# Annex II

# Banking System Developments and Corporate Sector Restructuring in Japan

The Japanese authorities have put in place over the past year a framework for addressing long-standing banking system problems. These measures, together with tighter prudential bank regulation and supervision, also added momentum to corporate restructuring in Japan. Legislation was enacted in October 1998 that sharply increased public funds available to deal with banking problems, toughened the conditionality for bank recapitalization with such funds, and created the mechanism for temporary nationalization of failed banks. In addition, supervision improved under the newly established Financial Supervisory Agency (FSA). Looking ahead, the principal remaining challenges for banks are to set aside adequate provisions for loan losses, address other sources of capital weakness, and restore core profitability. Progress in these areas is important given the planned reintroduction of limited deposit insurance coverage after March 2001.

Japanese nonfinancial companies have started to take decisive steps toward restructuring. Since the beginning of 1999, the authorities have moved to introduce several measures to facilitate this process, including the drafting of a more workable insolvency law to support firms' financial reorganization and measures to facilitate labor mobility and the scrapping of excess capacity. In the period ahead, the priorities for corporations are to focus on their core business and strengthen their balance sheets.

## Overview of Banking System Issues

During much of 1998, market perceptions of the financial soundness of most major banks deteriorated.[1] Bank stock prices fell, credit ratings were downgraded, and funding spreads widened (Figure A2.1). The visible difficulties of one of Japan's major banks and the apparent political deadlock over plans to inject public money into troubled banks contributed to the intensification of market concerns.

In response to continued banking system problems, legislation was enacted in October 1998 that provides a broad framework for resolving banking problems. The authorities have started to apply the new instruments: two major banks were nationalized in late 1998, most remaining major banks were recapitalized with public funds in March 1999,

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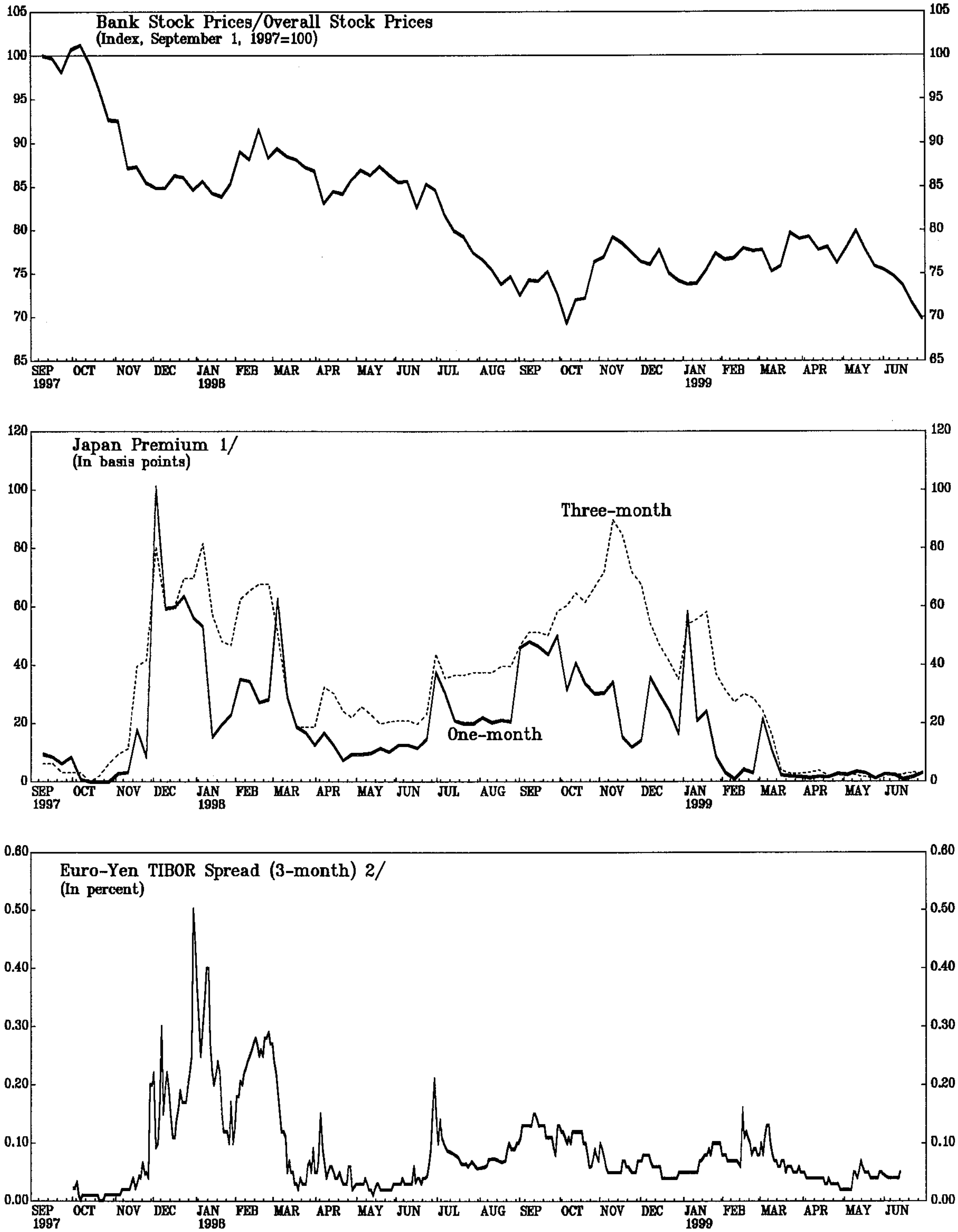
[1]Major banks refer to city banks, long-term credit banks, and trust banks. Data on these banks were obtained from Fitch IBCA unless otherwise stated.

# Figure A2.1. Japan: Banking System Strains, 1997-99




Sources: WEFA; and Bloomberg Financial Markets L.P.

1/ Average U.S. dollar LIBOR of Fuji Bank, Bank of Tokyo-Mitsubishi, and Norinchukin Bank minus the LIBOR fix.

2/ Highest rate minus lowest rate.

and the authorities have begun addressing problems in regional banks. In addition, the FSA conducted on-site inspections of all major banks in the summer and fall of 1998 and of all regional banks in the winter and spring of 1999. The expectation of public capital injections helped strengthen bank equity prices, and the loosening of monetary policy in February 1999 contributed to the disappearance of the Japan premium.

Performance of major banks in FY1998 remained weak, although virtually all major banks reported capital ratios above 10 percent for March 1999 after the injection of public funds. Major banks' loan loss charges were, however, more than double their operating profits, resulting in substantial net losses (Figure A2.2). The banks' net losses would have been even larger in the absence of an accounting change that allowed them to post large deferred tax credits in their unconsolidated accounts. Public funds and deferred tax assets together accounted for more than half of Tier 1 capital as of March 1999.

Notwithstanding recent progress, Japan's banking problems continue to be a source of concern for macroeconomic performance, pointing to the importance of restoring the full functioning of financial intermediation and ensuring continued financial stability. The need for action is highlighted by the expiration of the current blanket coverage of deposit insurance in April 2001. Weaknesses remain in three key areas:

- Bad loans are still not fully recognized or adequately provisioned. The scale of uncovered losses remains a major source of uncertainty.
- Capital adequacy remains unclear, reflecting not only possibly inadequate provisioning, but also unusually large deferred tax assets and the use of book rather than market valuation of securities holdings.
- Core profitability is weak, due in particular to the large scale of corporate lending, which earns thin interest margins.

