RECENT BANKING SECTOR REFORMS IN JAPAN :

AN ASSESSMENT*

by

Maximilian J.B. Hall

Professor of Banking and Financial Regulation
Department of Economics
Loughborough University

June 2004

*The financial support of the British Academy, the Japan Society for the Promotion of Science and the Anglo-Japanese Daiwa Foundation is gratefully acknowledged, as is the co-operation of officers from the FSA, BoJ, DIC, RCC, IRCJ and Moody's Japan.

ABSTRACT

There is widespread agreement that a two-pronged attack, embracing both micro- and macro-economic reform, is necessary to turn around the fortunes of the Japanese economy. This paper focuses on the former set of initiatives adopted by the authorities in Japan, concentrating on those banking sector reforms implemented since around the year 2000 when the reform programme appeared to enjoy renewed impetus.

The paper begins by reviewing the main problems still besetting the Japanese banking industry and responsible for its continued fragility, as exemplified by low profitability, both in absolute terms and relative to G7 competitors, weak capitalisation, poor asset quality and excessive credit and market (stock and bond) risk exposure. The main reform initiatives are then identified. These embrace: the creation of a new financial architecture governing the regulation and supervision of banks, with the newly-formed Financial Services Agency featuring as its operational epi-centre; the reform of safety net arrangements, and most especially those concerned with deposit insurance; the authorities' attempts to speed up the banks' resolution of their non-performing loan problems; the Bank of Japan's share-buying activities; the authorities' quest for the right to engage in "pre-emptive" capital injections; and recent improvements in corporate governance arrangements. The latter part of the paper represents a personal assessment of these reform initiatives, from an efficiency/cost-effectiveness standpoint, and includes recommendations for further change.

1. INTRODUCTION

Since the bursting of the asset price bubble in Japan in the late-1980s/early-1990s, both the Japanese economy and Japan's banking system have languished under the burdens created by a weak macro-economy, weak domestic property and stock markets, excess capacity, an over-indebted corporate sector and, more recently, a severe bout of deflation. In addition, policy "failures", on both the monetary and prudential front, have all too often served to exacerbate the problems and delay the recovery. This paper is concerned with an analysis of the "micro" (rather than "macro") reforms adopted in respect of the Japanese banking industry as part of the authorities' overall strategy for reinvigorating the Japanese economy, concentrating on the post-1999 period. [Studies of earlier reforms can be found in Hall, 1998a, 1998b, 1999a, 1999c and 2003a.]

Following a brief review, in Section 2, of the structure of the Japanese banking industry and recent developments therein, the nature of the continuing fragility facing the sector is identified in Section 3. This highlights the very low profitability achieved by Japanese banks, the extent of the weakness in their capital positions (especially if a more rigorous interpretation of Basel I is adopted), the worrying scale of their continuing exposures to credit and market (stock and bond) risk and the asset quality problems still facing the banks. Section 4 then explains the recent reform initiatives adopted by the Japanese authorities to address some of the problems identified earlier, ranging from wholesale reform of the governing regulatory/supervisory institutional landscape to more focussed measures relating to attempts to reduce banks' exposure to the stock market, speed up their resolution of NPLs and improve the cost-effectiveness of the supervisory regime more generally. The following section, Section 5, comprises a personal evaluation from an efficiency/cost-effectiveness standpoint, of the likely impact of the reform measures adopted, building on the earlier work carried out by the IMF in its 'Financial System Stability Assessment' of August 2003 (IMF, 2003). Proposals for further reform are duly presented in the final section, Section 7, following the provision of a summary of the paper's findings and conclusions reached in the penultimate section.

2. THE JAPANESE BANKING SECTOR : STRUCTURE AND RECENT DEVELOPMENTS

2.1 Classification of Depository Institutions

Apart from the public sector-owned postal network – "Japan Post" – the biggest deposit-taking organisation in the world, a number of privately-owned depository institutions operate in Japan. These are separated into banks proper and cooperative type institutions – *see* Table 2.1. The banking group comprises 'City Banks', 'Regional Banks', 'Second Association Regional Banks', foreign banks, 'Long-Term Credit Banks', 'Trust Banks' and 'other' banks; whilst the cooperative grouping includes, *inter alia*, 'Shinkin Banks', 'Credit Cooperatives', 'Agricultural Cooperatives', 'Fishery Cooperatives' and their National Federations.[1]

Within the bank grouping, institutions are further sub-divided into 'Ordinary Banks' and 'Specialised Long-Term Financial Institutions', although recent financial liberalisation (*see* below) has served to erode somewhat the strict traditional business demarcations. All ordinary banks operate in accordance with the Banking Law of 1981 (as subsequently amended by the 1992 and 1998 revisions) and under license from the Financial Services Agency (FSA). Although their primary focus is on the provision of short-term financing facilities, especially in the form of deposits, loans and funds transfer, they are also engaged today in medium- and long-term finance with both corporations (of all sizes) and individuals. Many are also substantial operators in international markets, although, since the bursting of the asset bubble in the late eighties, overseas operations have been scaled back by the majority.

The first group of ordinary banks, the *City Banks*, are typically large-scale operators in both domestic and international markets, with nationwide branch networks at home and their headquarters sited in the major cities. Traditionally, they have been the major suppliers of short-term finance to large corporations but, with the development of securities markets in Japan (Hall, 1998a, Chapter 3), have been forced to court SMEs and retail customers more actively. Liberalisation (*see* below) has also allowed them to diversify more widely into securities and insurance business; and the growth in derivatives activities in Japan has provided further business opportunities in the last few years.

The *Regional Banks* constitute the second grouping of ordinary banks. They can be distinguished from the City Bank grouping by virtue of their smaller scale of activity and greater geographical concentration of business, typically focussing their operations on SMEs and individuals residing in the prefecture within which they are headquartered. As a group, they are also major providers of funds to the call and bill money markets (Hall, *ibid.*).

The third group of ordinary banks, the *Second Association Regional Banks*, are also distinguished by the strength of their regional ties and the degree of geographical concentration of their business activities. The main difference with the regional banks lies in their reduced scale of activities and this is due, in part, to the fact that the majority are converted *mutual banks* which ceased to exist as a distinct class of bank in 1993.

The fourth and final grouping of banks classified as ordinary banks are the *foreign banks*. Traditionally focussed on foreign trade financing and foreign currency transactions, liberalisation has forced them to look elsewhere for their salvation, leading them to develop off-balance-sheet trading activities and to diversify into risk management, advisory services and derivatives operations.

As for the 'Specialised Financial Institution' category of bank, the *Long-Term Credit Banks* and the *Trust Banks* jointly make up the so-called 'Long-Term Financial Institutions'. These are distinct from the other specialist depository institutions, the cooperatives, which are all non-profit-making organisations. The Long-Term Credit Banks, of which there are now only two following the Industrial Bank of Japan's decision to become part of Mizuho Holdings in September 2000 (*see* below), operate in accordance with the Long-Term Credit Bank Law of 1952. They were originally established to clearly differentiate the provision of short-term from long-term finance and to lighten the ordinary banks' burden in respect of the supply of long-term financing. Their funding activities are also distinguishable from those of ordinary banks by virtue of their greater ability to issue debentures (liberalisation has, however, reduced this comparative advantage) and the restrictions imposed on their deposit-taking – they can only accept deposits from their borrowers and the purchasers of their debentures. The other group of specialist long-term financial institution, the *trust banks*, comprises institutions which are allowed to concurrently engage in ordinary banking and trust banking. The initial governing legislation was provided by the 'Law Concerning the Joint Operation of Ordinary Banks, Savings Bank Business and Trust Business' of 1943, but this was subsequently revised in 1981 and, more recently, in 1992 under the 'Financial System Reform Law' (*see* below). The last piece of legislation has led to a dramatic growth in the number of trust banks operating in Japan (there were only 16 in existence in 1990) as newly-established entities now operate alongside those set up prior to 1960 and the nine locally-incorporated foreign bank subsidiaries approved in 1985.

2.2 Recent Consolidation Amongst the Major Banks

In a bid to cut costs and improve operating efficiency, a wave of consolidation has swept across the City Bank sector of the banking industry. This has resulted in their numbers falling from 13 in 1990 to just 7[2], with 5[3] major banking groups now dominating the banking scene in Japan – *see* Table 2.2. These groups typically include both a city bank and a trust bank and, in the case of Resona Holdings, regional banks also.

Nor have the other sub-sectors escaped the chill winds of changes. For example, although the number of regional banks in existence has remained constant since 1991 – notwithstanding the nationalisation of the Ashikaga Bank in December 2003[4] - the number of Second Association Regional Banks contracted sharply from 68 to 53 over the same period as a result of mergers. And, despite the deregulation - induced growth in trust bank numbers noted earlier, several mergers have also occurred in this sector.[5]

2.3 Challenges Facing Japanese Banks

Since the bursting of the asset price bubble in the late-1980s, the Japanese banks have faced a number of serious problems. These comprise, *inter alia* (Hall, 1999a; IMF, 2003): weakness in the domestic economy,[6] reversal of which is hampered by the limited remaining scope for manoeuvre available to the government given that nominal interest rates have been held at around zero per cent for a number of years now and the public finances are at crisis point (Hall, 2003b); continuing weakness in the domestic property market (both commercial and residential); weakness in the Japanese stock market;[7] continuing excess capacity in the banking sector (despite some exit); low profitability; and persistent deflation,[8] which exacerbates the corporate sector's ability to service its debts and raises the government's real debt burden. And to this list must be added the internal management failings which have allowed the industry to be brought to its knees, the flawed corporate governance arrangements which have contributed to the banks' malaise, and the inadequate external oversight exercised by the supervisory authorities (Hall, 2003a).

Notwithstanding these long-standing problems, however, there are tentative signs that the banks' fortunes may be improving, in part due to the opportunities presented by the programme of "liberalisation and deregulation" instituted since the 1980s (Hall, 1998a, Chapter 4).[9] This was evident from the release of the banks' interim results for the period to end-September 2003 which showed that the big four[10] banking groups had each returned to the black, reporting positive net profits for the first time in three years. The turnaround, which saw the major banks' combined net income rise to ¥921 billion from a net loss of ¥16 billion a year earlier, was mainly due to the stock market rally noted earlier and the economic recovery, which led to a drop in non-performing loans (NPLs)[11] (though, in part, this was due to debt forgiveness) and lower "credit costs". Despite the evident improvement, however, which led each of the 'big 4' to forecast full year profits for fiscal 2003,[12,13] things remain bleak: core profitability remains weak; no significant expansion in lending margins was achieved; the demand for loans remains sluggish (bank lending has fallen for seven consecutive years); gross fee and commission income[14] remains at around 17 per cent of operating income, compared with figures of around 30 per cent for US banks; NPLs still average around 6.5 per cent of total loans for the big banks; no generalised recovery in land prices is in sight; the corporate sector remains in a precarious financial position; when deferred tax assets are stripped out, most, if not all, banks are exposed to be seriously under-capitalised; and most banks are still believed to be under-provisioned and overstating the value of the collateral backing their loans, thereby inflating stated profitability. It will therefore be some time yet before the Japanese banking industry becomes rehabilitated, ready to face once again the competition in today's global banking industry.

