JAPAN’S NON-PERFORMING LOAN PROBLEM AND FINANCIAL RECONSTRUCTION

MR. HIROFUMI GOMI

NISHIMURA & ASAHI
(FORMER COMMISSIONER, FSA, JAPAN)

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Japan’s Non-Performing Loan Problem and Financial Reconstruction

The Third International Conference
Financial Stability and Financial Sector Supervision
Lessons From the Past Decade and Moving Forward

December, 2007
# The 3rd International Conference - resume

## 1. The onset of Japan’s non-performing loan problem and bank bankruptcies

1. Bank operations during the bubble period
2. The onset of the non-performing loan problem following the bubble collapse
3. Bank bankruptcies and its causes
4. The government’s response
   - Pay-offs frozen
   - Corrective measures rapidly introduced
   - Major banks intensively inspected
   - System to deal with bankruptcies introduced (Financial Reconstruction Act)
   - Injection of public funds (Financial Function Early Strengthening Act)

## 2. The increasingly serious non-performing loan problem

1. Growing deflationary pressure and management deterioration at large-scale debtors
2. Flaws in banks’ risk management systems
3. Decline in banks’ lending power (falling credit ratings, the Japan premium, credit-crunch)
4. The government’s response
   - Creation of a financial inspection manual
   - Discovery and rapid disposal of non-performing loans (special inspections – the 2 to 3 year rule)
   - A financial reconstruction program
   - Progress report on disposal of non-performing loans
Principal Events within Japan’s Non-Performing Loan Problem (1)

The 1980’s  Onset of the bubble economy

Pressure caused by a declining trade surplus, the rapid rise in the value of the Yen, and low-level economic growth

⇒ Official discount rate reduced to achieve economic expansion

⇒ Low-level interest rate policy embedded long-term ⇒ spurred speculative investing in real-estate, shares etc.

⇒ Onset of the bubble economy (from the mid 80s)

The 1990s  The onset and the increasing seriousness of the non-performing loan problem

Collapse of the bubble economy ⇒ long term economic recession, asset deflation, banks confronted with the non-performing loan problem
Principal Events within Japan’s Non-Performing Loan Problem (2)

The 1990s  Onset and increasing seriousness of the non-performing loan problem

(Principal events)

1994  Bankruptcies of the Tokyo Kyowa Credit Union and Anzen Credit Union

1995  Bankruptcy of Hyogo Bank

1995  Injection of approximately ¥680 billion in public funds to deal with bankrupt home-loan financial institutions

1996  Decision taken to insure savings for the entire amount, and other assets (until March 2001) (pay-offs frozen)

1997  Bankruptcies of Hokkaido Takushoku Bank, Yamaichi Securities and others

1998  Financial Supervisory Agency established – collaboration with the Bank of Japan for intensive inspections at major banks

Financial Reconstruction Act implemented (a system for dealing with bankruptcies)
Financial Function Early Strengthening Act implemented (capital strengthening via public funds)
Nationalization of the Long Term Credit Bank of Japan
Falling credit ratings, the Japan premium, credit-crunch

1999  Financial inspections manual published

Capital strengthening for 15 major banks and 4 regional banks
5 bankruptcies among Second Association Regional Banks
Principal Events within Japan’s Non-Performing Loan Problem (3)

The 2000’s  Normalization of the non-performing loan problem

2000  Financial Services Agency established
2001  Direct repayment of non-performing loans promoted (establishment of the 2 to 3 year rule etc.)

Special inspections implemented (major banks)
Extension of insurance for entire amount of savings and other assets (until March 2005)
2002  Establishment of a bridge-bank to continue operations of two bankrupt Second Association Regional Banks
Announcement of the Financial Reconstruction Program

2003  Capital strengthening for a major bank (Resona Bank)
Temporary nationalization of a major regional bank (Ashikaga Bank)
2004  Financial Reform Program announced
2005  Ban on pay-offs lifted

Target of reducing in-half non-performing loan ratios at major banks achieved (end of March 2002, 8.4% ⇒ end of March 2005, 2.9%)
## Number of Failed Financial Institutions

<table>
<thead>
<tr>
<th>Year (Japanese Heisei Calendar)</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
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</table>

(Note) Shift in number of financial institutions dealing with savings: 1990, 1012 → 2006, 582
## Trends in Bankruptcies at Financial Institutions and Creating and Maintaining a Safety-Net