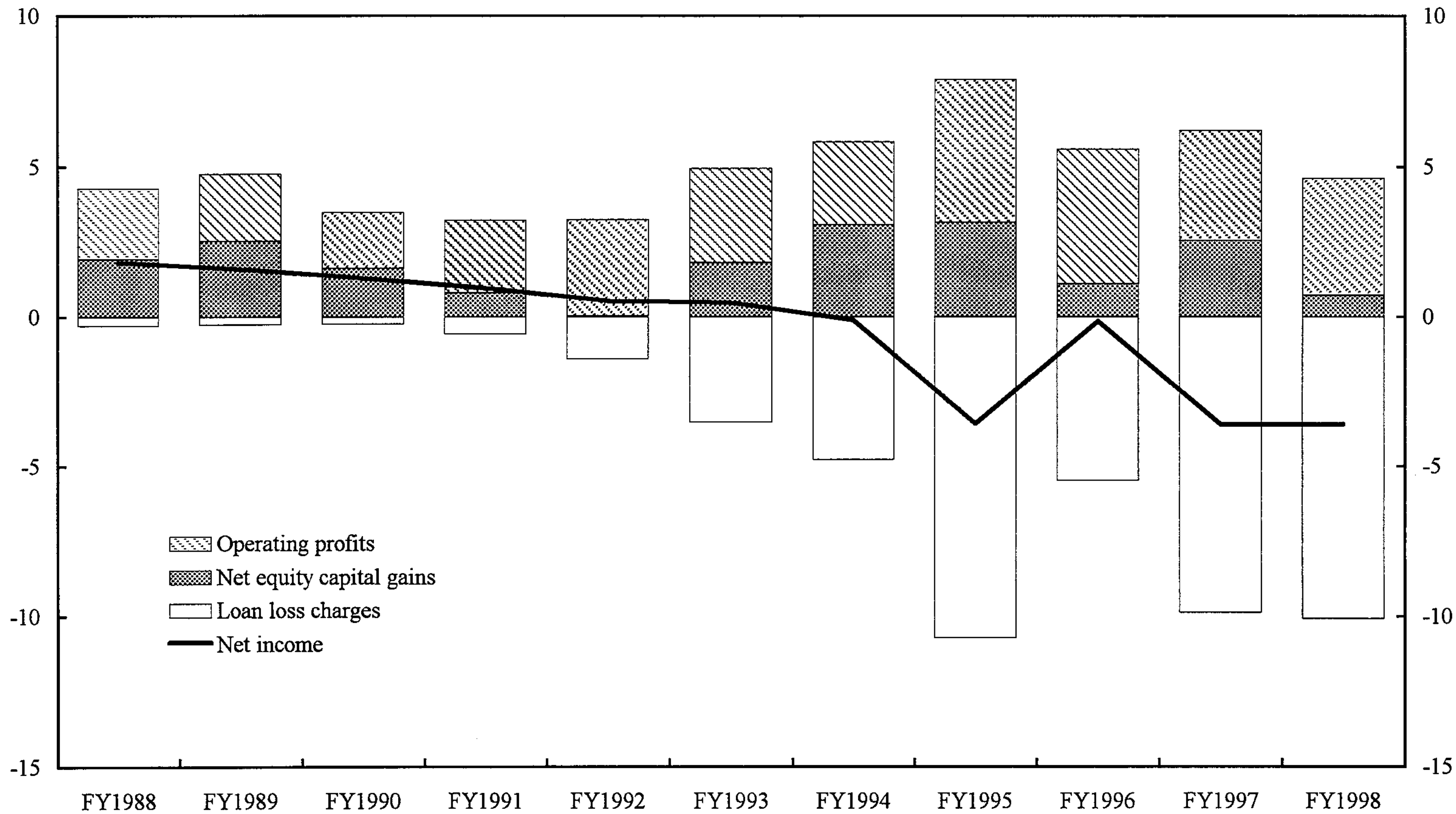
## Asset Quality

While supervisory standards have improved, concerns remain that uncovered losses from bad loans could be substantial. There are three main measures of problem loans in Japan (Table A2.1).[2] The Federation of Bankers Associations (FBA) disclosure standard includes loans to borrowers in legal bankruptcy, past due loans in arrears by 3 months or more, and restructured loans. According to these rules, major banks reported in their financial statements nonperforming loans totaling ¥20.3 trillion (6.3 percent of total loans) for March 1999. A second, somewhat broader measure is based on the recently enacted Financial Reconstruction Law. Under this measure, major banks' nonperforming loans amounted to ¥28.0 trillion (8.7 percent of total loans) in March 1999. Finally, the aggregate figure of

[2]Data obtained from Fitch IBCA.

Figure A2.2. Japan: Major Banks' Profits, FY1988-99

*(In trillions of yen)*




Source: FitchIBCA.

## Table A2.1. Japan: Estimates of Problem Loans for the Major Banks

| | Source | | |
|---|---|---|---|
| | **Federation of Bankers Associations (FBA)** | **Financial Reconstruction Law** | **Banks' Self-Assessments of Asset Quality** |
| Features | Includes loans to borrowers in legal bankruptcy, past-due loans in arrears by three months or more, and restructured loans. | Requires the disclosure of unrecoverable loans (Class 4), doubtful loans (Class 3), and watchlist loans that are in arrears by at least three months or for which there has been a change in terms or conditions beneficial to the debtor (the substandard portion of Class 2 loans). | Covers watchlist loans (Class 2), doubtful loans (Class 3), and unrecoverable loans (Class 4). |
| Changes and notes | (i) The rule for charging off nonperforming loans (NPLs) was relaxed. Starting in March 1999, banks were allowed to charge off problem loans that were fully covered by specific reserves even before legal proceedings were completed. This reduced reported NPLs but also decreased reported reserves.<br>(ii) the definition of NPLs was broadened. Also starting in March 1999, some banks began to include loans to bankrupt or potentially bankrupt borrowers on which interest was not yet overdue. This increased reported NPLs. | This definition is somewhat broader than the FBA measure because it includes claims other than loans, such as guarantees. | Banks are not required to publicly disclose this information, but the Financial Supervisory Agency reports aggregate amounts for groups of banks with a delay of about four months. |
| Estimated value of problem loans | Major banks reported NPLs of ¥20.3 trillion for March 1999. Adding back partial charge-offs, NPLs amounted to ¥27.1 trillion. | Major banks' NPLs amounted to ¥28.0 trillion in March 1999. | Major banks' classified loans, net of collateral, guarantees, and specific loan loss provisions, amounted to ¥44.2 trillion in September 1998. |

Source: FitchIBCA, 1999.

banks' own self-assessments of asset quality provided by the FSA, which covers watchlist, doubtful, and unrecoverable loans, indicated that major banks' classified loans amounted to ¥44.2 trillion (13.8 percent of total loans) in September 1998, *net* of collateral, guarantees, and specific loan loss provisions.

The size of uncovered losses associated with problem loans is uncertain. A conservative estimate can be derived from banks' self-assessment results (Table A2.2).[3] Using actual provisioning rates for various categories of loans, disclosed by the Financial Reconstruction Commission, and a Bank of Japan study of banks' loss experience, the classified loans for September 1998 (latest available) would imply a total uncovered loss in *all banks* of ¥14 trillion (about $120 billion or 3 percent of GDP).

While substantial additional provisions have been made since September 1998, remaining uncovered losses could be considerably higher for three reasons: (1) banks may have been overly optimistic in loan classification, especially with regard to the impact of the current recession on loan quality; (2) loss rates—especially for class 2 loans—may be higher in the future than during the mid-1990s, when banks were not actively disposing of bad loans (even taking into account the special provisions made in 1995 and captured in some of the figures used in the Bank of Japan study); and (3) possible uncovered losses in credit cooperatives are not included (based on data for March 1998, including credit cooperatives would boost uncovered losses by about ¥3 trillion).

Overall, despite the substantial charge-offs already effected, provisions in coming years are likely to remain significant relative to banks' operating profits, possibly requiring further capital injections in selected banks.

## Capital Position

Notwithstanding banks' relatively high reported capital ratios, concerns remain about capital adequacy. The failure of LTCB demonstrated that measured capital adequacy may overstate a bank's true financial position: LTCB reported a capital adequacy ratio of 10.3 percent for March 1998, but was subsequently found to have negative net worth of ¥2.7 trillion (equivalent to 15.3 percent of risk assets) as of October 1998. It is unlikely that the entire deterioration in the bank's capital strength occurred just during this seven-month period. While inadequate loan loss provisions are clearly the primary concern, there are three other important concerns.

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[3]These figures are based on a Bank of Japan study of historical write-off rates for a sample of 18 banks during 1995–97. Future write-off rates may be different from historical write-off rates, owing to recent policy measures and changes in the Japanese economic situation.

**Table A2.2. Japan: Estimated Uncovered Loan Losses, September 1998**

| | Classified Loans | | | Total |
|---|---|---|---|---|
| | Class 2 | Class 3 | Class 4 | Losses |
| | | *(In trillions of yen)* | | |
| All banks | | | | |
| Classified loans[1] | 66.1 | 6.9 | 0.1 | ... |
| Uncovered losses[2] | 10.3 | 3.3 | 0.1 | 13.7 |
| Major banks[3] | | | | |
| Classified loans[1] | 45.5 | 5.7 | 0.1 | ... |
| Uncovered losses[2] | 7.1 | 2.7 | 0.1 | 9.9 |
| Regional banks | | | | |
| Classified loans[1] | 20.5 | 1.2 | 0.0 | ... |
| Uncovered losses[2] | 3.2 | 0.6 | 0.0 | 3.8 |
| | | *(In percent)* | | |
| Provisioning rates | | | | |
| Actual[4] | 2 | 52 | 100 | ... |
| Historical[5] | 17 | 75 | 100 | ... |

Sources: Bank of Japan, 1998, pp. 19-32; Financial Reconstruction Commission; Financial Supervisory Agency; and staff estimates.

[1]Net of specific provisions.

[2]Uncovered losses are the difference between appropriate and actual provisions. In turn, actual provisions are equal to gross loans minus net loans. So, uncovered losses = (appropriate rate - actual rate)*(net loans / (1 - actual rate)).

[3]Including Long-Term Credit Bank and Nippon Credit Bank.

[4]Based on loan-loss provisions at major banks.

[5]Derived from Bank of Japan study. Based on historical three-year cumulative loan writeoffs at a sample of 18 banks.

- *Deferred tax assets,* which arise mainly from loan loss provisions, amounted to about one-third of major banks' Tier 1 capital as of March 1999.[4] Given that the realization of these credits depends on future taxable income, and that the prospects for bank profitability are uncertain, the regulatory ceiling on deferred tax assets of five years' taxable profit would appear high. For example, in the United States, deferred tax credits are limited to 10 percent of Tier 1 capital or one year's taxable profit, whichever is smaller.

- *Unrealized losses on securities holdings.* Banks are allowed to value securities holdings at cost, rather than the lower of cost or market, and in practice only one major bank—Bank of Tokyo-Mitsubishi—still uses the latter system. Although major banks in aggregate had net unrealized *gains* on listed securities as of March 1999, several banks carried unrealized losses. Moreover, major banks' large equity holdings (whose market value is roughly 2½ times banks' own equity) imply a significant exposure of capital to market risk.

- *Provisions against Class 2 loans* are considered to be general provisions and are therefore allowed to be counted as Tier 2 capital. However, such provisions are specific to a group of assets and should arguably be excluded from capital.[5] Although provisions against Class 2 loans are currently only a small fraction of risk-weighted assets, they are becoming larger as loan provisioning standards are tightened.

## Profitability

Japanese major banks' core profitability remains weak compared with large banks in other industrial countries. Although Japanese banks have huge asset bases, they have relatively low revenues and consequently relatively low returns on equity or assets—their return on assets is about one-third to one-half that of large U.S. banks.[6] A key reason for major banks' low revenues is that their primary business is wholesale corporate lending, on

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[4]Banks were allowed to adopt the deferred tax accounting method for their *unconsolidated* accounts for their FY1998 financial statements (this method was already used for *consolidated* accounts). The adoption of this method increased parent banks' equity capital (this year only) by the amount of deferred tax receivables that they carried. There was no effect on capital adequacy ratios, because these were already calculated on a consolidated basis.

[5]In the United States, all provisions are aggregated and banks are allowed to include an amount up to 1.25 percent of risk assets as Tier 2 capital.

[6] For example, Bank of Tokyo-Mitsubishi has twice the assets of Citibank, but produces only one-third of the revenues.

which interest margins are as thin in Japan as they are in other industrial countries. While large-scale, low-margin corporate lending was important in other countries in the past, over time banks have expanded their retail lending operations and moved into more profitable lines of business, such as the production of "leveraged loans," that is, loans that are repackaged and sold to institutional investors and other nonbank institutions (through securitization), freeing capital and increasing fee income. In addition, in other countries, increased competition has generally resulted in exit, and consolidation also contributed to a widening in interest margins.