3. CONTINUING FRAGILITY IN THE JAPANESE BANKING SECTOR

Despite substantial narrowing of the "Japan premium" since the crisis of Autumn 1997, when a number of important financial institutions collapsed and investor panic set in (*see* Hall, 1998a), the Japanese banking sector today is still inherently fragile. This is evident from the relatively-poor "financial strength" ratings accorded the Japanese banks by external credit rating agencies (*see* Table 3.1) and is due to low profitability, a weak capital base, poor asset quality, excessive exposure to the stock market and significant exposure to credit and other market risks. Each of these issues will now be addressed in turn.

3.1 Profitability

With respect to the profitability of Japanese banks, recent trends are exhibited in Tables 3.2 (which traces the trend in net profits (measured in ¥trillion), and its constituent components, from 1990 to 2003) and Table 3.3 (which looks at movements in the major indicators of profitability over the more recent period of 1998 to 2003, expressing the date in percentage terms). [For a more detailed study *see* Oyama and Shiratori, 2001.] The evidence is clear: profitability is very low, both in absolute terms (indeed, substantial net *losses* were recorded in fiscal 2001 and 2002 and in earlier years – *see* Table 3.2) and relative to other G7 countries (only the absolute pre-tax RoE and RoA figures are, however, given in Table 3.3; for a comparison with other G7 countries *see* IMF, 2003, p.14); interest income, currently around 60 per cent of gross income, remains the main source of income, although fee and trading income has more than doubled (to nearly 17 per cent of total income) since 1998; profitability is heavily influenced by movements in the local stock market (*see* the correlation between net profit and realised capital gains on Table 3.2); spreads remain low (for a comparison with the US and Germany *see* Bank of Japan, 2003) and have hardly changed in recent years (*see* Table 3.3) in spite of deregulation, the pressure to raise spreads in order to cover rising loan losses and a move into higher margin credit card business; and the growth in NPLs since 1994, through its impact on loan losses, has caused operating profit to be negative since 1993 (*see* Table 3.2). This low level of profitability is, in turn, due to the weakness of the domestic economy and the corporate sector, the collapse in asset values since the bursting of the bubble in 1989/90, the continuing excess capacity in the financial services sector, the competition faced from "subsidised" public sector institutions and weaknesses in corporate governance, which result in an eschewal of the profit-maximising goal. And, in respect of those banks which received capital injections during 1998/99 (*see* Tables A3 and A4 in the Appendix), adherence to the SME lending targets they were obliged to adopt is unlikely to have done much to further their cause. Although all the major banking groups (other than Resona) announced positive net profits at the interim reporting stage for end-September 2003 – combined net income came in at ¥921 billion – and are forecasting significant profits for fiscal 2003 as a whole (*see* endnote 13 for the realised figures), it will be some time before they catch up with their G10 counterparts. Nevertheless, looking on the positive side, the interim results, which were heavily influenced by the recovery in the local stock market, did demonstrate the banks' success in reducing their NPL ratios, their exposure to the stock market[15] and their reliance on deferred tax assets as a source of capital (*see* below) - trends confirmed with the publication of the full year's results for fiscal 2003. Moreover, there was some evidence of an expansion of fee income as a proportion of total income.

3.2 Capital Adequacy

As demonstrated in Table 3.4, which provides data for the overall and Tier 1 adjusted ratios posted by Japanese banks during the period 1998-2003, all groups of banks have consistently met the minimum standards laid down by bank regulators, namely a minimum risk asset ratio of 8 per cent (and a minimum Tier 1 ratio of 4 per cent) for internationally-active banks and a 4 per cent (almost Tier 1) ratio for domestic-only operators. This, however, masks a number of serious problems, as revealed in Table 3.5. Firstly, deferred tax assets (DTAs), which are credits arising from accumulated loan losses, against taxes levied on taxable income over the next five years, are exceedingly high, accounting for ¥10.6 trillion (or 43 per cent) of reported aggregate core capital at end-March 2003. [For the major banks, DTAs as a proportion of Tier 1 capital, increased from 42 per cent to 55 per cent during fiscal 2002, mainly due to a large decline in Tier 1 capital.] Given this form of capital is not available in a liquidation and hence does not satisfy the main characteristic of prime quality capital, namely the availability to absorb losses in all prospective circumstances, it should, arguably, be deducted from regulatory capital, or at least limited further (i.e. beyond the current 40 per cent of estimated taxable income over the next five years), as in the US – *see* below.

Secondly, the historical dependence of the banks' net capital on movements in the local stock market – under BIS rules, 45 per cent of the latest gains on securities holdings are eligible for inclusion in Tier 2 capital – is depicted in Table 3.5, showing the damage wrought by the collapse in stock prices in Japan since 1989/90.

Thirdly, the steady decline in core capital is also evident, the result of poor profitability (which reduces retained earnings) and the inability to issue common stock (at a reasonable price) because of the declining value of a bank franchise.

Fourthly, it is also clear from Table 3.5 that a significant amount (i.e. ¥7.3 trillion or 29 per cent of the total) of core capital is still owned by the government, the product of the DIC capital injections of 1998/9; this has yet to be repaid.

Fifthly, as noted by the IMF (IMF, 2003), the provisions held against loans needing "attention" and "special attention" (i.e. "Category II" loans) are, in reality, specific provisions as they are held against the impairment of identified assets. Accordingly, they should not be treated as general provisions and should, instead, be fully deducted from capital.

Sixthly, a strict interpretation of the BIS rules would require full deduction of commercial institutions' cross-shareholdings; as banks routinely issue preferred securities and subordinated debt to affiliates and other financial institutions (especially life companies)[16] a portion at least of such reciprocal cross-shareholdings, should be deducted from capital to avoid the illusion of financial strength generated by such "double gearing".

Finally, to the extent that banks still hide losses, mis-classify their NPLs,[17] and hence under-provision,[18] and exacerbate the value of their loan collateral,[19] both profitability and capital adequacy are likely to be further over-stated. Taking these and other factors[20] into account would cause most banks to breach the minimum capital requirements.

3.3 Asset Quality and the Banks' NPL Problems

Despite many years of grappling with their bad debt problems – between fiscal 1992 and fiscal 2001, for example, the banking industry incurred ¥82 trillion of "losses" on its disposal of bad debts, including making direct write-offs of ¥35 trillion and transfers to allowances for loan losses of ¥41 trillion – the Japanese banking industry still faces a huge burden to overcome. The latest official figures available reveal that, for the banking sector as a whole, "bad" loans, when defined as "risk management loans" [which comprise "non-performing loans" (i.e. loans to borrowers in legal bankruptcy plus past due loans in arrears by three months or more) plus "restructured loans" (*see* Hall, 2000, p.80, for a full definition], amounted to ¥31.2 trillion at end-September 2003 – *see* Table 3.6. This represented 7.2 per cent of the banking sector's total loans. These figures compare with figures of ¥31.6 trillion and 6.8 per cent for the industry's "classified assets" – that is, loans classified as "bankrupt or *de facto* bankrupt", "doubtful" and "special attention" – posted for end-September 2003 under the "self assessment of asset quality" required by the Financial Reconstruction Law (*see* Table 3.7). For the deposit-taking sector as a whole (i.e. including credit co-operations), the figure for bad loans (using the first definition) was ¥45.7 trillion at end-March 2003 (*see* Table 3.8), the latest date for which figures are available.

As demonstrated in Tables 3.8 to 3.10, however, a new downwards trend in reported bad loans, under both definitions, appears to have started in March 2002, with the major banks' NPL ratio being down to 6.39 per cent by end-September 2003 (*see* Table 3.7). This suggests the major banks are on track to meet the authorities' "target" of halving their NPL ratios between end-March 2002 and end-March 2005 (*see* below), although, to the extent that it has been achieved through debt forgiveness, the drive to revitalise the economy through removal of "zombie" companies will have been slowed.

3.4 Risk Exposures

Given the relatively-weak capital positions of most banks, it is of major concern that their risk exposures remain so high. In particular, market risks, arising from exposure to stock and government bond markets, and credit risks are significant. In connection with exposure to the stock market, banks, under pressure from the authorities (*see* below), have markedly reduced their exposures – major banks, for example, cut their holdings by ¥9.7 trillion during fiscal 2002, to ¥14.8 trillion, roughly equivalent to their combined Tier 1 capital – but, given the volatility of stock prices, further reductions are necessary to ensure a more efficient use of capital (Bank of Japan, 2003). And, as shown in the previous section, credit risks are still very high, and the deterioration in asset quality may not yet be fully reflected in banks' financial statements, despite the best endeavours of the FSA.

In the light of the above, the IMF (IMF, 2003) decided to carry out a number of stress tests to see how vulnerable Japanese banks are to a variety of eminently possible "shocks". Following the Japanese authorities' refusal to share supervisory data, the IMF used the published accounts of a sample of banks relating to their end-March 2002 and 2003 reports. For the first set of tests, the sample covered 7 city, 21 regional and 2 credit cooperative central banks, which represented 56 per cent of total banking sector assets. Three stress scenarios were examined: a market risk stress shock based on a 20 per cent decline in equity prices; another market risk stress shock based on a 100 basis points (i.e. a one percentage point) increase in yields; and a credit risk stress shock based on a 3 per cent loss on the book value of the banks' loan portfolios. In each case, the banks' loss-bearing capacities are measured according to their ability to absorb losses against shareholder equity value, measured both gross and net of DTAs.

The group average stress test results are presented in Table 3.11. They demonstrate that each single market stress event consumes a significant portion of risk-bearing capacity for each group. The equity stress event, for example, would erode city banks' shareholders' equity by 37 per cent if DTAs are included and by 102 per cent if they are excluded. For the regional banks the figures are somewhat better, coming in at 11 and 15 per cent respectively. The cooperative central banks prove least affected, recording figures of 3 per cent and 3 per cent respectively. Contrariwise, the cooperative central banks are shown to be most exposed to interest rate risk (recording figures of 49 per cent and 51 per cent respectively), compared with figures for the city banks of 17 per cent (43 per cent) and 16 per cent (22 per cent) respectively. If the market risk stress events are combined, the regional banks fare best (*see* IMF, Box 4, p.20).

