Total (A)		-17.6	-21.6
Collection and Repayment		-12.1	-16.6
Business Improvement		-4.1	-6
----- Total (B)		-16.3	-22.6
Total (A)+(B)		-33.8	-44.1



- 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

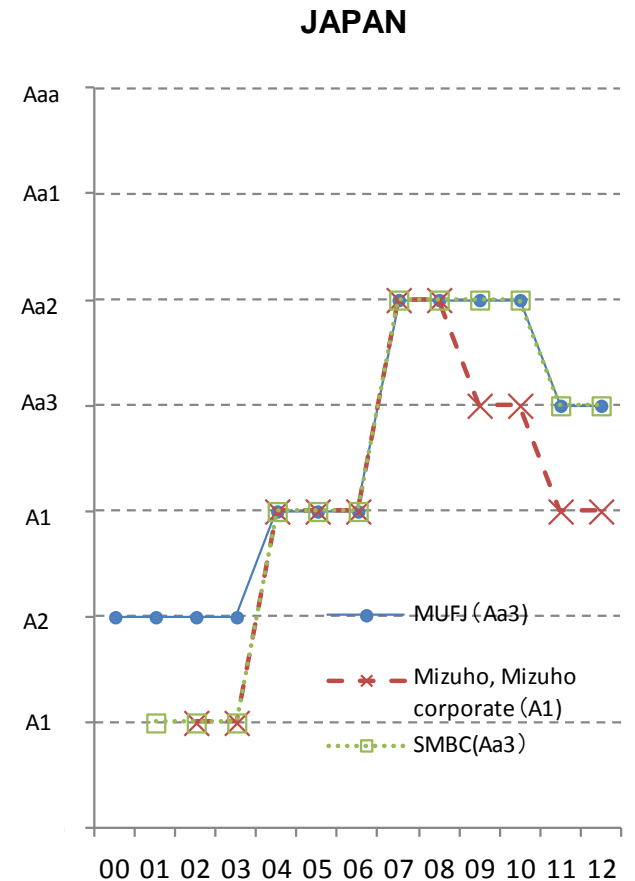
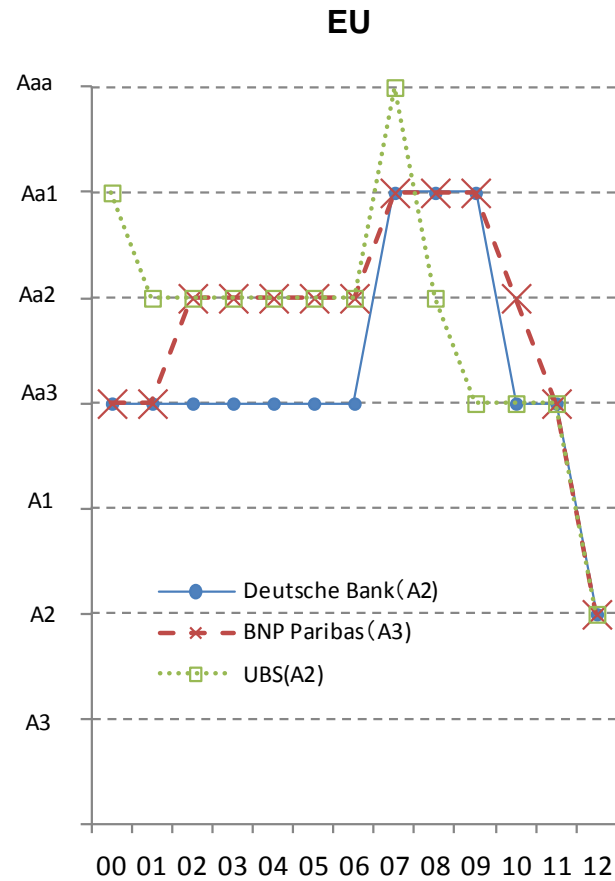
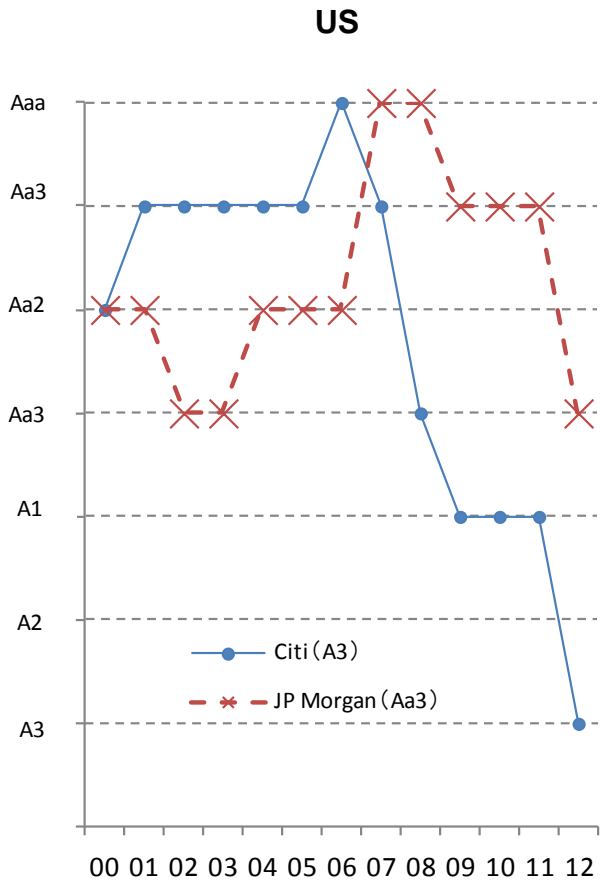
Depository Institution Resolutions in Japan