Besides the need for a strategic reorientation, banks must compete in mortgage lending with the Government Housing Loan Corporation and in deposit taking with the Postal Savings System. Outstanding mortgages by the Government Housing Loan Corporation exceed those by domestically licensed banks. Postal Savings deposits have two main advantages over deposits at private institutions: (1) they are viewed as backed by the full faith and credit of the government; and (2) long-term deposits are very liquid, as they can be redeemed without penalty after six months, which provides an attractive hedge against an increase in interest rates.[7] In addition, the Postal Savings system pays no taxes or deposit insurance premia and is not subject to the same capital adequacy requirements. Although the interest rate on postal saving deposits is set as a fraction (usually about 90 percent) of the average three-year deposit rate at private banks, the differential appears inadequate—especially when interest rates are low—to compensate for the nonpecuniary benefits of postal saving deposits. As a result, the share of personal deposits with the postal saving system in total personal deposits increased sharply during the 1990s, as market interest rates fell and concerns about the financial positions of some private institutions increased (Figure A2.3).

## Main Policy Developments in Banking

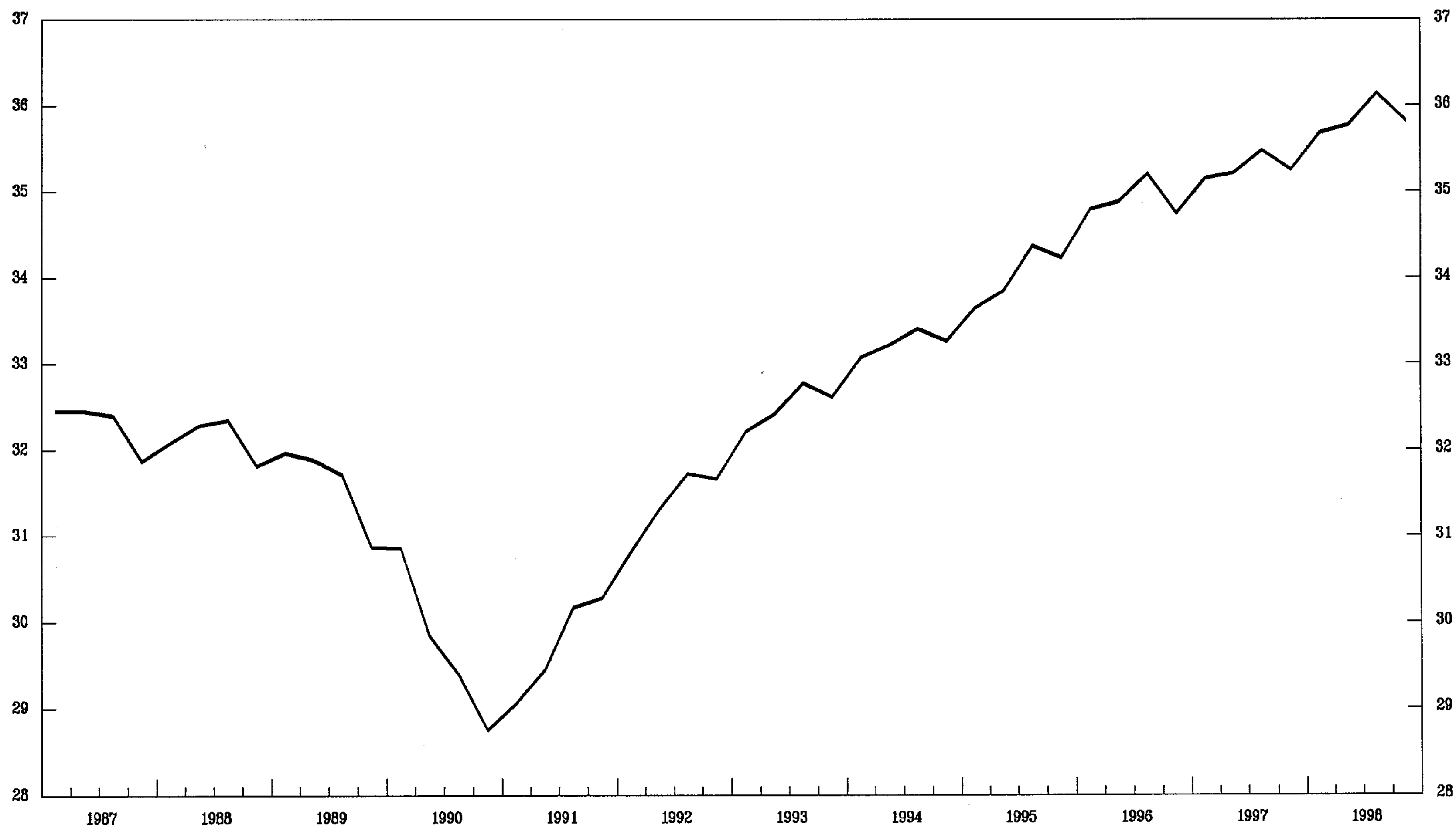
The authorities have made important progress in addressing banking problems during the past year. A framework—backed by public money and administered by the FRC—was created to resolve banking problems. Through its on-site inspections of all major and regional banks, the newly established FSA improved the recognition of the bad loan problem. Partly as a result, major banks made loan loss charges of ¥10 trillion in FY1998, bringing cumulative loan loss charges since April 1990 to over ¥47 trillion (9½ percent of GDP).[8] Together, an improved resolution framework and strengthened supervision laid the groundwork for recapitalization of weak but solvent major banks, nationalization of two insolvent major banks, and interventions in regional banks. Banks receiving public funds announced restructuring plans that point in the right direction. These actions stabilized the

[7]See Lipworth (1996).

[8]IMF staff estimates based on data provided by Fitch IBCA.

Figure A2.3. Japan: Postal Saving Deposits, 1987-98

*(In percent of total personal deposits)*




Source: Bank of Japan.

banking system—as reflected in the virtual disappearance of the Japan premium—and are providing a window of opportunity for further reform.

### Legislative Framework

Legislation approved in October 1998 expanded and strengthened the framework for ensuring banking system stability. The legislation had three main components.

- The amount of public funds available to cover banking sector losses was doubled to ¥60 trillion ($500 billion or 12 percent of GDP). Of this, ¥25 trillion was allocated for recapitalization of weak but solvent banks, ¥18 trillion for financial revitalization activities such as temporary nationalization and state administration of banks, and ¥17 trillion for special financial assistance exceeding the pay-off costs.

- A new high-level body, the FRC, was established to oversee banking system stability and restructuring. The FRC, headed by a cabinet-level minister, is responsible for inspection and supervision, recapitalization, and resolution of failed institutions. The FSA, which assumed inspection and supervisory responsibilities from the Ministry of Finance in June 1998, was placed under the FRC.

- Two bad loan collection and disposal agencies (the Resolution and Collection Bank and the Housing Loan Administration Corporation) were consolidated into a new agency, the Resolution and Collection Corporation. This new agency has expanded authority to purchase bad loans not only from failed banks but also from solvent institutions.

### Supervision

The FSA conducted special on-site inspections of major banks in the fall of 1998 and of regional banks in the winter and spring of 1999. These inspections were more intensive than in the past and provided the authorities effectively with simultaneous evaluations of banks' asset quality. Following the inspections, the FSA sent letters to banks, detailing its evaluation of each bank's loan classification. Banks were required to respond within a month and were encouraged to incorporate recommendations into subsequent loan classification exercises. The FSA's policy is not to comment publicly on any individual bank (with the exception of nationalized banks), but the FSA retains the ability to use market pressure to encourage compliance, for example through frequent examinations, which would become known in the financial community.

The FSA found that major banks had understated classified loans by ¥5.4 trillion in March 1998 (Table A2.3). However, the bulk of the FSA's reclassification (¥3.6 trillion) was from Class 1 to Class 2, which implied little additional provisioning, and the only significant reclassification (¥1.6 trillion to Class 3) applied mainly to banks that were subsequently nationalized. Similarly, the FSA found significant discrepancies in loan provisioning only in

**Table A2.3. Japan: Financial Supervisory Agency's Special Inspections of Major Banks, December 1998**

*(In trillions of yen)*

| | Assessment of Credit Quality, as of March 1998[1] | | |
|---|---|---|---|
| | FSA | Banks | Difference |
| Total credit | 394.2 | 394.2 | 0.0 |
| LTCB and NCB | 27.5 | 27.5 | 0.0 |
| Class 1 | 344.7 | 350.1 | -5.4 |
| LTCB and NCB | 19.6 | 21.5 | -1.9 |
| Class 2 | 43.8 | 40.2 | 3.6 |
| LTCB and NCB | 5.2 | 5.0 | 0.2 |
| Class 3 | 5.3 | 3.8 | 1.6 |
| LTCB and NCB | 2.4 | 1.0 | 1.4 |
| Class 4 | 0.4 | 0.1 | 0.3 |
| LTCB and NCB | 0.3 | 0.0 | 0.3 |
| Required loan-loss provisions | 8.6 | 7.6 | 1.0 |
| Of which | | | |
| LTCB and NCB | 1.6 | 0.8 | 0.8 |

Source: Financial Supervisory Agency (FSA).

Note: LTCB stands for Long-Term Credit Bank and NCB stands for Nippon Credit Bank.

[1]Classified loans are reported net of specific provisions.

the nationalized banks. These results were not surprising, given that the FSA's evaluation of the adequacy of loan classification and provisioning was based on banks' own criteria. The FSA also found that regional banks had understated their problem loans as of March 1998, with the amount of reclassification (1.4 percent of loans) being similar to that in major banks.

A new inspection manual was issued in April 1999 and will become effective in July. Although the new manual is intended to clarify—rather than strengthen—existing standards, it will effectively tighten standards by removing loopholes. The new manual is not expected to have a large impact on loan loss provisioning.

The increase in supervisory resources will allow for more frequent regular on-site inspections. Staff of the FSA's Inspection Department are to increase from 165 to 249. Although about 90 percent of current FSA staff are on secondment from other ministries, most are expected to remain at the FSA because it is already the principal agency for financial issues and will acquire the financial planning system function from the Ministry of Finance in 2000. The FSA's current objective is to inspect all major banks and about half the regional banks every year, and to inspect the remainder of the regional banks (generally the stronger ones) every other year. In addition, special inspections will focus on particular issues, such as Y2K preparedness.