As far as credit risk is concerned, the city banks are again shown to be the most exposed, with a 3 per cent credit loss destroying 54 per cent (140 per cent if DTAs are excluded) of shareholders' equity. The other groups, however, are not much better off, the regionals recording figures of 41 per cent and 63 per cent, and the cooperative central banks 38 per cent and 39 per cent.

Using the same sample and methodology (*see* IMF, 2003, Appendix III, pp.83-4) for the banks' end-March 2003 results, the risk-bearing capacities of both the city bank and cooperative central bank groupings are shown to have been further eroded – *see* Table

3.12. In the case of the former grouping, the reduction in potential losses arising from lower equity prices was more than offset by a decline in shareholders' equity, thereby increasing equity risk [44 per cent of shareholders' equity, excluding DTAs, would be destroyed]. And a rebalancing of their portfolios away from equities and in favour of government bonds increased interest rate risk (a 33 per cent reduction in shareholders' equity would result, 98 per cent if DTAs are excluded). For the cooperative central bank grouping, although exposure to equity risk remained static, a big jump (to 72 per cent and 76 per cent respectively) in exposure to interest rate risk was evident. Finally, for the regional bank grouping, the results were mixed. Whilst equity risk exposure declined slightly, interest rate risk and credit risks increased.

These results duly led the IMF to conclude that the Japanese banking system is under-capitalised relative to the interest rate, equity price and credit risks in the system, and all the more so if DTAs are excluded from shareholders' equity, as they recommend. Accordingly, they argued for an urgent recapitalisation of the banking sector, using public funds where necessary – *see* below. While the recovery in share prices since March 2003 will act to boost bank profits and capital, and hence reduce equity risk, the fall in government bond prices will serve to pull in the other direction. Moreover, the acceleration in the disposal of the banks' NPLs will, in the short term, further damage profitability by raising credit costs, although asset quality should have improved.

4. RECENT BANKING SECTOR REFORMS

4.1 Reform of the Regulatory and Supervisory Framework

As explained in Hall (2003a), the institutional framework governing the regulation and supervision of financial institutions in Japan has evolved since 1998 from one dominated by the Ministry of Finance (MoF) to the current one dominated by the Financial Services Authority (FSA). The other main agencies involved, in respect of banking regulation and supervision, are the DIC and the BoJ – *see* Tables 4.1 and 4.2 for a summary of their main roles and an outline of how they interact respectively.

4.2 Reform of the Safety Net Arrangements

The current safety net arrangements operating in Japan embrace the traditional lender of last resort role exercised by the central bank (as outlined in Articles 1 and 2 of the Bank of Japan Law of 1997), deposit insurance arrangements, which cater for both 'normal' and 'financial crisis' situations, and prudential regulation and supervision, as predominantly exercised by the FSA (although the BoJ retains the right to inspect institutions who hold current accounts with it). Recent reforms in the last two areas – little has changed in respect of the lender of last resort function – will now be examined.

4.2.1 Deposit Insurance Reform

As noted in Appendix 1, which provides a more detailed review of the deposit insurance arrangements currently operating in Japan, recent reforms (i.e. post-2000 – for a discussion of reforms prior to this *see* Hall, 1999c and 2003a) have centred on the following: amendment to the schedule for removal of the blanket guarantee given to depositors; introduction, in 2003, of the "Special Measures Law for the Promotion of Organizational Restructuring"; the introduction of on-site inspections by the Deposit Insurance Corporation of Japan (DICJ); and the establishment, in April 2003, of a new body – the Industrial Revitalization Corporation of Japan (IRCJ) – to help revitalise the business of ailing corporations and further assist the banks in their disposal of NPLs.[21] As for the DICJ's continuing operations, it was the bailout of Resona Bank in May 2003 and the nationalisation of Ashikaga Bank in November 2003 which attracted the limelight – *see* below.

4.2.2 Prudential Regulation and Supervision of Banks

A number of developments in the FSA's inspection and supervision regime occurred during the period July 2002 and June 2004 (for a consideration of the BoJ's activities in this area *see* BoJ, 2003b). For the FSA's "Program Year" for 2003, which ran from 1 July 2002 until 30 June 2003, the emphasis was on an intensification in inspection of the major banking groups. This involved: (i) re-organising inspection units so that a single unit was responsible for year-round supervision of each major banking group; (ii) forcing banks to make more realistic valuations of their assets (consistent with the "Program for Financial Revival" – *see* below – this was done through routine and special inspections and the disclosure of the gap between major banks' self-assessments and the FSA's assessment, on an aggregated basis); (iii) intensive examination, by a special team established in December 2002, of the appropriateness and progress of the reconstruction plans adopted by the major banks' debtors; (iv) introduction and monitoring of the banks' use of the "Discounted Cash Flow" (DCF) method for determining provisions; (v) harmonisation of the borrower classification of large debtors with loans from more than two banks;

(vi) inspections (during April and June 2003) checking for compliance with guidelines relating to increases in capital; (vii) ensuring that the banks classify their credits to SMEs correctly; (viii) establishing special teams (in July 2002) to carry out inspections relating to market risk and systems (i.e. computer) risk; and (ix) introducing an inspection manual for Financial Holding Companies (July 2003).

The FSA's inspection priorities for the Program Year 2003 (i.e. lasting from 1 July 2003 to 30 June 2004) largely represented a continuation of initiatives adopted in the previous Program Year. Accordingly, the measures adopted under the Program for Financial Revival aimed at improving the accuracy of the major banks' classification of assets, and hence provisioning, were carried forward, with a closer look now also being taken at the value of banks' DTAs and their internal audit functions and risk management systems. Additionally, however, the FSA undertook measures to ensure that banks treat their corporate borrowers properly and, more generally, adequately protect the interests of the consumers of their products and enhance the convenience of users. Finally, the FSA began inspections, for the first time, of government financial agencies and the postal agency.

In all, inspections of 830 financial institutions are planned for this Program Year, compared with 832 carried out last year, excluding inspection of the postal agency and four other public sector financial agencies. And, in terms of the banks, full-scope, risk-based on-site inspection of major banks will take place every year, with regionals being similarly inspected every two years.

4.3 The Authorities' Attempts to Speed up the Banks' Resolution of their NPL Problems

Under the 'Emergency Economic Package' of April 2001 the government announced plans to force banks to write off their existing bad debts by end-2003 and any new bank debts which surfaced within three years of their emergence (FSA, 2001). Although this commitment eventually related only to the resolution of the major banks' non-performing loans (NPLs) which had been classified as "in danger of bankruptcy" or worse, most commentators assumed that it extended to all banks and to all of their NPLs. The Government's resolve to deal with the NPL problem was reaffirmed in April 2002 when it tightened the initial requirement that any post-March 2001 bad loans be written off within three years of their emergence by requiring that banks dispose of half of any new bad loans within one year of their classification and 80 per cent within two years (FSA, 2002c). Subsequent to this, the Prime Minister reconfirmed his desire to "completely resolve the non-performing loan problem by 2004" on 30 September 2002 (FSA, 2002b), although the FSA has since said – *see* below – it is trying to halve the NPL ratios of the major banks by end-March 2005.

An early move (June 2001) taken by the government to assist in the prompt disposal of banks' NPLs was to extend the deadline for RCC purchases of NPLs from sound institutions to the end of March 2005 under an amendment to the Financial Revitalization Law. At the same time, it was agreed that the RCC's remit would be further extended in coming months. Accordingly, in August 2001, the RCC was authorised to conduct trust business, enabling it to subscribe non-performing loans via the trust method, after setting up a Trust Business Department. Then, in November 2001, it set up a Corporate Revival Department to engage in corporate restructuring of those debtors for whom such reorganisation was possible. [The services of the Development Bank of Japan and the Japan Bank for International Cooperation were later used and, by end-March 2004, 417 debtors had been assisted by the RCC in this way.] And then, in March 2002, it set up an Asset Purchase Promotion Department to enhance and strengthen the organisation and functions involved in the purchase of NPLs from sound institutions and others.

To accelerate the banks' rate of disposal of its NPLs the FSA announced, in September 2001, a new "three pillared" scheme to tackle the banks' bad debts.[22] This would involve: more rigorous and continuous (previously biennial) inspection of major banks' books by the FSA; requiring the banks to set aside higher provisions against bad debts to large corporate borrowers; and encouraging the banks to sell their doubtful loans to the RCC. A bill allowing the RCC to buy a broader[23] range of bad debts at "market prices" from the banks was subsequently approved in October 2001. The assets, however, must be disposed of within three years of the date of purchase.

With respect to the new inspection regime, "special inspections" of the major banks' loans to large troubled[24] corporates began in October 2001[25] and lasted through until April 2002. The outcome of the inspections (*see* FSA, 2002c) was that, of the 149 problem borrowers reviewed, 71 were downrated, with 34 of these being classified as "in danger of bankruptcy". This meant that, of the total amount of credits involved of ¥12.9 trillion, ¥7.5 trillion had to be downrated, ¥3.7 trillion of which moved to the lowest loan status, necessitating provisions of around 70 per cent of their value.

A second round of special inspections, again relating to the (11) major banks' loans to large troubled corporates, ended in March 2003. It covered the fiscal year ending March

2003 and, using discounted cash flow techniques[26] for the first time in the assessment of the adequacy of provisions, found that, of the 167 problem borrowers reviewed (including 25 new names but excluding 46 of those covered in previous special inspections) and covering ¥14.4 trillion of credit, 27 (including eight of the new names) required downgrading with respect of the classifications made in the interim reports of end-September 2002, involving ¥2.4 trillion (¥0.3 trillion) of credit (FSA, 2003). ¥1.0 trillion was reclassified as "in danger of bankruptcy" or worse. The findings meant that, for those banks affected, an additional ¥1.3 trillion of losses were incurred on their disposal of NPLs, embracing ¥0.8 trillion of write-offs and ¥0.5 trillion of additional provisions.