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Bankruptcies</th>
<th>Principal Bankruptcy Cases (Month/Year) and Cost of Disposal (Amount of credit offered: 100 million)</th>
<th>Maintenance of a Safety Net (year/month)</th>
</tr>
</thead>
<tbody>
<tr>
<td>71~90 Total</td>
<td>0</td>
<td></td>
<td>&lt;ul&gt;&lt;li&gt;Deposit insurance system established (71/4) (Deposits insured to upper-limit: limit calculated according to insurance payments)&lt;/li&gt;&lt;li&gt;Capital-assistance method introduced (86/7)&lt;/li&gt;&lt;/ul&gt;</td>
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<tr>
<td>91</td>
<td>1</td>
<td>(91/7) Toho Mutual Savings Bank (Lending 80)</td>
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<td>92</td>
<td>1</td>
<td>(92/4) Toyo Minshin Bank (200)</td>
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<tr>
<td>93</td>
<td>2</td>
<td>(93/7) Anzen Credit Union</td>
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<td>94</td>
<td>4</td>
<td>(94/12) Tokyo Kyowa Credit Union (2 credit unions, totaling 400)</td>
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<tr>
<td>95</td>
<td>6</td>
<td>(95/7) Cosmos Credit Union (1,250) (95/8) Kyuso Bank (4,730) (96/3) Taiheiyo Bank (1,170)</td>
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<tr>
<td>96</td>
<td>5</td>
<td>(96/11) Hanwa Bank (812)</td>
<td></td>
</tr>
<tr>
<td>97</td>
<td>17</td>
<td>(97/10) Kyoto Kyoei Bank (436) Sanyo Securities applies to the Company Rehabilitation Act (97/11) Hokkaido Takushoku Bank (17,631) Yamaichi Securities announces its voluntary discontinuance of business (97/11) Tokyo City Bank (1,192)</td>
<td>&lt;ul&gt;&lt;li&gt;Diversification of disposal methods introduced, such as new merger companies (97/11)&lt;/li&gt;&lt;li&gt;System to inject public funds to insure deposits etc. to entire amount introduced&lt;/li&gt;&lt;li&gt;The Resolution and Collection Bank’s sphere of operations expanded&lt;/li&gt;&lt;li&gt;System to inject capital into financial institutions established (98/12)&lt;/li&gt;&lt;/ul&gt;</td>
</tr>
<tr>
<td>2000</td>
<td>14</td>
<td>(00/12) Credit Union Kansai Industrial Bank (6,599)</td>
<td>&lt;ul&gt;&lt;li&gt;Diversification of methods for disposing of bankruptcies continued and made permanent&lt;/li&gt;&lt;li&gt;Exceptional measures for crisis situations established&lt;/li&gt;&lt;li&gt;The principle that deposits are insured for the entire amount abolished (02/4)&lt;/li&gt;&lt;/ul&gt;</td>
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<tr>
<td>91~00 Total</td>
<td>124</td>
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</table>

(Note 1) The number of bankruptcies is based on the official announcement of bankruptcy numbers in which deposit insurance was invoked.

(Note 2) Prior to 1998, the most common method of disposing of a bankruptcy was capital-assistance that presupposed the transfer of business and operations (another method was rescue mergers). However, from fiscal 1998, disposal methods were diversified. Within the table, * refers to special mergers incorporating the sale of assets without the provision of credit, ** refers to special public management, while *** refers to the financial liquidation administration.

(Note 3) Regarding the treatment of the Long Term Credit Bank of Japan, in addition to financial credit of 3,141.4 billion yen, 95.1 billion was paid as from the Financial Reconstruction Account as a compensation loss.

(Note 4) The actual amount of financial credit provided may differ due to later reductions.
Measure to Stabilize the Financial System – Injection of Public Funds

(as of August 9th, 2007)

○ Former Financial Stabilization Act (Feb. 98)
  • Injection of ¥1.8 trillion into 21 banks
  • Of which, ¥1.6 trillion recovered

○ Financial Function Early Strengthening Act (October 1998)
  • Injection of ¥8.6 trillion into 32 banks
  • Of which, ¥7.2 trillion recovered

○ Revised Deposit Insurance Act (April 2001) in response to financial crisis
  • Injection of ¥2.0 trillion into Resona Bank (June 2003)
  • Of which, ¥2.7 billion recovered

○ Special Measures Act Concerning the Promotion of the Organizational Restructuring of Financial and Related Institutions (January 2003)
  • Injection of ¥6.0 billion into the Kanto Tsukuba Bank

○ Financial Functions Strengthening Act (August 2004)
  • Injection of ¥40.5 billion into two regional banks
## Trends in Ratings For Major Banks (Moody’s)

<table>
<thead>
<tr>
<th>Year</th>
<th>Dai-ichi Kangyo Bank</th>
<th>Fuji Bank</th>
<th>The Mitsubishi Bank</th>
<th>Sumitomo Bank</th>
<th>Industrial bank</th>
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<td>1997</td>
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</table>