## Nationalization of Two Major Banks

The new bank legislation and the special inspections prepared the ground for the temporary nationalization of two major banks. LTCB's stock price had started to drop sharply in June 1998 on reports that the bank was having difficulties raising funds. The authorities' initial plan—announced at the end of June—was to merge LTCB with smaller Sumitomo Trust Bank, but this plan was eventually abandoned, in part because Sumitomo Trust was reluctant to take over LTCB's substandard loans. The failure in September of Japan Leasing, one of LTCB's main affiliates with more than ¥1.5 trillion in debt (including ¥256 billion to LTCB and ¥150 billion to Sumitomo Trust), left little doubt that LTCB was insolvent and contributed to the buildup of market pressures. After LTCB applied for nationalization on October 23, the Deposit Insurance Corporation acquired all the outstanding shares and provided financial support, thus allowing LTCB to continue its regular operations and meet all of its obligations.

LTCB's capital turned out to be much lower than originally believed. LTCB reported a capital adequacy ratio of 10.3 percent for March 1998 and 6.3 percent for September 1998. At the time LTCB was nationalized in October, the FSA's special inspection found that the bank had negative net worth of ¥340 billion (about 1.9 percent of risk-weighted assets) as of end-September, including unrealized losses on securities holdings. In March 1999, the FRC declared that LTCB's negative net worth was in fact ¥2.7 trillion (15.3 percent of risk-weighted assets as of end-September) as of October 1998. LTCB's losses were borne in part by its former shareholders, as the share price for the nationalization was set at zero.

LTCB's government-appointed management is currently seeking a buyer for the bank with the assistance of a foreign investment advisor. To increase its attractiveness to potential buyers, LTCB has begun to restructure by reducing employment and withdrawing from overseas operations, and is expected to transfer all of its bad assets to the Resolution and Collection Corporation. While several investment groups have expressed interest in LTCB, the original goal of finding a buyer by the end of April was not met. Although the government would prefer to sell the bank as an ongoing business, potential investors are reportedly more interested in buying the assets alone.

The authorities acted more swiftly with Nippon Credit Bank following the FSA's special inspection. During 1997–98, this bank had struggled through a series of attempts to restructure, including the complete withdrawal from overseas operations and cuts in employment and salaries, with financial assistance from other commercial banks and the Bank of Japan. The FSA notified Nippon Credit Bank in November 1998 that, based on its special inspection, the bank had negative net worth as of March 1998. Nippon Credit Bank failed to develop an acceptable remedial action plan; on December 14, the authorities put the bank under state control.

### Public Capital Injections into Major Banks

The banks that applied for public funds were largely those that had received public money under the previous recapitalization scheme in March 1998; the main exception—the Bank of Tokyo-Mitsubishi—did not apply for the more recent recapitalization. As in the 1998 recapitalization exercise, to qualify for public funds, banks had to demonstrate positive net worth and the ability to generate long-term profits.

The standard for determining net worth was more rigorous than in March 1998, as the FRC included all unrealized losses on securities holdings and applied somewhat stricter provisioning standards for classified loans. Specifically, the FRC called for 70 percent coverage of the unsecured portion of Class 3 (doubtful) loans and 15 percent coverage of the unsecured portion of substandard Class 2 (special mention) loans. However, the base for the higher provisioning ratios was rather narrow—the unsecured portion of substandard loans was only about 10 percent of Class 2 loans—so the net impact on provisioning was small compared with the magnitude of potential uncovered losses. Major banks made provisions and charge-offs of about ¥10 trillion in FY1998.

Banks submitted detailed restructuring plans to show long-term profitability (Table A2.4). These had four main components.

- *Expansion of profitable activities*. Gross income is to be raised on average by about 3 percent over four years, by increasing housing loans and loans to small enterprises, expanding ATM networks and business hours, offering private banking services to wealthy clients, and selling investment trusts (mutual funds). These efforts will occur against the background of strong competition in retail banking: regional banks have

## Table A2.4. Japan: Major Banks' Restructuring Plans, FY1998-FY2002

*(Percent changes)*

| | Net Income[1] | Gross Income[1] | Operating Expenses[1] | Personnel Costs | Number of Employees | Number of Directors | Number of Branches: Domestic | Number of Branches: Overseas |
|---|---|---|---|---|---|---|---|---|
| City banks | | | | | | | | |
| Dai-Ichi Kangyo | 19.8 | 3.0 | -7.8 | -16.1 | -18.2 | 0.0 | -13.2 | -20.5 |
| Fuji | 50.9 | 18.7 | -8.0 | -10.1 | -8.8 | -17.1 | -7.7 | -15.2 |
| Sakura | 35.3 | 8.2 | -10.2 | -16.4 | -21.0 | -58.8 | -24.9 | -29.6 |
| Sanwa | 13.7 | 6.3 | -2.3 | -15.4 | -16.2 | -62.5 | -7.5 | -7.5 |
| Sumitomo | 6.6 | -1.6 | -9.0 | -5.6 | -13.3 | -11.6 | -6.7 | -23.4 |
| | | | | | | | | |
| Asahi | 14.8 | 8.6 | -6.9 | -5.9 | -7.8 | -10.3 | -2.1 | -68.4 |
| Daiwa | 25.1 | 0.1 | -15.3 | -17.0 | -17.5 | -35.5 | -11.8 | -100.0 |
| Tokai | 20.2 | 2.8 | -10.6 | -16.9 | -12.5 | 13.3 | -10.0 | -48.8 |
| Long-term credit bank | | | | | | | | |
| Industrial Bank of Japan | -11.9 | -12.6 | -9.9 | -0.9 | -6.2 | -42.9 | -11.1 | -22.2 |
| Trust banks | | | | | | | | |
| Mitsubishi Trust | -53.3 | -28.1 | -0.6 | -7.1 | -2.8 | -13.9 | -9.4 | -47.4 |
| Sumitomo Trust | -14.6 | -1.6 | -2.9 | -14.8 | -11.9 | -9.4 | -3.6 | -53.8 |
| Mitsui and Chuo Trusts | 17.0 | 23.8 | -6.3 | -1.8 | -10.8 | -20.0 | -12.7 | -70.0 |
| Toyo Trust | 39.0 | 10.3 | -14.3 | -17.2 | -14.6 | -40.0 | -35.7 | -80.0 |
| Regional bank | | | | | | | | |
| Bank of Yokohama | ... | ... | ... | -14.9 | -21.1 | -36.8 | ... | ... |
| Total | 11.5 | 3.4 | -7.9 | -11.6 | -13.8 | -26.5 | -11.7 | -31.4 |

Sources: Merrill Lynch; and Nikkei Weekly.

[1] Change from FY1997 to FY2002.

large branch networks and finance companies dominate the technology-intensive consumer loan business. Also, the weak economic environment may continue to depress interest margins, while alternative strategies to raise profitability beyond that in retail banking, such as derivatives trading, are usually associated with greater risk.

- *Cost reduction* accounts for much of the projected improvement in net income. Operating expenses are projected to be reduced on average by about 8 percent over four years, mostly through cuts in personnel costs. The number of bank branches is expected to decline, with a sharp reduction in overseas branches, though all but one major bank expect to remain internationally active. Room for cost cutting may be limited by the fact that, compared with other international banks, Japanese banks already have low costs and need to upgrade information technology.[9]

- *Strategic alliances*. Trust banks have been especially active in strategic alliances. Yasuda Trust has become a subsidiary of Fuji Bank, and Mitsui Trust and Chuo Trust plan to merge in April 2000.

- *Balance sheet adjustments*. Banks are planning to increase sales of distressed unsecured loans and loans secured by real estate, and some banks are planning to reduce their holdings of equities. The announced plans to sell equity holdings appear modest (¥100–200 billion per year for five years) and do not involve selling the shares of *keiretsu* members.

In addition to restructuring, banks applying for public funds agreed to seek new capital from private sources (about ¥2 trillion) and to increase lending by ¥6.7 trillion in FY1999, of which nearly half (about ¥3 trillion) is earmarked for small and medium-sized businesses.

The public capital injections in March 1999 amounted to ¥7.5 trillion, about four times the amount injected in March 1998 (Table A2.5).[10] In contrast to last year's, the bulk of the public funds in 1999 were structured as convertible preferred stock, which—in principle—will give the authorities considerable leverage over banks that fail to perform. If the government converted its entire holdings of preferred stock into common stock (at book values), it would gain majority stakes in three major banks and a near-majority stake in a fourth. The government could exercise its right to convert stock at these four banks as early as July 1999; conversion dates are longer—up to seven years—for stronger banks. The

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[9]For example, Sanwa Bank as a whole reportedly spends less on information technology than does the Tokyo office of Goldman Sachs.

[10]In addition, during FY1998, banks raised about ¥2.8 trillion in Tier 1 capital from private sources, mostly related companies: about ¥1.4 trillion in common shares and about the same amount in higher yielding preferred securities.

**Table A2.5. Japan: Public Capital Injections, March 1999**

*(In billions of yen, unless otherwise specified)*

| | Total Funds | Convertible Preferred Shares | | Nonconvertible Preferred Shares | Subordinated Debt | Average Yield |
|---|---|---|---|---|---|---|
| | | Amount | Grace period[1] | | | |
| | | | *(Number of months)* | | | *(In percent)* |
| City banks | | | | | | |
| Dai-Ichi Kangyo | 900 | 400 | 64 | 300 | 200 | 1.27 |
| Fuji | 1,000 | 500 | 66 | 300 | 200 | 1.05 |
| Sakura | 800 | 800 | 42 | 0 | 0 | 1.37 |
| Sanwa | 700 | 600 | 27 | 0 | 100 | 0.54 |
| Sumitomo | 501 | 501 | 37 | 0 | 0 | 0.71 |
| Asahi | 500 | 400 | 39 | 0 | 100 | 1.25 |
| Daiwa | 408 | 408 | 3 | 0 | 0 | 1.06 |
| Tokai | 600 | 600 | 39 | 0 | 0 | 0.95 |
| Long-term credit bank | | | | | | |
| Industrial Bank of Japan | 600 | 350 | 51 | 0 | 250 | 1.06 |
| Trust banks | | | | | | |
| Mitsubishi Trust | 300 | 200 | 52 | 0 | 100 | 1.34 |
| Sumitomo Trust | 200 | 100 | 24 | 0 | 100 | 1.28 |
| Mitsui Trust | 400 | 250 | 3 | 0 | 150 | 1.44 |
| Chuo Trust | 150 | 150 | 3 | 0 | 0 | 0.90 |
| Toyo Trust | 200 | 200 | 3 | 0 | 0 | 1.15 |
| Regional bank | | | | | | |
| Bank of Yokohama | 200 | 100 | 28 | 0 | 100 | 1.50 |
| Total | 7,459 | 5,559 | ... | 600 | 1,300 | 1.09 |

Source: Financial Reconstruction Commission.