The third and final round of such special inspections began on 27 January 2004 and was completed on 23 April 2004. It covered the period ending at end-March 2004. As before, the inspections covered the 11 major banks and were designed to check the classifications used by the main banks in respect of large troubled corporate borrowers. The latest business conditions of the debtors were assessed using the DCF method, taking into account their reconstruction plans. The inspections duly found (FSA, 2004b) that, of the 133[27] problem borrowers reviewed, responsible for ¥10.5 trillion of credit, 26 (including four of the new names) required downgrading, compared with the classifications made at end-September 2003, 22 of which were reclassified as "in danger of bankruptcy" or worse. These downgradings covered total amounts of credit of ¥2.2 trillion and ¥1.8 respectively. Taking account of the upgradings given (to 23 borrowers), the results meant that additional losses arising from the disposal of NPLs amounting to ¥0.44 trillion were borne by those banks affected, comprising additional write-offs of ¥0.4 trillion and additional provisions for loan losses of ¥0.04 trillion.

The results suggested that, at least for the major banks (excluding Resona) and in respect of their loans to large troubled corporates, the banks' loan classifications (and hence provisions) were becoming more realistic and converging with the FSA's own estimates, although subsequent events at UFJ (*see* below) suggest this conclusion may be premature.

Added impetus to the speedy resolution of the banks' NPL problem was provided in October 2002 with the government's announcement of a "Program for Financial Revival". This represented the outcome of deliberations by a taskforce set up earlier by the Economics Minister to consider how best to resolve the banks' continuing bad debt problems. Following fierce opposition from politicians, bureaucrats and bankers alike, however, the delayed report was short on specifics and clearly not as radical as Mr Takenaka had originally intended. Forced to apologise earlier to the Diet for misleading statements concerning his personal belief that no company or financial concern should be "too-big-to-fail", the watering-down of his draft proposals was a further sign that the reforming zeal of the Koizumi administration was on the wane.

The package of proposals that duly emerged, in an attempt to revitalise the Japanese economy, comprised, *inter alia*, the following:[28]

(i) the government would work together with the BoJ[29] to try to halve the bad loan ratios of the big banks by end-March 2005 (compared with end-March 2002);

(ii) the government would consider the possibility of establishing a new system for the prompt infusion of state capital into under-capitalised banks (the so-called "pre-emptive" capital injections – *see* below);

(iii) the government would act to ensure a tightening of the assessment of bank asset quality, possibly involving the use of DCF techniques[30] in the assessment of the adequacy of provisions;[31]

(iv) the government would adopt stricter criteria concerning the banks' use of deferred tax assets within regulatory capital, although no limits or timetables[32] for implementation of a stricter approach were mentioned (Mr Takenaka had originally suggested that a 10 per cent limit should be imposed at end-March 2003);[33]

(v) as a means of enhancing bank performance, the government would consider converting the bank preference shares that it already owns, because of previous bailouts (*see* Appendix 1), into common stock, thereby triggering (partial) nationalisation for institutions whose operations had "seriously deteriorated"; and

(vi) the government would establish a new body, to operate alongside the RCC, to rehabilitate troubled companies whose future prospects appeared bright. [As noted above, the new body became known as the Industrial Revitalization Cooporation of Japan (IRCJ) and began operations in May 2004.]

Although the effect of the publication of the "Takenaka Plan", as it became known, was to reduce the immediate threats of widescale bank nationalisation (and associated management changes) and an escalation in the extent of corporate restructuring and bankruptcy, the firming-up of the timescale for reform unveiled on 30 December 2002 served to keep up the pressure on recalcitrant bankers. A four-month deadline (i.e. until the end of fiscal 2002) was duly delivered to the banks for convincing the FSA that they were serious about promptly remedying their financial weaknesses; otherwise, nationalisation beckoned. It was also confirmed that: a decision on the possible use of discounted cash flow analysis in the assessment of borrowers' strength would be taken by the end of fiscal 2002; talks would begin in December 2002 on whether or not the rules governing the inclusion of DTAs within regulatory capital should be changed, and, if so, how; the FSA would decide within six months whether new rules are necessary to facilitate the injection of public funds into ailing banks under "non crisis" conditions; the FSA will embark on a further round of "special inspections" of banks' loan books in February 2003 (*see* above); outside auditors will be used to calculate banks' capital adequacy ratios; guidelines will be drawn up concerning the possible conversion of government-owned preference shares into ordinary shares;[34] the FSA is to reduce the time banks are allowed to improve their financial strength under "Prompt Corrective Action" procedures from three years to one year; and that a taskforce, headed by Mr Takenaka himself, will be set up within the FSA to monitor the banks' disposal of their NPLs.

In the light of the relentless official pressure to accelerate disposal of their NPLs and, as an alternative to using the RCC[35] and the ICRJ, many of the banks have moved to set up their own distressed debt work-out facilities to try and secure better prices for the sale of their debts. Mizuho, for example, joined forces with four major international investment banks – UBS, Morgan Stanley, Deutsche Bank and Merrill Lynch – plus a high-profile US private equity investment company, Cerberus, to help resolve up to ¥4.6 trillion of NPLs through the establishment of new companies into which NPLs will be injected. Similarly, SMFG has teamed up with Goldman Sachs to set up a fund which will eventually receive up to ¥1 billion of bad loans from SMFG. Resona has also agreed with Nomura, the country's largest stockbroker, the Development Bank of Japan and a number of international investment banks, to set up a corporate revival fund to accelerate efforts to clean up its bad loans. And finally, UFJ Bank announced, in May 2004, that it is to team up with Merrill Lynch to create a fund of up to ¥100 billion to purchase its loans to SMEs. UFJ will use the "Genesis Fund", in which it will hold a 30 per cent stake, together with another UFJ–Merrill Lynch joint firm founded earlier for business turnaround services (i.e. UFJ Strategic Partner Co.) to accelerate the disposal of its NPLs. UFJ hopes, through this and other routes, to cut NPLs to ¥2.3 trillion by end-March 2005.

4.4 Other Reform Initiatives

The BoJ's share-buying activities. In the light of the government's decision[36] of June 2001 to force banks and bank holding companies to limit the value of their holdings of equity to 100 per cent of Tier 1 capital by September 2004 (extended in July 2003 to September 2006), the BoJ announced in September 2002 that it would, for the first time, purchase shares outright from the banks. The economic rationale behind the move was to help stem the fall in share prices, and hence limit the appraisal losses banks would be forced to book at the end of the fiscal year, caused in part by the earlier plan to force the banks to divest a portion of their equity holdings.[37] The BoJ also made it clear that there was a wider political motive behind its actions namely, to try and shame the authorities into adopting a more aggressive approach towards the handling of the banks' NPL problem, a move which apparently worked, as noted above.

The BoJ's programme of share purchases subsequently began on 29 November 2002 and, by the 12 December 2002, the BoJ let it be known that ¥71.2 billion of such purchases had been made. By 20 February 2003, this figure had risen to ¥700 billion and, by end-March 2003, to ¥1.2 trillion (BoJ, 2003, p.33). It is envisaged that purchases of up to ¥3 trillion (¥2 trillion has been spent to date) in aggregate – with a maximum of ¥750 billion from individual banks – will be made under this facility and that the shares will be held by the BoJ until at least September 2007 (Bank of England, 2002, p.39).

By end-March 2003 four of the five major internationally-active banks had achieved the target limit of 100 per cent of Tier 1 capital with the other, Mizuho, lagging behind by only 7 per cent.

Pre-emptive capital injections. As foreshadowed in the "Program for Financial Revival", a bill concerning the use of pre-emptive capital injections was eventually put before the Diet. It was duly approved by the lower house and approval from the upper house materialised on 15 June 2004. The purpose of the new framework for injecting public funds, which took effect on 1 August 2004 and will involve the establishment of a new account for strengthening financial functions at the DIC with a government guarantee of ¥2 trillion, is to revitalise the regional economy and maintain the orderly supply of credit by strengthening the financial functions of weak but solvent banks. As an alternative to the activities of the "financial crisis management" procedures, it allows for the public injection of capital (through the purchase of preferred stocks from banks, or preferred equity securities/subordinated loans from co-operatives) whilst avoiding the stigma and market uncertainty associated with the former. Applicants will have to demonstrate, to the satisfaction of a "Council for Strengthening Financial Functions" comprising external experts, that management reforms will allow them to both meet numerical targets for profitability and boost efficiency, and assist in the revitalisation of the regional economy.

Other. As noted by the IMF (IMF, 2003), a number of significant improvements in corporate governance arrangements have occurred in recent years in Japan. These embrace a raising of Japanese standards for accounting to near international best practices, a strengthening of the accounting and auditing framework [assisted by the establishment of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) in 1 April 2004], the revision to the Commercial Code in April 2003 giving corporations the option of a governance structure with a majority of outside directors on the Board, and reform of the corporate insolvency laws to both speed up[38] and enhance the cost-effectiveness of insolvency procedures. Moreover, in March 2004, the Tokyo Stock Exchange announced new corporate governance guidelines – covering the protection of shareholders' rights, shareholder equality, relations with employees and other stakeholders, information disclosure and transparency, and the roles of boards of directors and auditing boards – which it urges listed companies to observe. The guidelines were designed to be consistent with the OECD's "Principles of Corporate Governance".

5. A CRITIQUE OF RECENT BANKING SECTOR REFORMS

Having identified and explained the key banking sector reforms implemented over the last few years in Japan in the previous section, an assessment of each key reform is now provided. Recommendations for change/improvement are outlined in the next section.

5.1 Reform of the Regulatory and Supervisory Framework

As explained in Section 4.1 (and in more detail in Hall 2003a), the creation of a unified supervisory body in the guise of the FSA is a very recent phenomenon. Accordingly, a definitive judgement on the success or failure of the new "architecture" may be somewhat premature. Nevertheless, it has been in existence long enough for some initial assessment to be made.