**Aaa:** offers exceptional financial security.

**Aa:** offers excellent financial security – can be considered in the upper-level of mid-range rating

**A:** offers good financial security – indicates speculative elements.

**Ba:** offers poor financial security – indicates a lack of appropriate investment conditions

**Ba:** offers very poor financial security, considered a speculative investment

**Baa:** offers poor financial security

**B:** is the lowest rated class, offers extremely poor prospects of ever offering financial security.

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**Deposit ratings (long term) for the end of each fiscal year**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Rating</th>
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<td>The Mitsubishi Bank</td>
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<td>Sumitomo Bank</td>
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</table>

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**Languages:**

- **English**
- **Japanese**

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**Symbols:**

- **Aaa:** offers exceptional financial security.
- **Aa:** offers excellent financial security.
- **A:** offers good financial security.
- **Ba:** offers poor financial security.
- **Baa:** offers very poor financial security.
- **B:** is the lowest rated class, offers extremely poor prospects of ever offering financial security.
# Trends in Ratings For Major Banks (Moody’s)

<table>
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1. **Bank of Tokyo-Mitsubishi**
   - **Resona Bank**
   - **Sumitomo Mitsui Banking Corporation**
   - **Mizuho Bank**
   - **Mitsubishi UFJ Trust Bank**

2. **Mizuho Bank**
   - **Mitsubishi UFJ Trust Bank**
   - **Sumitomo Mitsui Banking Corporation**
   - **Mitsubishi Trust and Banking**
   - **Resona Trust & Banking Co., Ltd.**

3. **Sanwa Bank**
   - **Dai-ichi Kangyo Bank**
   - **Industrial Bank**
   - **Sakura Bank**
   - **Sumitomo Bank**

4. **Dai-ichi Kangyo Bank**
   - **Industrial Bank**
   - **Sakura Bank**
   - **Sumitomo Bank**
   - **Tokai Bank**

5. **Sakura Bank**
   - **Dai-ichi Kangyo Bank**
   - **Industrial Bank**
   - **Sakura Bank**
   - **Sumitomo Bank**

6. **Mitsui Trust and Banking**
   - **Yasuda Trust and Banking**
   - **Daiwa Bank**
   - **The Long-term Credit Bank of Japan**
   - **The Nippon Credit Bank, Ltd.**

7. **Daiwa Bank**
   - **Central Trust and Banking**
   - **The Chuo Credit Union**
   - **Resona Bank**
   - **Saitama Resona Bank**

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**Key Notes:****

- **Aaa**: Highest rating, indicates strong capacity to fulfill financial obligations.
- **A1**: Lower than Aaa, still strong but with some risk.
- **A2**: Lower than A1, still good but with more risk.
- **A3**: Lower than A2, still good but with significant risk.
- **Baa1**: Lower than A3, still good but with high risk.
- **Baa2**: Lower than Baa1, high risk.
- **Baa3**: Lower than Baa2, very high risk.
Special Inspections (period ending March 2002)

Special inspections:

- Based on the 2001 Front-Loaded Reform Program, debtors with significantly fluctuating market evaluations were inspected for the purpose of establishing timely and appropriate allocation of debtor status reflecting their company performance and other market signals, and also that provided for depreciation and reserve funds

⇒ Inspection and verification of ¥12.9 trillion in credit for 149 debtors

【Summary or results】

<table>
<thead>
<tr>
<th>Debit Status</th>
<th>Period ending September 2001</th>
<th>Period ending March 2002</th>
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<td>Number of Debtors</td>
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</tr>
<tr>
<td>Significant Bankruptcy Risk and Below</td>
<td>34</td>
<td>3.7</td>
</tr>
</tbody>
</table>

- 71 debtor companies – or approximately half and equivalent to ¥7.5 trillion – had their debtor status downgraded, among which 34 companies equivalent to ¥3.7 trillion were downgraded to “significant bankruptcy risk and below”

- as a result of the special inspections, loss on disposal of non-performing loans increased ¥1.9 trillion
# Financial Reconstruction Program

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**Financial Reconstruction Program**

— Economic Reconstruction Through Solving the Major Banks’ Non-Performing Loan Problem —

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

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### 1. A New Framework for the Financial System

1. Constructing a reliable financial system
   - Financial administration for the benefit of 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 medium-to-small businesses 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

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### 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.

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
   - Enhancing the securitization function

4. A new framework for the reconstruction of business and industry

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### 3. A New Framework for Financial Administration

1. 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

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.

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* 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

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**Basic philosophy**

Restoring trust in the Japanese financial system and financial administration, realizing financial markets highly regarded around the world

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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

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Early implementation (targeting November of the current year to create and announce an action timetable)
Financial Reconstruction Program (October 30, 2002)
By 2004, the ratio of nonperforming loans at major banks was reduced by half (period ending March 2002, 8.4%), and efforts to normalize the problem were continued.

(Note) Numbers are based on those published in disclosure for the Financial Reconstruction Act.