[1]Some banks issued two tranches of convertible preferred shares, with different convertibility dates. In these cases, the time to the first date is shown in this column.

average yields to be paid on the public funds are low—even lower than the interest rates on last year's injections of subordinated debt—and little differentiated across banks. The injections were funded by the Deposit Insurance Corporation, which borrowed ¥6.3 trillion from private financial institutions with a government guarantee.

### Application of Prompt Corrective Action to Regional Banks

The regulatory authorities began implementing the prompt corrective action (PCA) framework for domestically-active banks in April 1999 (internationally active banks became subject to PCA in April 1998).[11] On the basis of the FSA's special inspections, three second-tier regional banks—Kofuku, Kokumin, and Tokyo Sowa—have been declared insolvent and three more have been required to implement a capital enhancement plan. The authorities confirmed that all deposits would be fully protected and appointed receivers to manage the banks' operations while buyers are sought. Receivership can last up to one year, though a bridge bank can take over within one year, and the banks are expected to sell their bad loans to the Resolution and Collection Corporation. Three more banks—first-tier Hokkaido Bank and second-tier Niigata Chuo and Namihaya—have been ordered to increase their capital to meet the newly effective 4 percent capital adequacy ratio for banks that only operate domestically.

### Measures to Facilitate Debt Workouts and Bad Loan Disposal

The tax code was amended in June 1998 to facilitate debt workouts. Specifically, banks were permitted to deduct from taxable income the losses incurred from out-of-court debt restructuring agreements, and debtors were allowed to offset the corresponding windfall gains against past losses. To benefit from this favorable tax treatment, the debt workout agreement must involve a comprehensive restructuring plan and be approved by all creditors.

The October 1998 bank legislation aided disposal of bad loans by legalizing private loan collection companies. Until recently, only lawyers had been allowed to collect loans on behalf of financial institutions. Under the new law, private companies not only may collect loans on behalf of financial institutions but they may also buy collateralized loans from financial institutions and collect loans on their own account. Thus far, the Ministry of Justice has licensed 4 companies and expects to license about 30 altogether by the summer.

Legislation enacted in June 1998 facilitated the creation of special purpose vehicles. The new securitization law, which regulates securities backed by loans collateralized by real estate, enhances the special purpose vehicles' ability to secure claims on specific assets by creating a centralized system for registering secured interest in (or ownership of) specified financial assets. Under the new law, the original borrowers no longer need to be notified

[11] For details of the PCA framework, see International Monetary Fund (1998).

about the sales of their loans. Favorable tax treatment was also granted to special purpose vehicles and related transactions.

### Implementation of Big Bang Reforms

The "Big Bang" financial reforms remain on schedule. Following the enactment of the Financial System Reform Law in June 1998, most remaining measures were implemented during the course of FY1998. Important recent changes include allowing banks to sell investment trusts (mutual funds), establishing investor protection schemes for the life insurance, non–life insurance, and securities industries, abolishing the securities transaction tax, instituting market pricing of short-term government financing bills, and allowing finance companies to issue bonds to raise funds for lending.[12] Among the remaining reform measures, three major ones are scheduled to take effect in October 1999: commercial banks will be allowed to issue straight bonds, restrictions on the stock brokerage business of banks' securities subsidiaries will be lifted, and brokerage commissions will be fully liberalized. Cross-sectoral competition between banks and insurance companies will be allowed at some time in the future.

## Remaining Challenges

### Planned Removal of Blanket Deposit Insurance

The planned removal of blanket deposit insurance in 2001 is refocusing attention on banking sector restructuring. Given that there are potential uncovered losses and given the uncertainty about banks' future profitability, the planned replacement of blanket deposit insurance with limited insurance in April 2001 is raising interest spreads on bank debentures with maturities greater than two years. While the prospect of market discipline could spur bank restructuring efforts, markets could begin anticipating liquidity problems well ahead of April 2001. The government must be prepared in case important weaknesses remain.

### Recognition and Provisioning of Bad Loans

Notwithstanding the improvement in supervision, concerns remain that bad loans may not be fully recognized and adequately provisioned. The authorities might consider four steps to address these concerns. First, loan classification and provisioning standards, especially for

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[12] Hitherto, nonbanks were allowed to use funds raised through bonds for capital investment, but had to raise loanable funds through bank borrowing or equity financing. The right to issue bonds to raise loanable funds will be limited to nonbanks capitalized at over ¥1 billion (these nonbanks also have to meet the same standards for bad loan disclosure as banks). This change is expected to benefit large nonbanks engaged in mortgage lending, consumer lending, and leasing.

Class 2 loans, as well as capital adequacy requirements, might be further strengthened. Second, supervision could be further improved by increasing the FSA's resources, to allow more frequent on-site inspections of troubled banks, and increasing its autonomy, including through independent funding (such as levies on supervised institutions) and the authority to set its own salaries.[13] Third, adequate provisioning could be encouraged through the automatic tax deductibility of specific provisions consistent with loan classification standards, subject to future recapture if actual losses turn out to be less than expected.[14] Finally, disclosure standards could be strengthened by increasing the frequency and depth of disclosure, with, for example, quarterly rather than semiannual disclosure, and full disclosure of self assessments, including gross amounts of loans by asset class, the amounts covered by collateral or guarantees, and provisions.

## Bank Restructuring

Major banks' restructuring plans by themselves may not boost core profitability. Market participants consider that banks need to more aggressively consolidate (to generate economies of scale), securitize corporate loan portfolios, and expand fee-based income. Although the mergers announced so far are welcome, they are probably not sufficient to eliminate the excess capacity in the banking system. The authorities could facilitate restructuring in three ways. First, the injection of further public funds could be tied to a market test, such as a requirement to raise matching funds from private markets. Second, the early exit of nationalized banks from the marketplace could be encouraged, for example, by allowing them to cease functioning as ongoing concerns while selling off their assets and liabilities. Finally, strategies to reduce the role of the public sector in financial intermediation (e.g., the Postal Savings system) could be considered.

## Disposal of Bad Loans

The pace of bad loan disposal remains slow. Analysts have often noted the importance of sales of loans and collateral to introduce better recognition of value and to establish realistic floors on asset prices. Delayed progress on this front is impeding restructuring in banks and nonfinancial corporations. The main obstacle is inadequate recognition of bad loans, as disposal would force banks to realize additional losses. In addition to ensuring the full recognition of loan losses, the authorities could encourage the

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[13]Improved supervision is especially important in light of the Big Bang financial reforms that expand banks' range of activities.

[14]The recent tax change that allows banks to deduct debt forgiveness did not address the deductibility of provisions. Currently, provisions are automatically deductible only under certain narrow circumstances; otherwise tax deductibility depends on rulings by the tax authorities.

Resolution and Collection Corporation to periodically auction bad loans that it has acquired from failed financial institutions.

## Financial Reorganization and Corporate Restructuring

Japanese corporations have lagged behind their counterparts in several large industrial countries throughout the 1990s. While a number of large export-oriented companies remain international leaders, a general concern has surfaced that many Japanese firms are too highly leveraged, inefficient, and in need of real or financial restructuring. The depletion of many firms' financial resources and a gloomy profit outlook have led to a persistent decline in equity prices since their high at the start of 1990. Credit ratings have been reduced for many Japanese corporations—including major trading companies. Indeed, the consequences of the large expansion of credit during the years of rapid increases in asset prices (notably land) in the 1980s, and the surge in investment that accompanied it, continue to have ramifications throughout the corporate sector, contributing to low corporate profitability. A reallocation of resources continues to be hindered by several factors, including shortcomings of existing insolvency laws, the weak capital position of banks, and firms' reluctance to shed labor.

Several factors have raised concerns about the Japanese corporate sector. First, the high level of corporate investment during the late 1980s yielded low real rates of return; much of this investment was directed to sectors in which Japan likely did not have a comparative advantage, and similar diversification strategies pursued by many large firms led to excess capacity in several markets.[15] Second, Japanese companies have recently been adversely affected by cuts in credit availability and widening credit spreads linked to Japanese banks' attempts to maintain adequate capital. Third, the economic slowdown in Japan has been accompanied by deflationary pressures that have contributed to an imbalance between firms' cashflow and debts. These problems have been compounded by the weakness of corporate accounting systems and financial control mechanisms, as well as by the accumulation of corporate pension liabilities. For example, when accounting rule changes[16] cause firms to disclose the size of corporate pension underfunding, market pressures may spur firms to take steps to improve profitability.[17]

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[15]See, for example, Mitsuhiro (1994); and Moriaki and Yoshinobu (1997).

[16] Several changes in accounting rules are scheduled to take effect in 1999–2002. At the end of FY1999 the publication of consolidated accounts will become mandatory. The new rules will require the consolidation of the accounts of all firms over which a company exercises effective control, including through minority participation. Starting with FY2000, firms will have to mark to market all their financial assets (except for cross shareholdings, marking to market of which will become mandatory at the end of FY2001). The disclosure of corporate pension liabilities will also become mandatory at the end of FY2001.

[17]In the case of nonfinancial firms listed in the TSE1 First Section of the Tokyo Stock Exchange, for example, their liabilities are estimated at ¥50–80 trillion, while current profits

(continued…)

Pressures in the corporate sector have resulted in a string of recent announcements of restructuring plans, mainly by major corporations. Market reaction to these announcements has generally been positive, but concerns remain, reflecting doubts about whether the degree of planned restructuring is on par with the magnitude of the challenges. The Economic Planning Agency has estimated that corporate restructuring could entail asset write-downs totaling up to ¥85 trillion (about $700 billion), and market analysts have suggested that top companies might need to shed 10–15 percent of their employees to achieve average historical rates of return similar to those observed in the 1980s.[18]

There have also been official initiatives to encourage corporate restructuring in Japan. The government has considered measures to facilitate restructuring of corporate assets and liabilities, as well as reallocation of labor across sectors. A three-pillar strategy appears to be emerging, which can be summarized as follows. First, several tax incentives have been proposed to reduce production capacity. Second, the government is working toward introducing measures to address the debt overhang. Measures are likely to include reforms of the bankruptcy law to simplify reorganization procedures, financial cushions for creditors and small enterprises, changes in the commercial code and other laws to facilitate debt-for-equity swaps, corporate spin-offs, and exchange of stocks for debt in connection with firms' restructuring. Third, the government has announced that additional funds will be provided for retraining programs and is considering measures to reinforce the social safety net.