To date, the overall picture is very encouraging, a view shared by the IMF, which alludes to the "immense strides" made by the FSA since its inception (IMF, 2003, p.30). Nevertheless, as argued in Hall (1999d and 2003a), there is still a case for formalising the relationships between the FSA and the other regulatory bodies involved, with a view to enhancing co-ordination and co-operation and clarifying their respective roles. For example, the introduction of UK-style 'memoranda of understanding', both to cover the form of co-operation expected from the FSA/BoJ/DIC in the event of a financial crisis[39] and bilateral arrangements with overseas supervisors is desirable.[40]

Another serious concern raised by the IMF relates to the FSA's apparent lack of autonomy and poor corporate governance. Accordingly, to minimise the possibility of political interference, to clarify the responsibilities of the Commissioner (i.e. the 'Head') of the FSA and the Minister for Financial Services and to increase the accountability of the FSA, the IMF calls for the establishment of a Board with outside members to whom the Commissioner, as Chief Executive, should be accountable. They also seek a change in the legal framework limiting the Prime Minister's and Minister for Financial Services' roles in the taking of decisions on individual supervised institutions to instances where public money is involved (IMF, 2003, p.30, para.71).[41]

Other concerns highlighted by the IMF relate to a lack of resources (human and physical) at the FSA, the frequent rotation of staff, the limited recruitment of outside specialists, its relationship with external auditors and the scope of its operations (IMF, 2003, pp.30-31). With respect to human resources, the IMF argues that more staff should be engaged in supervision and inspection and that more outside specialists, including actuaries and reinsurance specialists, should be hired. Less frequent rotation of staff would also assist in the continuity of policy. Whilst accepting these criticisms, the FSA, in private conversations, claims that, at least in respect of banking inspection and supervision, it is able to cope with the demands placed on it with current staffing levels.

As regards its relationship with outside auditors, the IMF is concerned that not enough use is made of them. They argue that auditors should be asked to report on internal controls and similar issues on which they have expertise. In response, the FSA argues that full use is made of auditors within the confines of their confidentiality constraints. Maybe, therefore, as occurred in the UK post-BCCI (*see* Hall, 1999e, chapter 11), there may be a case for formally requiring external auditors to share their concerns with regulators, the *quid pro quo* for the auditors being increased protection from litigation by their clients.

Finally, in respect of its operational remit, the IMF wants its activities confined to regulation and supervision. Accordingly, it calls for responsibility for auditing standards to be transferred to an independent body outside the FSA with private sector participation, as is done with respect to the setting of accounting standards.

Of all the eminently sensible recommendations of the IMF, perhaps the most important is the call to enhance the autonomy and accountability of the FSA. This would help to dispel the fears held by many that the FSA is still subject to too much political interference[42] and is largely unaccountable for its actions.[43] Moreover, the creation of a new Board with outside members would hopefully end the apparent feud between the reactionary 'old guard' (comprising mainly former MoF officials) and the more reform-minded newcomers, as well as encourage greater co-operation with outside bodies such as the IMF.[44]

5.2 Reform of the Safety Net Arrangements

5.2.1 Deposit Insurance Reform

Of the post-2000 reforms discussed in Section 4.2.1, those which have received most[45] attention are the decision to further delay the restoration of limited deposit protection and the creation of the IRCJ.[46] In respect of the former, a move supported by the IMF given the continued financial fragility in Japan (IMF, 2003, p.31, para.81), the result is to further postpone the return of some vestiges of market discipline into deposit insurance arrangements, already undermined by the DICJ's failure to adopt risk-related premia and embrace the co-insurance principal; such measures would serve to limit the moral hazard created by the use of deposit insurance. The decision to grant permanent blanket protection to qualifying "payment and settlement deposits" beyond April 2005 is also open to challenge on the same grounds. Perhaps a better approach would have been to offer 100 per cent protection on a limited amount of such deposits, an approach recently adopted in the UK to protect a reasonable level of "working capital" balances.[47] Co-insurance could then kick-in above this level until the *de jure* limit of ¥10 million is reached, beyond which *caveat emptor* applies.

As for the operations of the IRCJ, the body itself is only too aware of the criticisms levelled at it: that it is too susceptible to political interference aimed at keeping non-viable firms, especially in the construction sector, and banks alive (IMF, 2003, p.23, para.51); and that there is no need for another public sector work out agency to work alongside the RCC,[48] the creation of which risks crowding-out the more experienced private sector. The slow take-up of its services and the limited amount spent to date by the IRCJ are also cited as evidence of very low demand for its services. To counter such criticisms the IRCJ has gone out of its way to maximise the transparency of its operations, to set tougher support criteria for the construction industry, to hire outside experts where necessary, to conduct painstakingly-detailed due diligence analysis to determine the likely viability of restructured firms and fair market values of assets, and to "discipline" management and shareholders of any companies supported. Although only ¥1 trillion or so of the ¥10 trillion available to the IRCJ has been spent so far, and only seven months remain to find further customers, the spread of cases taken on board to date – covering companies of different sizes and from different sectors of the economy – suggest that some at least of the IRCJ's claimed comparative advantages (*see* Appendix 1) are real. Moreover, to the extent that the inauguration of the ICRJ accelerated the banking industry's own efforts to establish distressed debt work-out units – *see* Section 4.3 – the money may well have been well spent.

5.2.2 Prudential Regulation and Supervision of Banks

Despite addressing many of the concerns raised in Hall (2003a) relating to internal and external audit and the balance between on-site and off-site supervision, as detailed in Section 4.2.2, a number of worries remain. These relate, primarily, to the determination of capital adequacy of Japanese banks and the operation of prompt corrective action (PCA) in Japan, both of which have come to the fore in recent instances of failure resolution – i.e. the bailout of Resona Bank and the nationalisation of Ashikaga Bank. More generally, the Japanese authorities appear to have somewhat further to go down the road of compliance with the Basel Committee's "Core Principles for Effective Banking Supervision".

Starting with the issue of capital adequacy determination, it has become clear over the last year or so that it is the external auditors, through their judgements on the appropriate amounts of DTAs to allow for inclusion in capital, who have become the final arbiters of the adequacy of capital. This follows the FSA's explicit move to involve them more closely in such activities (FSA, 2003b). In the case of Resona Bank, for example, the auditors to the bank, Shin Nihon & Co.,[49] refused to accept the earnings forecasts of the bank, which meant that the bank's value of DTAs (which represented around 70 per cent of Tier 1 capital) faced a similar downgrading; in the event only three years of DTAs (equivalent to ¥400 billion) were accepted. This meant that the bank's overall capital adequacy ratio fell to around 2 per cent, well below the 6 per cent claimed by the bank and the minimum of 4 per cent demanded of all "domestic-only" bank operators in Japan.[50] The capital deficiency duly prompted the bank to seek help from the FSA and, under the emergency legislation designed to ward off a systemic crisis – *see* Appendix 1 - ¥2 trillion of public funds was injected by the DIC, thereby raising the bank's capital adequacy ratio above 10 per cent.[51] The action taken by Shin Nihon was apparently made independently of the FSA and reflected a new resolve of the accounting profession in Japan to adopt a more rigorous, and realistic, approach to their audit function. This, of course, was driven in part by a growing fear of litigation if their work is subsequently found wanting but, nevertheless, represents a welcome improvement in corporate governance arrangements in Japan.

Further evidence of the auditors' newly-found virility was not long in coming. On 29 November 2003, Ashikaga Bank, the tenth largest regional bank in Japan, admitted that it was insolvent, with liabilities exceeding assets by ¥102 billion at end-September 2003. This followed an FSA inspection which identified under-provisioning of ¥95 billion and the external auditors' refusal to accept any DTAs (which, at the time, amounted to 186 per cent of Tier 1 capital) within capital. This meant that the bank's capital adequacy ratio fell to –3.7 per cent and duly prompted the government to nationalise it, again using the emergency legislation.[52]

Notwithstanding the welcome increase in the auditors' assertiveness, the real issue is why the FSA, as the regulator, is hiding behind the auditors in the determination of bank capital adequacy. Is it because it does not want to shoulder the responsibility for the decision-taking, either because it fears litigation, or the ensuing hostility from banks, politicians and/or the general public? Whatever the reason, such a stance is not defensible and the FSA should "bite the bullet" and promulgate a "Prudential Note" making it clear that it is the final arbiter of a bank's capital adequacy. To assist in this policy, the FSA should clearly specify, as soon as possible, a final ruling on what maximum proportion of DTAs should be eligible for inclusion in regulatory capital.[53]

With respect to the operation of PCA in Japan (*see* Table 5.1), it is clear that it is not functioning as intended. Apart from limiting supervisory forbearance, by prescribing, in part, the form of action that supervisors must take as various capital adequacy levels are breached, it is designed to protect tax-payers from the cost of bank failure. If it works well, the costs imposed on the tax-payer should be minimal, although the usage of book value rather than market value accounting does inevitably usually lead to some losses falling on the general public. In the case of Japan, however, the losses have been substantial.[54] Clearly, PCA was not exercised promptly enough, suggesting the trigger points for action are set too low and/or the remedial action taken (mandatory and otherwise) has not been tough enough. The design of Japan's scheme of PCA should be looked at again; it is not enough simply to reduce the timescale for certain types of remedial action to be implemented by banks from three years to one year.

Finally, as regards Japan's compliance with the Basel Committee's "Core Principles for Effective Banking Supervision", it would appear from the IMF's recent survey that additional measures are required (*see* Table 5.2). Apart from the need to further address the pre-conditions for effective banking supervision, because of the FSA's lack of operational and budgetary independence and the absence of formal arrangements governing information exchanges between the FSA and the BoJ on the one hand and between Japanese and overseas regulators on the other (noted above), action is urgently required to redefine regulatory capital (taking on board the criticisms noted earlier), improve the supervision of country risk and tighten the rules concerning large exposures.[55] Other action suggested by the IMF is also presented in Table 5.2.

Although adoption of all these recommendations should increase the cost-effectiveness of banking regulation and supervision in Japan, at the end of the day it is down to the way in which crisis situations are actually handled within the architectural framework created and individual institutions are actually treated by FSA officers during routine inspections and off-site monitoring. Whilst the worst excesses of the previous regime of forbearance (*see* Hall, 1999a) appear to be behind us, not all are convinced that much has changed with the ushering in of the new FSA, still dominated by ex-MoF officials and lacking in operational independence from government. The recent events at Resona Bank, discussed above, have only served to fuel suspicions that the FSA is not fully in control of events, a charge difficult to dismiss given the opacity of the FSA's operations. Moreover, the need for such a rescue only three months after the creation of the bank through a merger of Daiwa Bank and Asahi Bank, banks widely recognised as being amongst the weakest of the city banks and which had benefited from previous state handouts in 1998/9, indicates the futility of trying to preserve desperately-weak organisations, at the expense of stronger institutions. Similarly, the nationalisation of Ashikaga Bank, although conducted on a more market-oriented basis – it followed an external audit and inspection by the FSA and resulted in the wholesale change of management and complete impoverishment of existing shareholders, unlike in the Resona case (Fukao, 2003) – followed years of turmoil at the bank, which had clocked up losses of over ¥400 billion since 1996 despite receiving state-funded capital injections in 1998 and 1999 (*see* Appendix 1). At some stage, the need to weed out excess capacity through a cull of terminally-weak institutions will have to take priority over concerns about the possible consequences for the regional and national economies. Similarly, some semblance of market discipline will eventually have to be restored through reform of the deposit insurance arrangements.