Year	Bank	Shinkin Bank (Credit Association)	Credit Union	Total
1991	1	0	0	1
1992	0	1	0	1
1993	0	1	1	2
1994	0	0	4	4
1995	2	0	4	6
1996	1	0	4	5
1997	3	0	14	17
1998	5	0	25	30
1999	5	10	29	44
2000	0	2	12	14
2001	2	13	41	56
2002	0	0	0	0
2003	1	0	0	1
2004	0	0	0	0
2005	0	0	0	0

Source: NICMR based on Deposit Insurance Corporation of Japan

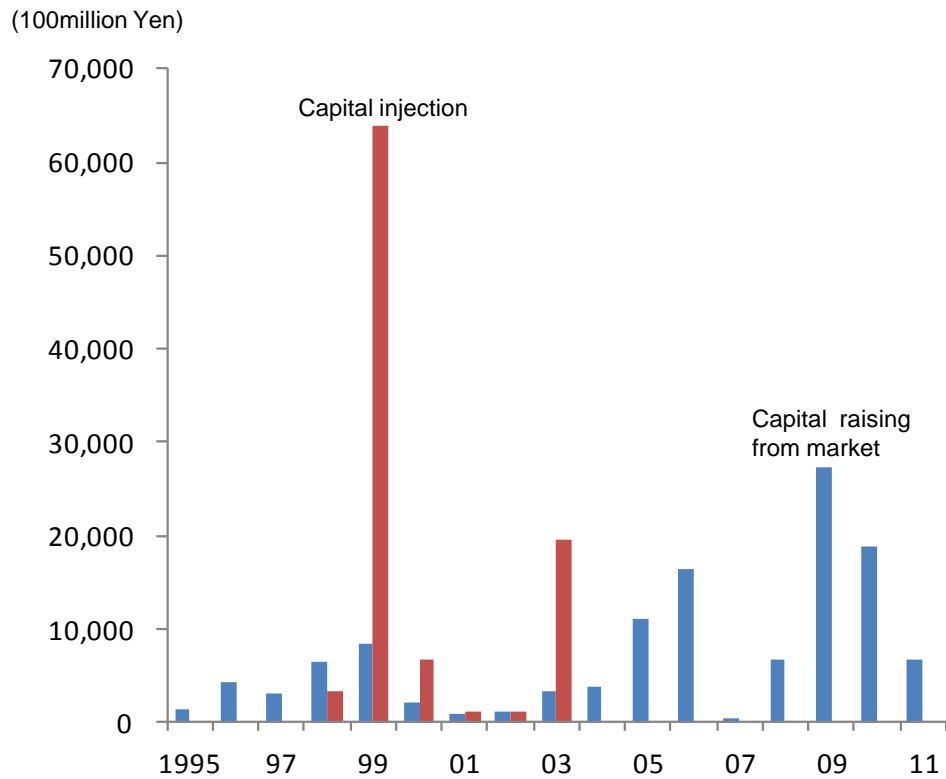
Credit Ratings Trends for Japanese Banks

Historical Credit Ratings in Major Banks



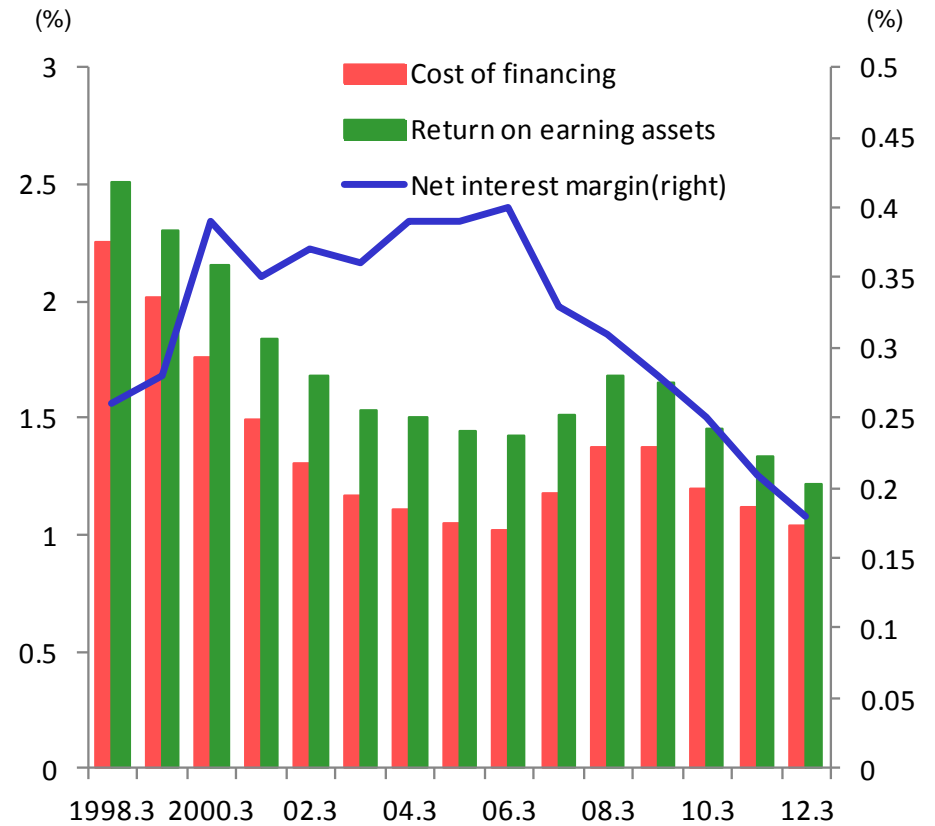
Note: Long-term issuer ratings . The present rating is in parenthesis.
 Source: NICMR based on Moody's