## Approaching a Crossroad

### The Degree of Leverage in the Corporate Sector

Aggregate corporate leverage is higher in Japan than in the United States and the United Kingdom, although less than in continental Europe. The aggregate figure is boosted by the leverage of small and medium-sized firms (which is about 600 percent and about twice that of large firms).[19] Moreover, the most indebted large Japanese firms are becoming

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earned by those firms were less than ¥10 trillion in 1998, and after-tax profits were about ¥1 trillion.

[18] See Morgan Stanley Dean Witter (1999).

[19] Direct comparisons across countries are difficult because of differences in definitions and reporting procedures. The aggregate debt-equity ratio of Japanese corporations is close to 450 percent, while the ratio of liabilities to net worth of U.S. corporates is about 200 percent, and the ratio of debt to own funds of firms in western Germany is somewhat above 300 percent. By contrast, the average debt-equity ratio of TSE1 companies (350 percent) is actually lower than that of the U.S. firms included in the S&P Industrial Index (450 percent) or of large German nonfinancial firms (460 percent).

more leveraged over time: the average net debt-equity ratio of the top quartile (in terms of indebtedness) of firms listed in the TSE1 First Section of the Tokyo Stock Exchange has increased by about one-third since 1992.

The main sources of corporate leverage in Japan are bank credit and intercorporate credit. Roughly 70 percent of bank corporate loans in Japan are to small and medium-sized firms. Although banks are an important source of financing to large corporations, bond issuance has increasingly been substituted for bank finance by many large firms. Corporate indebtedness also varies across sectors of the economy. As is typical in most countries, leverage in Japan is higher in nonmanufacturing than in manufacturing.[20] Average leverage has been pushed up by increases in leverage in the construction sector (a fourfold increase since 1990), the retail and trading sectors, and some segments of the manufacturing sector (e.g., electrical machinery and pulp and paper).

The high leverage of Japanese corporations can be attributed in large part to two factors: Japanese firms have relied more on external sources of funds than is the case for firms in some other major economies, and Japanese firms have historically had high levels of investment. For most of the post–World War II period, retained earnings were insufficient to finance the investment plans pursued by Japanese firms: internal funds accounted for less than 60 percent of corporate investment in nonfinancial assets in the late 1980s (a share that increased only marginally when the economy slowed down), which is much lower than in Germany or the United States. These factors, in conjunction with stimulative monetary policy in the 1980s and corporate diversification strategies that fueled a 60 percent increase in the stock of reproducible fixed assets, have contributed to a rapid rise in corporate debt.

## Strains Caused by High Debt Loads

Until recently, leverage in the Japanese corporate sector was not a major issue, in part because of the relief provided by declining interest rates—a trend that has now ended. Average interest rates on loans declined from 8 percent to 2 percent during 1991–97, allowing the ratio of gross interest expenses to revenues to decline by 40 percent, despite the deterioration of firms' revenues during this period. Beginning in late 1997, the impact on banks of financial turbulence, and the tightening of regulatory standards, have changed the dynamics of corporate debt. Credit spreads have widened and credit lines have been curtailed. Adding to pressures on debt service, sales have declined by 6 percent and profits have dropped by more than 30 percent over this period. In sum, despite further declines in market interest rates through 1998, the ratio of interest payments to sales has begun to increase.

[20] The net-debt-equity ratios for the nonmanufacturing and manufacturing sectors are, respectively, 250 percent and 60 percent.

Widespread corporate losses and troubles in the banking system have weakened traditional sources of mutual support among corporations. Historically, firms belonging to an economic group (*kigyio shudan* and associated *keiretsus*) could count on support from their peers, parents, and main banks when facing financial distress. The financial deterioration of banks and nonfinancial corporations has weakened this support mechanism. This development underlies warnings by credit agencies that the relationship between Japanese firms' credit ratings and their leverage will converge toward that of U.S. firms if the trend continues. As a consequence, Moody's downgraded 82 Japanese nonfinancial corporations between February 1998 and March 1999, while Standard & Poor's placed 22 companies on Credit Watch in late 1998, and eventually lowered the ratings on more than two-thirds of these companies.

The growth rate of new corporate bankruptcies peaked at 35 percent (year-on-year) in May–July 1998. Moreover, for the first time, some large firms have declared bankruptcy, which has contributed to the growth in the aggregate debt of failing companies; in 1997–98, such debt stood 70 percent above 1995–96 levels. In the second half of 1998, several steps were taken to cap the rise in corporate bankruptcies. They included Bank of Japan credits to banks that extended new corporate loans, widespread loan guarantees for small and medium-sized enterprises, and special credit lines for some firms facing redemption of maturing bonds.

## Directions for Change

### How Much Restructuring Will Be Needed?

The deterioration of corporate balance sheets appears to largely reflect overcapacity in several industries. Return on equity in Japan has dropped from about 7.5 percent in the late 1980s to an average of 2.8 percent in FY1991–98.[21] The capital-output ratio in Japan is currently above trend and capacity utilization in the manufacturing sector is below trend. Excess capacity is greatest in many industries in which capacity increased the most in the 1990s, and arguably cannot be fully attributed to cyclical factors.

The burden of excess capacity has been compounded by a rise in labor costs that has out-paced sales. In the 1990s, corporate sales have grown by a cumulative 2 percent, while labor costs among large Japanese companies and their subsidiaries have increased by more than 25 percent. Although a large part of the increase in labor costs occurred in the early 1990s, and reductions in bonuses have recently contributed to a decline in labor costs, the disconnect between costs and revenues has become more prominent with time. For instance, in 1998, labor costs declined by 1 percent, but sales dropped by 6 percent.

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[21] By comparison, return on equity in the United States is on the order of 20 percent.

Increasing corporate return on assets to international levels would require substantial real restructuring. Since 1990, return on assets for Japanese firms has halved to about 2 percent, compared with 5.5 percent for U.S. companies. According to some financial analysts, restoring the return on assets to its historical average would require (assuming constant revenues) a 15 percent reduction in total labor costs, or asset write-downs equivalent to $5 trillion.

## Institutional Factors and Recent Restructuring Measures

Traditionally, corporate sector adjustment in Japan has followed a pattern in which large firms use their intra-group relationships to internalize adjustment costs (e.g., reshuffling labor), whereas small and medium-sized companies downsize or exit. That pattern was broadly maintained through mid-1998, but since then new patterns of corporate restructuring have emerged. In particular, some large firms have undertaken significant efforts to restructure, while small and medium-sized firms have been given some breathing room by temporary special loan guarantees.

The number of announced corporate restructuring plans surged in 1999. The announcing firm's stock price rose when markets viewed its plans as underpinned by genuine change (Box A2.1). The surge in announcements was in part because of the magnitude of losses that many firms expected to incur in 1998-99,[22] and possibly in part because of the example set by a few large, profitable firms that have announced restructuring plans. In the past, the majority of restructuring plans were aimed at restoring near-term solvency rather than improving longer-term profitability. By contrast, more recent plans have increasingly focused on the establishment of clear lines of authority and stronger mechanisms for financial control, withdrawal from non-core business lines, and the forging of links with foreign partners.[23]

Bank-led informal reorganizations, which have been hindered in recent years by banks' weak financial condition, have also picked up recently, owing to the injection of public funds into major banks and recent tax provisions associated with asset write-downs by banks. About a dozen midsized companies, notably in the construction and trade sectors, reached agreements with their bank creditors in the first half of 1999.

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[22]Recurrent profits of nonfinancial listed corporations fell 26 percent and total profits dropped by 70 percent in 1998 compared with 1997.

[23]Mergers and acquisitions by foreign companies in Japan are still few in absolute terms (75 in 1998) but their number has doubled from 1996 to 1998. They have increasingly involved large financial and industrial companies in which the foreign partner is expected to play a major role.

## Box A2.1. Stock Market Reaction to Recent Restructuring Announcements in Japan

During the first three months of 1999, several listed Japanese firms announced restructuring plans, often coinciding with the forecast of large losses for the fiscal year. Many plans involved marginal adjustments, such as a reduction in labor through attrition. Other plans involved improved corporate governance mechanisms, including a reduction in the size of the board of directors (which, in Japan, often include more than 50 directors comprised of present and past managers). Several firms appeared to take larger steps, including major structural changes aimed at refocusing businesses activities, notably through divestment of non-core businesses and consolidation of subsidiaries. Mergers and acquisitions figured prominently among recent announcements, in some cases reflecting increased reliance on foreign partners, and in a few cases the outright transfer of control to them. Some plans took advantage of the upcoming introduction of consolidated accounts to simplify corporate structures and establish "in-house" units aimed at identifying cost and profit centers, which are key ingredients, together with the clarification of lines of authority, for restoring the profitability of Japanese firms.

The ultimate effectiveness of these plans is difficult to discern, although they certainly indicate an incipient change in attitude. Changes in stock prices in reaction to announcements are one way to gauge the potential effectiveness of these plans, because they provide insight into the market's reaction to these announcements. An event study, based on a sample of about 60 announcements made in the first two-and-a-half months of 1999, is therefore undertaken here.

Event studies are a standard method to identify the information content of market news by measuring abnormal returns on stocks around corporate actions or announcements. In these studies, the actual return on a share within a time window around the event day is computed and compared to the prediction of some benchmark model such as the Capital Asset Pricing Model (CAPM) portfolio model. Here, abnormal returns are also computed against the average returns in the second half of 1998, in order to address the possibility that the results using the CAPM might be biased by the cumulative effect of announcements on overall market sentiment.

Variables that reflect the nature of the announced plan, recent changes in the firm's profitability, and the firm's industry sector are used to assess market reactions. Plans were grouped into five categories, and firms were grouped in three sectors: manufacturing (37 observations), finance (13 observations), and other sectors (construction, services, and light industry) (20 observations). Two financial variables were used: the percentage change in  earnings per share between FY1998 and FY1999, and a discrete variable indicating whether or not the 1999 dividend was expected to be zero. The allocation of plans into the five categories was based on news reports and comments by market analysts from major investment banks in Japan, which unavoidably involved some judgment. For example, major restructuring plans typically involved reductions in the labor force and divestment in non-core activities, and divestment of single lines of business could be considered a merger and acquisitions activity. Results were, however, broadly unchanged by the reclassification of some plans that had ambiguous features. Also, the results using the CAPM and those based on historical average returns were similar.