5.3 The Authorities' Attempts to Speed up the Banks' Resolution of their NPL Problems

Clearly, the authorities deserve praise for their determination to speed up the NPL resolution process, often against the wishes of the banks who are happy to wait for better times (whilst the zero interest rate policy persists, a factor which itself complicates matters by undermining the usefulness of the term "NPL") rather than risk damaging long-standing business relationships. The major banks, as a group, look like meeting the target set for them – i.e. to halve their NPL ratios between end-March 2002, when they represented 8.4 per cent of total loans, and end-March 2005[56] and even Resona Holdings hopes to reduce its NPL ratio to 4 per cent by the due date.[57] The fear remains, however, that unless the nascent economy recovery proves sustainable and gathers pace, the banks' exposures, especially to SMEs, may cause some upward rebound in major banks' NPL ratios. Moreover, the authorities have yet to get to grips with the regional banks' asset appraisal and provisioning policies[58] and thus reduce their real NPL ratios to manageable levels. It should also be appreciated that the battle to quickly reduce the major banks' NPL ratios has been won at the expense of a serious depletion of economic capital, given the concomitant credit costs involved, thereby increasing the overall fragility of the banks given the size of the risks they are still running (*see* the results of the IMF's stress tests discussed in Section 3.2). This may necessitate even larger injections of public funds if banks' capital adequacy levels are to be boosted to international levels – *see* next section. Moreover, to the extent that debt forgiveness has been used to reduce reported NPLs, the process of structural reform in the corporate sector will have been slowed down, with weak companies being subsidised at the expense of stronger ones.

5.4 Other Reform Initiatives

Starting with the *BoJ's share-buying operations*, it can be argued that the broader objective of trying to kick-start the reform process, thereby shaming the FSA into taking more decisive action, was achieved, given subsequent developments at the FSA. What is less clear, however, is the desirability of the initiative itself. As part of an innovative approach to the conduct of monetary policy, designed to decelerate the pace of deflation, it can perhaps be defended, notwithstanding the potentially adverse impact on the quality of the BoJ's own assets, which has recently led the BoJ to record its first operating loss for 32 years.[59] As a device for shoring-up the banks' balance sheets, though, it is not clear that this should be a central bank function.[60]

As for the plans for *pre-emptive capital injections*, the ¥2 trillion to be set aside at the DIC to fund such operations is unlikely to make much impact on the overall strength of the regional bank sector, the intended target of the initiative. Moreover, to the extent it is used to finance mergers between struggling banks, it is likely to be yet another case of "throwing good money after bad"; the money might be better spent reducing capacity in the banking industry if recovery in the real economy continues, as widely expected. A much bolder move – *see* below – would have been to use the funds already available at the Early Strengthening Account at the DIC - ¥15 trillion remains unspent – to recapitalise the major banks (including regionals) to boost their capital adequacy levels nearer to international norms, after taking a stricter interpretation of Basel I. Similar safeguards could be adopted as envisaged under current legislation, that is only weak, but sound banks will receive support and management will have to meet exacting profitability/efficiency targets; and the pre-emptive mechanism, obviating the need for the activation of the financial crisis management procedures, would be equally beneficial to those banks assisted in this way.

Finally, with respect to *corporate governance arrangements*, although the improvements made to date are to be warmly welcomed, further developments are desirable. As the IMF notes, the system is still characterised by a low level of shareholder activism and few outside directors, and lacks transparency. And the relatively-small corporate bond market and remaining high degree of cross-shareholding also deter structural changes. Accordingly, the IMF's "wish-list" for reforms in this area, including the mandatory establishment of board audit committees by banks, with outside directors making up a majority of the Committee and from whom the Chairman is chosen, merit serious attention. The audit committee is expected to appoint the external auditor (subject to approval by the FSA) and internal auditors would be required to report to the audit committee. More generally, the IMF is seeking corporate governance arrangements more consistent with Basel Committee guidelines (IMF, 2003, pp.8-9, para.9).

6. SUMMARY AND CONCLUSIONS

After a number of false dawns, the recent marked improvement in the real economy may well presage the return of sustainable economic growth in Japan. This has already assisted the banks in their own recovery through its impact on credit costs, the fiscal 2003 results suggesting that, for the majority of the major banks at least – doubts still surround UFJ and Resona – the worst is behind them. As a group, they are likely to meet the target set for them in respect of the halving of their NPL ratios by end-March 2005 (relative to their positions at end-March 2002); and most are forecasting further profits for fiscal 2004, notwithstanding the one-off benefits enjoyed during fiscal 2003 in the shape of tax refunds from the municipal government and a near 50 per cent surge in the local stock market. The fundamental problems, however, have not changed, causing the rating agencies to leave their financial strength ratings untouched. While a return to the black for most is very welcome news, the underlying level of *profitability* of the banks remains pathetically low, as recognised by the banks themselves in the profits forecasts. Net income growth, the mainstay of the banks' fortunes, will remain sluggish as long as corporate loan demand remains sluggish and the zero interest rate policy remains in place, thereby constraining banks' ability to raise lending margins. And even if the zero interest rate policy is ended, following the curtailment of deflation and a return to inflation – and this time round, such action is unlikely to be taken until economic recovery is firmly entrenched – what the banks may gain on the net interest income front may be swallowed up by losses incurred on Japanese government bold holdings. Moreover, even if declining credit costs continue with respect to loan exposures related to large corporate borrowers, there is a real danger that exposures to SMEs will extend the NPL pain, both for the major banks and regional banks.

Similarly, the fundamentals on the *capital adequacy* front have not changed, notwithstanding the banks' renewed ability to generate at least some funds internally and reduce reliance on DTAs. Given the scale of the continuing risks being run by the banks – notably credit and market risks – the current levels maintained by most banks are woefully inadequate, particularly if a less-charitable view is taken by the authorities in connection with its interpretation of Basel I. Unwillingness to upset existing shareholders by diluting ownership through further common stock issues is likely to continue to constrain the growth in Tier 1 capital in the short- to medium-term alongside their limited ability to boost retained earnings. This leaves preference share issues as the likely focus of future capital-raising activities yet concerns have already been raised about the scale of previous sales to affiliated companies and other financial institutions, the most likely source of investors; an official desire to see a further unwinding of cross-shareholdings and concerns about "double gearing" may stymie ambitions in this area. Yet funds have to be found somewhere if the current level of risk-taking continues and the repayment of previous publicly-funded capital injection is to proceed on time. It is far from clear that the banks can "square the circle" and meet such requirements without outside help. Accordingly, in agreement with the IMF (*see* Table 6.1), I recommend widescale recapitalisation of the (sound parts of the) banking industry, using funds already committed to the DIC – *see* next section. And, to assist the banks in their attempts to boost profitability,[61] I also agree with the IMF and Oyama and Shiratori (2001) that the extent of direct government involvement in the financial system should be scaled back, particularly in respect of the operation of the Postal Savings system (scheduled for (partial) privatisation in 2007). Moreover, a re-focusing of failure resolution policy to close down terminally-ill institutions and only support sound and solvent institutions, as argued for by

Fukao (2003), would help to alleviate the problems caused by excess capacity in the banking/finance industry. A return to sustainable economic growth should assist in this process by reducing policymakers' opposition to such a move on the grounds that the national/local economy will suffer irreparable damage if such a policy is adopted. Invocation of the financial crisis management procedures should thus prove less frequent as the return to a more market-based economy gathers momentum.

Turning to the actual banking sector reform initiatives recently adopted in Japan, early indications are that the new *financial architecture* created, with the FSA at its centre, is a significant improvement on that which operated prior to the beginning of this century. Nevertheless, there is room for further improvement. It is difficult, for example, to argue against the IMF's call for full operational autonomy and greater accountability of the FSA and, maybe, financial independence for the FSA. Moreover, as called for in Hall (1999d), there is still a case for formalising the relationship between the FSA and other regulatory bodies through, for example, the introduction of UK-style 'memoranda of understanding', both to cover the form of co-operation expected from the FSA/BoJ/DIC in the event of a financial crisis and bilateral arrangements with overseas supervisors. And, if the BoJ is allowed to retain its supervisory function, there is a case for introducing a 'lead regulator' principle to formalise the co-operation of the FSA and BoJ in respect of their inspection/supervision of individual banks. Finally, it would appear desirable to impose a requirement on external auditors to consult more widely with regulators, especially in instances where they suspect fraud or malpractice.

With respect to recent *reform of the safety net*, the DIC would be well advised to urgently consider the introduction of the co-insurance principle and risk-related premia to limit the moral hazard created. Moreover, the decision to grant permanent blanket protection to "payment and settlement accounts" should be reconsidered. The IRCJ, in turn, should be robust in its defence of operational independence, highly selective in its choice of companies to support, tough in its treatment of the management and shareholders of assisted companies and fair in its determination of asset values. And the RCC should do its utmost to minimise the time between asset purchases and their subsequent disposal in the market place. The cost-effectiveness of the prudential regulation and supervision of banks could also be increased by the FSA assuming sole responsibility for the determination of banks' capital adequacy (a process assisted by its early passing of a ruling concerning the maximum amount of DTAs that are eligible for inclusion in regulatory capital), the authorities reviewing the operation of PCA in Japan with a view to reducing the costs imposed on tax-payers as a result of bank failure resolution policy, and the implementation of measures to boost Japan's degree of compliance with the Basle Committee's "Core Principles for Effective Banking Supervision". At the very least, this would involve the changes to the FSA's operations noted above if the "pre-conditions for effective banking supervision" are to be satisfied, plus a redefinition of regulatory capital (more in tune with the spirit if not the letter of Basel I), an improvement in the supervision of country risk and a tightening of the large exposures rules.

As regards the authorities' attempts to speed up the banks' resolution of their *NPL problems*, it would be churlish not to compliment the government and the FSA on what has been achieved in respect of the majority of the major banks. But, as noted earlier, some reservations remain. Recent events at UFJ and Resona call into question the FSA's assertion that it has induced standardisation in the way the major banks classify loans to large corporate borrowers and hence in their provisioning policies. There are also fears that exposures to SMEs will slow down the pace at which the major banks can continue to reduce their NPL ratios. And, of course, the FSA has yet to seriously tackle the regional banks' and co-operative institutions' problems in these areas. Moreover, the success achieved has come at a high cost in terms of the serious depletion of economic capital that has resulted. Nevertheless, the overall impact of the moves taken to date is positive, and the FSA should seek to consolidate the success it has achieved in respect of the major banks whilst, at the same time, turning its attention to the other deposit-taking institutions operating in Japan.