Capital Raising by Japanese Banks



Source: Thomson, Deposit Insurance Corporation of Japan

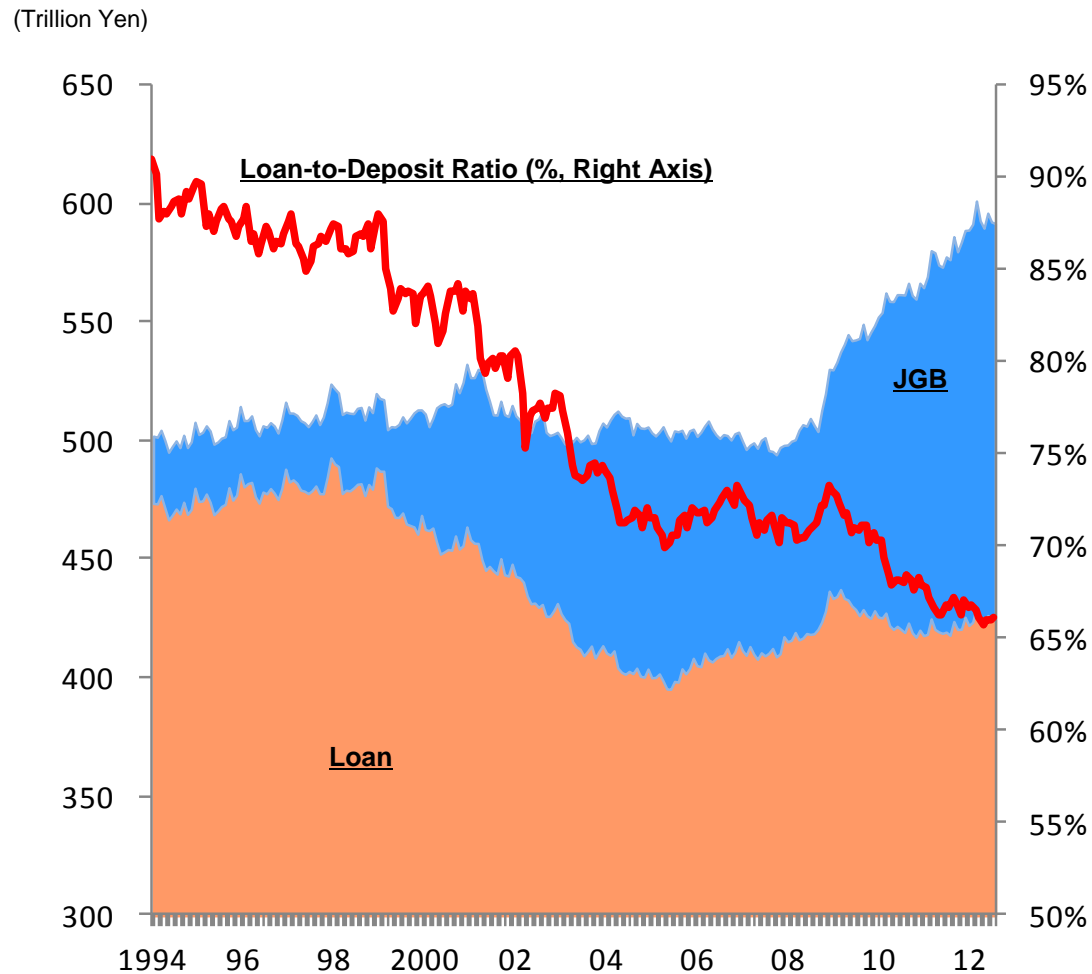
Profitability of Japanese Banks



Source: NICMR based on Japanese Bankers Association

Remaining Issues (2) : Lack of Loan Demands and Overreliance on JGB

Amount of JGB and Loan in Japanese Banks Assets



Note: End of Month
Source: NICMR based on BOJ

- **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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