The results suggest that markets were in general cautious about restructuring announcements, particularly those of financial institutions. Only a small fraction of announcements resulted in cumulative abnormal returns during the subsequent four days that were in excess of two standard deviations from those predicted by the CAPM or from the average return on individual stocks in the second half of 1998. It is noteworthy that some of the largest increases were associated with an announced acquisition by a foreign firm. It should also be noted that the low significance of stock price changes around announcements could also reflect information leakage, market skepticism, and simply the high level of volatility of Japanese stock prices in recent months owing to macroeconomic factors that are not captured fully by the CAPM.

An alternative to the above approach is to assess the qualitative reaction of markets rather than the magnitude of these effects. A probit model can be used for this purpose. The probit analysis indicates that an announcement by a financial institution involving a reorganization plan was viewed by the market, more often than not, less positively than those made by other companies. A second finding from the probit analysis is that announcements of major restructuring plans, mergers and acquisitions, and the sale of non-core business were generally favorably viewed by the market, while plans based on attrition were associated with a decline in stock prices. The coefficient on the variable indicating plans based mainly on a multiyear reduction in the workforce through attrition was significantly negative in all model specifications. In contrast, the coefficient associated with plans based on other strategies was uniformly positive. A third finding is that financial variables appear to suggest that market discipline contributed to more rigorous corporate restructuring: expected declines in earnings per share were negatively correlated with changes in stock prices.

## Japan: Stock Price Reaction to Recent Restructuring Announcements

| | OLS | | | | | Probit | | | |
|---|---|---|---|---|---|---|---|---|---|
| Variable | CAPM | | | Average Return | | CAPM | | | |
| Percent change in earnings per share | -2.E-04 | | -4.E-04 | -2.E-0.4 | -4.E-0.4 | -7.E-0.4 | -4.E-0.4 | | -7.E-0.4 |
| | [0.393] | | [0.068] | [0.336] | [0.122] | [0.031] | [0.091] | | [0.011] |
| No dividend in 1999 | | -0.20 | | | | | | -0.31 | |
| | | [0.755] | | | | | | [0.556] | |
| Financial sector | -1.01 | -0.85 | -0.84 | -0.80 | -0.72 | -1.32 | | -1.10 | -1.18 |
| | [0.071] | [0.165] | [0.185] | [0.105] | [0.147] | [0.004] | | [0.029] | [0.034] |
| Industry[1] | | | | | | | 0.69 | | |
| | | | | | | | [0.71] | | |
| Attrition | -1.65 | | | -1.23 | | -2.24 | -2.24 | | |
| | [0.014] | | | [0.035] | | [0.001] | [0.001] | | |
| Governance | | 1.32 | 1.59 | | 1.46 | | | 1.32 | 2.06 |
| | | [0.066] | [0.155] | | [0.168] | | | [0.039] | [0.022] |
| Merger/acquisition | | 1.99 | 2.39 | | 1.88 | | | 1.22 | 2.21 |
| | | [0.004] | [0.024] | | [0.020] | | | [0.038] | [0.008] |
| Divestment | | 0.95 | 1.24 | | 2.32 | | | 1.49 | 2.29 |
| | | [0.190] | [0.001] | | [0.066] | | | [0.018] | [0.004] |
| Major restructuring | | 2.40 | 2.70 | | 1.18 | | | 1.61 | 2.39 |
| | | [0.010] | [0.084] | | [0.002] | | | [0.042] | [0.003] |

Note: Numbers in brackets indicate the significance level of the estimated coefficient.

[1]Industry excludes construction and beverage.

Corporate restructuring, nonetheless, still faces significant institutional impediments. One major impediment is the high cost to firms of reducing employment. Job separation from large Japanese firms has historically been voluntary. Court rulings in the late 1970s made dismissals cumbersome (thus favoring the shift of labor across subsidiaries), which has led firms to offer voluntary early retirement programs. The typical early retirement program is estimated to cost about ¥22 million ($180,000) a worker. Although financial analysts have noted that the recent performance of some companies suggests that the payback period of eliminating redundancies could be as short as three years, cash-strapped firms may have trouble financing such cuts. Other impediments to restructuring include: the low net tax benefits to restructuring; remaining obstacles to securitization (despite the 1998 law promoting asset-backed securities) that include multiple liens on loan collateral and inadequate loan documentation; inadequate debt segregation within companies (parent companies often offer loans or comprehensive loan guarantees to subsidiaries); and the lack of effective bankruptcy proceedings.

Reform of bankruptcy laws is an important priority for public policy because of weakness in the banking sector and the general lack of other mechanisms that enable debtors to engage creditors in negotiations. There are three laws regulating corporate financial reorganization in Japan, in addition to two laws regulating liquidations (Table A2.6). Under current laws, debtors in Japan face numerous restrictions and incur large risks when they attempt to initiate formal reorganization procedures.[24] Formal reorganization procedures are thus seldom used in Japan: only about 300 petitions are filed in a typical year, of which a large number are withdrawn before proceedings actually start. By contrast, some 20,000 petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code were filed every year in the United States during 1983–93. In the past, the lack of effective formal procedures might not have posed a major problem because banks were not financially constrained and thus could initiate necessary workouts.

## Official Initiatives

The Ministry of International Trade and Industry has issued a set of proposals in advance of the introduction of government legislation to facilitate corporate restructuring. The following are among proposals that reflect early suggestions made by the Economic Strategy Council, and have in part been incorporated in recent government plans:

- *Tax incentives to reduce production capacity and promote corporate reorganization***.** The measures include exemptions of capital gains realized in connection with the transfer or reorganization of subsidiaries and divisions; an extension of favorable tax treatment of land transactions not involving sales (such as in-kind transfer of land to

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[24]Rehabilitation procedures using bankruptcy laws aimed at small and mid-sized firms focus on protecting secured debtors. Other procedures aimed at large firms entail the transfer of corporate control to a court-appointed trustee and can be relatively complex.

## Table A2.6. Japan: Legal Procedures for Insolvent Companies

| | Liquidation | | Reorganization | | |
|---|---|---|---|---|---|
| Procedure | Bankruptcy | Liquidation | Composition | Corporate rearrangement | Corporate reorganization |
| | *Hansan* (under the Bankruptcy Law of 1922). | *Tokubetsu-seisan* (section 432 et. seq. of the 1899 Commercial Code). | *Wagi* (Composition Law of 1922). | *Kaisha-seiri* (Section 381 et. seq. of the Commercial Code, modified in 1938 to add features of U.K. laws). | *Kaisha-kousei* (Corporate Reorganization Law 1952, revised in the 1970s). |
| Application | Similar to U.S. Chapter 7 although inspired by German law. Can be transformed into a reorganization. Conversely, it may result from the failure of reorganization efforts. | Applicable to companies being wound up that are considered to be insolvent. Any joint stock company may use it. It is more efficient than bankruptcy if the creditors are cooperative. | Popular system where an arrangement with creditors can allow the firm to continue in business. | Reorganization occurs under minimal supervision by the court. Can be used only by unanimous agreement among creditors. Typically applied to small- and medium-sized companies. | Similar to Chapter 10 of the old U.S. Bankruptcy Code, or the "Administration Order" under the U.K. Insolvency Act. Typically used by large corporations; it often takes a long time to be completed. |
| Control of the firm | A trustee (a lawyer) is appointed, who will liquidate the company independently of the creditors and distribute money pro rata. | A former director of the company is chosen as liquidator; no trustee is appointed. | An appointed trustee retains the power of administration over the firms' assets (management retains some control over ordinary business actions). | The company retains its administrative powers, except if the court decides otherwise. | A reorganization trustee is appointed, who holds all necessary management powers. |
| Secured credits | May be executed separately. | Separate execution may be restricted by court order. | May be executed separately. | Separate execution may be restricted by court order. | May be executed only through the procedure. |
| Unsecured creditors | Participate in the procedure; seniority rights not absolute. | "Equality" is required by law, but may be adjusted reflecting agreement by a majority of creditors. | Absolute priority subject to trustee's decision. | Individual execution of claims is suspended, but the firm may repay specific debts (preference). | All creditors participate in the procedure. |
| Voting | — | Votes equivalent to three-fourths of claims required. | Votes equivalent to three-fourths of claims required. | Unanimity. | Qualified majority by class of creditor. |
| Power to ratify plans | Amounts recovered are divided by the court; typically they add to less than 10 percent of the claim. | Payments will be made according to a convention approved by the legal majority of creditors, after approval by the court. | The court approves the sharing arrangement, subject to agreement by creditors. | The firm has discretion on which payments it makes, subject to agreement by creditors. | The scheme of reorganization should be agreed by the majority of creditors. The scheme itself and execution are subject to the supervision of the court. |

newly incorporated firms); tax breaks for asset write-offs in connection with the scrapping of production capacity (e.g., a firm absorbing a loss-making operation could carry losses forward for 10 years rather than 5 years). Consideration has also been given to shifting corporate income taxation to a consolidated basis. This would permit firms to offset taxable income from one subsidiary with losses in other subsidiaries, and could lead to uniform corporate tax rates and fewer subsidiaries (small firms are currently subject to lower corporate tax rates).

- *Legal changes to facilitate corporate reorganization and change in corporate ownership structures***.** These include proposals to permit banks to exceed the 5 percent limit on equity holdings in a nonfinancial firm in the event of a swap of debt for equity; [25] more flexible implementation of antimonopoly laws, to permit Japanese companies competing in the global economy to hold a large share of the Japanese market; and changes in the Commercial Code to facilitate change in ownership structures (that includes broadening the ability of corporate boards to dispense with a general shareholders' meeting when deciding on the sale of businesses or other restructuring steps, to force minority shareholders to sell their shares when a bidder has acquired over 50 percent of company shares, and to allow payment in shares of the acquiring firm for corporate acquisitions).

- *Use of public funds,* such as a public lending facility to finance capacity reductions at special interest rates; subsidies to firms that increase employment (in designated sectors); and the financing of individual training.