With regard to the authorities' other reform institutions, praise should perhaps be more muted. The *BoJ's share-buying operations*, for example, undoubtedly accelerated the pace at which banks reduce their exposure to the stock market and unwound their cross-shareholdings, both of which are desirable outcomes. Whether or not this should be a function of a central bank, however, is debatable, even if difficult times call for imaginative policymaking. Similarly, in respect of the planned use of *pre-emptive capital injections*, the ¥2 trillion of financial assistance envisaged is unlikely to make much impact on the strength of the regional bank sector. Moreover, to the extent it is used to shore-up very weak banks, by funding takeovers by others, it will represent a continuation of a failure resolution policy more concerned with preservation of the weak than promotion of the strong, thereby prolonging the problems associated with excess capacity in the banking industry. The money would be better spent as part of a broader recapitalisation programme, as argued in Section 5 above. Finally, on the *corporate governance* front, the conclusion must be that recent developments are welcome, but further reform is needed.

In conclusion, recovery in the real economy and the knock-on effects for the banks' fortunes, should not be used as an opportunity to slow the pace of reform; the opposite is required. Accelerating the pace of reform, along the lines suggested, would bring forward the day when Japanese banks can compete on the international stage again, unaided by governmental subsidies, and the authorities can safely dismantle the recent extensions to the safety net which have done so much to undermine market discipline in the Japanese financial system and thus reduce economic efficiency in the wider economy.

7. RECOMMENDATIONS

(i) **To help boost bank profitability**

: scale back the operations of governmental financial institutions (especially the Postal Savings system);

: re-focus failure resolution away from preservation of the weak and in favour of promotion of the strong by doing more to remove excess capacity in the banking industry;

: make specific provisions tax deductible.

(ii) **To help boost capital adequacy**

: having re-defined regulatory capital (*see* (vi) below), those banks which remain solvent or are deemed systemically important but which breach the minimum capital adequacy requirements laid down by the Basel Committee should be recapitalised using, in the first instance, the ¥15 trillion remaining in the DIC's Early Strengthening Account. Recipient institutions would be required to meet exacting profitability targets and managers would be held accountable for the banks' performance.

(iii) **To help restore market discipline**

: scale back the scope of the safety net (i.e. the operation of the 'Too-Big-To-Fail' policy and the extent of protection enjoyed under the deposit insurance arrangements – *see* (v)a below);

: take a tougher line on shareholders and other creditors when intervening in the market.

(iv) **To improve the regulatory and supervisory framework**

: introduce new mechanisms to ensure the FSA enjoys full operational autonomy yet is held fully accountable for its actions;

: formalise the relationships between the FSA and other regulators by:

(a) introducing a 'memorandum of understanding' to govern the relationships between the FSA/BoJ/DIC in the event of a financial crisis; and

(b) negotiating 'memoranda of understanding' with all relevant overseas supervisors;

: end the BoJ's involvement in the supervision of financial institutions by integrating the relevant staff with the FSA's own staff (a 'second best' solution to the problems posed for co-ordination and co-operation by multiple agencies is the establishment of a 'lead regulator' principle to govern the supervision of individual institutions and the removal of legal barriers to the full exchange of information between the FSA and the BoJ);

: require auditors to consult more closely with the FSA, particularly if they suspect fraud or malpractice by their client institutions.

(v) **To increase the cost-effectiveness of the safety net**

(a) Amend the deposit insurance law to allow for the introduction of co-insurance (below the normal *de jure* limit of protection of ¥10 million) and risk-related premia, and removal of the blanket protection given to "payment and settlement deposits".

(b) Raise the cost-effectiveness of prudential regulation and supervision by:

: forcing the FSA to assume sole responsibility for the determination of banks' capital adequacy;

: giving the FSA the power to set bank-specific capital charges (as called for in Basel II);

: reviewing the operation of PCA in Japan with a view to reducing the costs imposed on tax-payers by bank failure resolution policy.

(vi) **To increase the extent of Japan's compliance with the Basel Committee's "Core Principles for Effective Banking Supervision"**

: introduce new measures to guarantee the full operational autonomy and accountability of the FSA and to formalise arrangements for information exchanges with the BoJ (necessary to help Japan meet the "Pre-conditions for Effective Banking Supervision", i.e. Core Principle number 1);

: re-define regulatory capital by limiting the inclusion of DTAs, excluding general provisions held against Category II assets and deducting all holdings of other credit institutions' capital instruments (necessary to comply with Core Principle number 6);

: improve the supervision of country risk (necessary to comply with Core Principle number 11);

: tighten up the large exposure limits (necessary to comply with Core Principle number 9); and

: agree memoranda of understanding with relevant overseas supervisors (necessary to comply with Core Principles numbers 24 and 25).

(vii) **To increase the extent of Japan's compliance with the Basel Committee's guidelines on corporate governance**

: introduce further corporate governance reforms along the lines suggested by the IMF to embrace, *inter alia*, the compulsory establishment of board audit committees by all banks with a majority of outside directors.

TABLES

TABLE 2.1 : CATEGORISATION OF PRIVATE DEPOSITORY INSTITUTIONS OPERATING IN JAPAN AS OF 1.4.03*

			Total assets at end-March 2003 (¥ trillion)
Banks	-	City Banks (7)	407
	-	Regional Banks (64)	204
		Second Association of Regional Banks (53)	61
		Foreign Banks (73)	43
	-	Long-Term Credit Banks (2)	13
	-	Trust Banks (27)	61
		Others (5)	0.7
Cooperatives	-	Shinkin Central Bank	139
	-	Shinkin Banks (326)	
	-	National Federation of Credit Cooperatives	19
		Credit Cooperatives (191)	
	-	Shoko Chukin Bank	N.A.
	-	Rokinren Bank	18
		Labor Banks (21)	
	-	Norinchukin Bank	N.A.
	-	Credit Federation of Agricultural Cooperatives (46)	130
	-	Agricultural Cooperatives (944)	
	-	Credit Federations of Fishery Cooperatives (34)	4
		Fishery Cooperatives (452)	

* Figures in parentheses represent the number of institutions in each category operating at 1 April 2003.

Source: Japanese Bankers' Association, 2003, p.1; IMF, 2003, 'Supplementary Information', p.5.

TABLE 2.2 : CONSOLIDATION AMONGST THE MAJOR JAPANESE BANKS, 2000-2003

Merged Entities	**Date of Merger**	**New Entity Formed**	**Latest Developments**
Dai-Ichi Kangyo Bank[1] Fuji Bank[1] Industrial Bank of Japan[2] Mizuho Trust[3] (jointly owned)	September 2000	Mizuho Holdings, comprising: Dai-Ichi Kangyo Bank[1]; Fuji Bank[1]; Industrial Bank of Japan[2]; Mizuho Trust[3]	Mizuho Holdings, Comprising (at April 2002): Mizuho Bank[1]; Mizuho Corporate Bank[1]; Mizuho Trust[3]
Sakura Bank[1] Sumitomo Bank[1]	April 2001	Sumitomo Mitsui Banking Corporation	Sumitomo Mitsui Financial Group, Comprising (at Dec. 2002): Sumitomo Mitsui Banking Corporation[1]
Bank of Tokyo Mitsubishi[1] - Tokyo Trust[3] Mitsubishi Trust[4] Nippon Trust[4]	April 2001	Mitsubishi Tokyo Financial Group, comprising: Bank of Tokyo- Mitsubishi[1]; Mitsubishi Trust[4]; Nippon Trust[4]; Tokyo Trust[3]	Mitsubishi Tokyo Financial Group, Comprising (at Oct. 2001): Bank of Tokyo- Mitsubishi[1]; Mitsubishi Trust[4]
Sanwa Bank[1] Tokai Bank[1] - Tokai Trust[3] Toyo Trust[4]	April 1001	UFJ Holdings, comprising: Sanwa Bank[1]; Tokai Bank[1]; Toyo Trust[4]; Tokai Trust[3]	UFJ Holdings, Comprising (at Jan. 2002): UFJ Bank[1]; UFJ Trust[4]
Daiwa Bank Holdings, Comprising (at Dec. 2001): Daiwa Bank[1]; Kinki Osaka Bank[5]; Nara Bank[5]; Asahi Bank[1]; Asahi Trust[3]	March 2002 (effective October 2002)	Resona Holdings, comprising: Daiwa Bank[1]; Asahi Bank[1]; Kinki Osaka Bank[5]; Nara Bank[5]; Daiwa Trust[4]	Resona Holdings, Comprising (at March 2003): Resona Bank[1]; Saitama Resona Bank[1]; Kinki Osaka Bank[5]; Nara Bank[5]; Resona Trust[4]

Notes: (1) City Bank.
(2) Long-Term Credit Bank.
(3) Trust Bank Subsidiary.
(4) Trust Bank.
(5) Regional Bank.

Source: Japanese Bankers' Association, 2003, p.15.

TABLE 3.1 : MOODY'S FINANCIAL STRENGTH RATINGS FOR THE MAJOR JAPANESE BANKS (as at 2 June 2004)

		Date Last Amended
Mizuho Bank	E	2/7/02
Tokyo Mitsubishi Bank	D-	2/7/02
Mitsubishi Trust Bank	D-	16/12/02
UFJ Bank	E	2/7/02
Resona Bank	E	13/2/98
Chuo Mitsui Trust Bank	E	3/4/00
Sumitomo Mitsui Bank	E	2/7/02
Sumitomo Trust Bank	D-	16/12/03
Shinsei Bank	D	16/12/03
Aozora Bank	D	16/12/03

Source: Moody's Japan.