The authorities are also reviewing *bankruptcy laws* with the aim of improving the efficiency of corporate rehabilitation procedures. Specifically, the Ministry of Justice has announced the acceleration of plans to complement the law typically applied to small and medium-sized companies (the Composition Law) with a new Financial Rehabilitation Law. The latter would incorporate several provisions paralleling those in Chapter 11 of the U.S. code (see Table A2.7). Although some of the proposed provisions already exist in Japanese law, they are scattered over three different laws and are therefore not fully operational. Main proposed features include:

- Relieving debtors of the need to prove that their firm is insolvent (or nearly insolvent) when petitioning for court protection, and embracing the *debtor-in-possession* principle. This principle permits incumbent management to maintain control of the

[25]This change is expected to aid corporate reorganization. The experience in the United States may be illustrative. James (1995, 1996) shows that U.S. banks were willing to participate in debt-equity swaps of severely impaired claims and take advantage of exemptions to the U.S. law banning banks from holding corporate equity when the going-concern value of a distressed debtor was higher than its liquidation value. Banks usually agreed to swaps when other creditors also participated in the workout.

**Table A2.7. Japan: Features of Reorganization Procedures in the United States and Germany and the Prospective Financial Rehabilitation Law in Japan**

| | United States | Germany | Japan |
|---|---|---|---|
| Procedure | Chapter 11 of Bankruptcy Code | 1994 Bankruptcy Code | (Prospective) Financial Rehabilitation Law |
| Main objective and application | Reorganization of the firm as an ongoing concern; only indirect consideration for stakeholders other than the debtor. | Liquidation, reorganization (composition), or possible auction; some consideration for "social" and other external objectives. | Financial rehabilitation of individuals, unincorporated firms, and corporations through a streamlined procedure. |
| Solvency and other requirements | Firm need not be insolvent; protection is often sought by debtor. | Firm cannot meet payments or is overindebted. It needs to prove it has enough funds to pay for procedural costs (after netting out secured assets). | Solvent firms can apply if debt burden becomes excessive; prepayment of court costs is likely to still be required. |
| Control rights and authority to propose a reorganization plan | Debtor in control: in 50 percent of cases, previous managers retain control; in remainder, new managers are appointed by debtors. Managers have 120 days after the filing (extendable by the court) to present reorganization plan. The 1995 reform somewhat increased the power of creditors to reject that plan. | Power is shared. Court appoints a creditors' committee and an administrator, who proposes a reorganization plan to the creditors' assembly within three months. If the plan is rejected, the administrator may be allowed to propose a new plan or a chance can be offered for the debtor to take the lead. | Debtor-in-possession principle is embraced; similar to current practice under the commercial code, incumbent managers may retain control of the firm, with some supervision from the court, and propose the reorganization plan. Implementation of the plan will be overseen by court, but without deep involvement. |
| Automatic stay against creditor claims | Most creditors' claims and the service of those claims are stayed (with exceptions such as lease payments). | Automatic minimum three-month stay for all claims; stay can be extended by creditors' assembly. | Stays against secured creditors are not automatic, but are expected to be granted liberally and expeditiously by courts (comprehensive stays will substitute for the current system where the debtor has to seek individual injunctions against each creditor). |
| Renegotiation of liabilities and voting rights | Great discretion to renegotiate debt contracts. Impaired creditors vote by class; plan is approved by simple majority by number and 2/3 majority by claim, subject to court confirmation. Court can "cram down" junior creditors. | Ample scope for renegotiation (in the past, essentially only the repayment schedule of claims could be renegotiated). Creditors vote by class; plan is approved by simple majority by number and by size of claim, and subject to court confirmation. | Creditors are likely to vote as one class, with plans to be approved by a qualified majority by number and size of claim. Firms will be able to be sold as going concerns during the procedure. |
| New financing | New financing is easily accommodated because it has priority over existing claims, under the debt-in-possession (DIP) statute. | New senior financing allowed (it was the case in the old code). | New financing to receive senior status. |
| Preservation of residual claims on equity holders and deviations of absolute priority | Equity often retains value, usually through creditor's consent, and sometimes through a court "cram down". Junior creditors may by paid while senior creditors may not be paid in full, when the latter were undersecured, or made concessions. | Deviations can be proposed, but must be agreed by a creditor's vote. In compositions, they tended to occur. | Deviation from absolute priority expected, e.g., debtors will be able to satisfy the claims of secured creditors by paying off the actual value of the collateral (arbitrated by a third party) and debt-for-equity swaps will not require the wiping out of shareholders' wealth. |
| Other options for distressed firms and their main objectives | "Prepackaged" Chapter 11 (in which impacted creditors agree on a plan before filing); informal debt workouts, including through the exchange of claims; liquidation under Chapter 7 of the Bankruptcy Code. | The new code combined the compulsory liquidation (*Konkurssordnung*) and composition (*Vergleichsordnung*) procedures; informal debt workouts most common. | All existing legislation (Composition, Rearrangement, and Corporate Reorganization Laws) will remain in place until they are fully revised and possibly unified within a 3-5 year horizon. |

firm during the procedure, and to propose the reorganization plan; it is also associated with the granting of seniority of debt acquired after filing for court protection over previous debts.

- Greater protection against creditors, by allowing the court to *stay secured creditors*, thus reducing the risk of the firm being stripped of essential assets and wind up in liquidation. Also, a (qualified) *majority of creditors will suffice for approving reorganization plans,* rather than the unanimous consent of creditors.

- *Priority rules will be weakened* to permit debt-for-equity swaps whereby debt would be converted into equity through the issuance of additional equity, rather than by replacing existing equity (i.e., absolute priority would not be observed); and *debtors will be able to satisfy claims of secured creditors by paying off the current (estimated) value of the collateral*, and aggregating the residual part of the loan with other unsecured debts. This provision may be important because, given the decline in land prices since 1999, banks often consider holding a title on a loan with real estate collateral to be akin to holding an option on the value of that land. By permitting debtors to satisfy the secured part of those claims by paying cash for the current value of collateral, the law provides a way for companies to eliminate that option and creates an incentive for banks to renegotiate.

## Prospects and Risks

Official proposals to encourage financial and real restructuring in the Japanese corporate sector are, on balance, positive. The government has recognized the importance of establishing an environment conducive to corporate restructuring, while ensuring that primary responsibility for initiatives rests with individual firms. For the most part, the government appears to have resisted the temptation to provide direct corporate subsidies. In addition, current proposals may stimulate restructuring efforts and the implicit fiscal contribution may help the corporate sector to absorb the costs of restructuring. These fiscal measures could reduce the burden on banks and possibly also reduce the magnitude of required public injections of capital into the banking system. The possible expansion of the social safety net could help cushion the social impact of dismissals while helping to promote the needed reallocation of labor in the corporate sector; it could also dampen the rise in precautionary saving, reducing downward pressures on prices and corporate revenues. On the other hand, provision of public loans to firms undergoing reorganization could become a lifeline to impaired businesses that are not financially viable. Similarly, subsidization of jobs in designated sectors has the potential to introduce distortions into the market mechanism.

The reform of bankruptcy laws points in the right direction, but efficiency considerations highlight the importance of also fostering a market for corporate control. The incorporation of several Chapter 11 mechanisms into the new Financial Rehabilitation Law would tend to encourage the early use of formal procedures that could help mitigate the existing debt overhang problem. By giving protection to incumbent management, these provisions could favor firms that are not viable and should exit rather than be reorganized.

The new German bankruptcy code addresses these issues, inter alia, by giving prominence to creditors' committees in the decision about whether to reorganize or liquidate the firm. The new law in Japan is expected not to include explicit mechanisms such as those in the German code. Hence, greater reliance on a strong market for corporate control might be required, as suggested by the experience in the United States, where the existence of such a market has been an important factor to balance any pro-management bias in the law.

The effectiveness of new bankruptcy laws will also hinge on the amount of resources made available for their implementation. Key factors in the success of bankruptcy laws in the United States are the powers embodied in bankruptcy courts and the role of private trustees in relieving judges of much of their administrative responsibilities. In Japan, there are only two specialized bankruptcy courts. As a consequence, debtors may be discouraged from more use of formal procedures against creditors because of perceptions that the courts may not be expeditious. A review of court procedures and available resources, including in the legal profession, may therefore help improve the legal resolution of financial reorganizations.

Effective corporate governance is also an important factor in facilitating restructuring of the corporate sector. An increasing number of Japanese companies have professed that their main goal is to maximize shareholder value. Nonetheless, mechanisms to enforce management accountability remain limited. The high degree of corporate cross-shareholding significantly limits the scope for hostile takeovers. Although the forthcoming mandatory marking to market of cross-shareholdings could create incentives for firms to unwind them, prospective measures that would allow companies to reduce their exposure to these assets by shifting the ownership rights of stockholdings to trusts (to fund corporate pension commitments), but retain the associated control rights, may perpetuate this problem. On the other hand, the new holding-company law as well as the possible move toward consolidated corporate taxation have helped spur the reorganization of large firms into vertical organizations under holding companies, which may facilitate managerial accountability.

Further development of domestic capital markets could improve corporate governance and the efficiency of Japanese firms. For example, increased market incentives from well-functioning corporate debt and equity markets for small firms could facilitate the streamlining of existing *keiretsus* through an aggressive divestment policy supported by the redirection of domestic savings to new financial instruments (also helping address potential concerns of excessive ownership concentration on the heels of a relaxation of the anti-monopoly law). Wider use of these markets could also provide a potentially lucrative advisory business to banks, while submitting a larger share of the corporate sector to the discipline and disclosure implied by the reliance on public corporate instruments. Debt-for-equity swaps could also play an important role in supporting financial reorganization in Japan, provided other constraints on corporate restructuring are addressed. Specifically, banks may be reluctant to engage in such operations with firms that are limited in their ability to shed labor or take other measures to improve their performance.

In summary, there are encouraging signs that further restructuring will occur. There is recognition of the need for restructuring, and firms are increasingly committed to change.

The Japanese authorities have shown increasing resolve in advancing that process, for example, by encouraging large firms to restructure, considering an expansion of the social safety net to protect dislocated workers, and introducing measures to stimulate the development of start-up firms. Nevertheless, some observers have noted that the positive reaction of markets to steps taken to date could result in complacency. Although a rapid restructuring could lead to a temporary contraction in GDP, this shock may be partially cushioned by public policies. By contrast, a greater risk could arise from delaying corporate restructuring, as that might dampen economic growth for many years and entail considerable fiscal costs.

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