TABLE 3.2 : PROFITABILITY OF THE JAPANESE BANKING SECTOR, 1990-2003 (¥ trillion)

Financial Year	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Lending Margin [(i)]	7.1	8.9	9.8	9.2	9.7	10.8	10.7	10.0	9.6	9.7	9.4	9.8	9.4
Other Revenue [(ii)]	2.6	2.2	2.5	2.8	2.1	3.3	3.7	3.6	3.1	2.5	3.0	3.1	3.6
Operating Costs [(iii)]	7.1	7.5	7.7	7.7	7.8	7.8	8.0	8.0	7.5	7.3	7.1	7.0	7.0
Gross Profit [(iv)=(i)+(ii)-(iii)]	2.6	3.5	4.5	4.3	4.0	6.3	6.4	5.6	5.2	4.9	5.3	5.9	6.0
Loan Loss (v)	0.8	1.0	2.0	4.6	6.2	13.3	7.3	13.5	13.5	6.3	6.6	9.4	7.0
Net Operating Profit [(vi)=(iv)-(v)]	1.8	2.5	2.5	-0.4	-2.2	-7.0	-1.0	-7.9	-8.3	-1.4	-1.3	-3.5	-1.0
Realised Capital Gains [(vii))]	2.0	0.7	0	2.0	3.2	4.4	1.2	3.6	1.4	3.8	1.4	-2.4	-4.1
Net Profit [(vi)+(vii)]	3.8	3.3	2.5	1.7	1.0	-2.6	0.2	-4.2	-6.9	2.3	0.1	-5.9	-5.1

Source: Japan Center for Economic Research, 2003.

TABLE 3.3 : THE PROFITABILITY AND SPREADS OF JAPANESE BANKS, 1998-2003 (%)

Indicators	**Date (end-March)**					
	1998	**1999**	**2000**	**2001**	**2002**	**2003**
Return on assets (pre-tax)	-0.6	-0.9	0.3	0.1	-0.7	-0.6
Return on equity (pre-tax)	-20.0	-25.1	6.8	1.2	-19.5	-19.4
Interest margin to gross income	51.7	53.6	46.7	61.3	63.4	60.0
Non-interest expenses to gross income	80.3	86.2	88.5	83.2	91.3	N.A.
Personnel expenses to non-interest income	49.5	48.3	48.1	47.2	46.7	46.3
Trading and fee income to total income	7.7	8.4	7.8	11.6	13.6	16.6
Spread between average lending and deposit rates(1)						
: City banks (7)	1.6	1.6	1.7	1.7	1.7	1.6
: Trust banks (5)	0.8	0.8	1.0	1.1	1.1	1.2
: Long-term credit banks (3)	0.7	0.8	0.8	0.8	0.7	1.5
: Regional banks (64)	2.0	2.1	2.1	2.1	2.1	2.1
: Regional banks II (54)	2.4	2.3	2.4	2.5	2.5	2.5

Notes:
(1) Figures in parentheses show the number of institutions covered as of end-March 2003.

Source: IMF, 2003 ('Supplementary Information', Table 4. p.8).

TABLE 3.4 : CAPITAL ADEQUACY[1] OF JAPANESE BANKS, 1998-2003 (%)

Bank Grouping[2]		**Date (end-March)**					
		1998	**1999**	**2000**	**2001**	**2002**	**2003**
City Banks:	Internationally active (5)	9.3 (4.7)	11.9 (6.6)	12.4 (6.9)	11.7 (6.7)	11.1 (6.0)	10.3 (5.3)
	Not internationally active (2)[3]	--	--	12.7 (8.7)	12.0 (8.4)	8.7 (4.4)	6.7 (3.5)
Trust Banks:	Internationally active (2)	10.8 (6.1)	13.1 (7.7)	11.4 (7.0)	11.7 (6.7)	10.9 (6.2)	11.0 (6.1)
	Not internationally active (3)	13.5 (12.9)	8.2 (7.6)	11.7 (7.2)	11.2 (6.6)	10.3 (5.7)	7.1 (4.1)
Long-term	Internationally active (0)	10.3 (5.2)	11.5 (6.3)	12.4 (6.8)	12.1 (6.8)	11.0 (5.5)	N.A.
Credit Banks:	Not internationally active (2)	8.3 (4.3)	N.A.	N.A.	15.4 (9.6)	15.4 (11.1)	17.0 (13.5)
Regional Banks:	Internationally active (10)	10.7 (7.6)	10.6 (7.6)	11.5 (8.1)	11.3 (8.1)	10.9 (8.0)	10.7 (8.0)
	Not internationally active (54)	9.0 (7.0)	8.3 (6.2)	9.5 (7.1)	9.5 (7.2)	9.2 (6.9)	9.1 (6.8)
Regional Banks II:	Internationally active (0)	9.2 (5.7)	N.A.	N.A.	N.A.	N.A.	--
	Not internationally active (53)	6.1 (5.1)	5.0 (3.9)	8.1 (6.3)	8.1 (6.5)	8.1 (6.3)	8.2 (6.5)
All Banks:	Internationally active (18)	9.6 (4.9)	11.9 (6.9)	12.2 (7.1)	11.7 (7.0)	10.9 (6.2)	10.4 (5.7)
	Not internationally active (114)	7.7 (6.0)	7.2 (5.3)	9.7 (7.0)	10.0 (7.0)	9.4 (6.5)	8.5 (5.9)
Major Banks:[4]	Internationally active (7)	9.6 (4.9)	12.1 (6.7)	12.3 (6.9)	11.7 (6.7)	11.0 (5.9)	10.4 (5.4)
	Not internationally active (4)	13.5 (12.9)	8.2 (7.6)	12.0 (7.7)	11.5 (7.1)	9.4 (5.0)	6.8 (3.6)

Notes:

(1) Figures are provided for both total regulatory capital to risk-weighted assets and, in parentheses, for Tier 1 capital to risk-weighted assets.

(2) Figures in parentheses represent the number of institutions included as of end-March 2003.

(3) The end-March 2003 figure includes the Saitama-Resona Bank.

(4) Comprising the Mizuho Group (Mizuho Bank, Mizuho Corporate Bank and Mizuho Trust), the MTFG (Tokyo-Mitsubishi Bank and Mitsubishi Trust), the UFJ Group (UFJ Bank and UFJ Trust), SMBC, Resona Bank, Chuo-Mitsui Trust and Sumitomo Trust.

Source: IMF, 2003 ('Supplementary Information', Table 5, p.9).

TABLE 3.5 : AGGREGATE CAPITAL HELD BY JAPANESE BANKS, 1991-2003 (¥ trillion; unconsolidated data)

Period	(i) Core Capital[1]	(ii) Market Value of Shares Held	(iii) Book Value of Shares Held	(iv) [=0.6((ii)-(iii))[2]]	(v) Net Capital [=(i)+(iv)]	(vi) Deferred Tax Assets	(vii) Equity Capital held by Government
End-March '91	30.2	77.7	33.1	26.7	57.0	0	0
" '92	31.3	56.4	34.5	13.1	44.4	0	0
" '93	31.8	56.4	34.5	13.1	44.9	0	0
" '94	32.3	61.9	36.5	15.2	47.5	0	0
" '95	32.3	52.0	39.8	7.3	39.6	0	0
" '96	27.9	64.3	43.0	12.8	40.7	0	0
" '97	28.5	54.1	42.9	6.7	35.2	0	0
" '98	24.5	50.8	45.7	3.1	27.6	0	0.3
" '99	33.7	47.1	42.7	2.6	36.3	8.4	6.3
" '00	35.2	54.5	44.4	6.1	41.3	8.1	6.9
" '01	36.7	44.5	44.3	0.1	36.8	7.3	7.1
" '02	29.3	34.4	34.4	0	29.3	10.7	7.2
" '03	24.8	23.2	23.2	0	24.8	10.6	7.3

Notes:
(1) Equivalent to unconsolidated Tier 1 capital.
(2) Reflects a 40 per cent deferred tax liability rate.

Source: Federation of Bankers Associations of Japan (various); Fukao, 2003.

TABLE 3.6 : "BAD LOANS", WHEN DEFINED AS "RISK MANAGEMENT LOANS", OF JAPANESE BANKS BY INDUSTRY GROUPING, AS AT END-SEPTEMBER 2003 (¥ billion)

Category of Institution	Number of Institutions	Bankrupt Loans[1]	Past Due Loans[2]		Restructured Loans	Total of 'Bad' Loans	% of Total Loans
			6 PDL[3]	3 PDL[4]			
City Banks[5]	6	601	6,656	247	7,490	14,994	7.1
Long-term Credit Banks	2	16	176	22	65	280	4.2
Trust Banks	5	125	776	27	1,332	2,261	6.2
Major Banks Sub-Total	13	742	7,609	296	8,888	17,534	6.9
(Major 11 Banks)[6]	(11)	(725)	(7,433)	(274)	(8,822)	(17,255)	(7.0)
Regional Banks[7]	64	811	5,774	124	3,383	10,091	7.5
Regional Banks II	51	407	1,994	25	1,027	3,453	8.3
All Banks	129	1,964	15,458	454	13,368	31,244	7.2

Notes:
1. i.e. loans to borrowers in legal bankruptcy.
2. i.e. loans on which interest has not been collected and is not recognised as earnings, excluding loans to borrowers in legal bankruptcy and loans on which payment of interest is in a grace period for the purpose of reconstructing the borrowers.
3. i.e. past due loans in arrears by six months or more.
4. i.e. past due loans in arrears by more than three months but less than six months.
5. Figures for the Mizuho Group and UFJ Bank include those NPLs transferred to subsidiary companies for corporate revitalisation.
6. i.e. excluding the Shinsei Bank and Aozora Bank.
7. Includes the figure for Saitama Resona Bank.

Source: FSA, 2004, the "Reference".

TABLE 3.7 : THE JAPANESE BANKING SECTOR'S NON-PERFORMING LOANS, AS DEFINED UNDER THE FINANCIAL RECONSTRUCTION LAW, AS AT END-SEPTEMBER 2003 (¥ billion)

Institutional Grouping	**Total Credit Exposure**	**NPLs (i.e. "Classified Assets")**				**NPLs as % Total Credit Exposure**
		"Bankrupt/ *De Facto* Bankrupt"	**"Doubtful"**	**"Special Attention"**	**Total**	
City Banks[1]	232,398	1,951	5,496	7,737	15,184	6.53
Long-term Credit Banks	6,958	24	170	89	284	4.08
Trust Banks	38,097	247	663	1,365	2,274	5.97
Major Banks Sub-Total	277,453	2,221	6,329	9,191	17,742	6.39
(Major 11 Banks)[2]	(270,496)	(2,198)	(6,159)	(9,102)	(17,458)	(6.45)
Regional Banks[3]	137,726	2,371	4,460	3,396	10,227	7.43
Regional Banks II	42,443	975	1,477	1,048	3,500	8.25
Total of All Banks	462,362	5,592	12,328	13,715	31,635	6.84

Notes:
1. Figures for the Mizuho Group and UFJ Bank include those NPLs transferred to subsidiary companies for corporate revitalisation.
2. i.e. excluding the Shinsei Bank and Aozora Bank.
3. Including the Saitama Resona Bank.

Source: FSA, 2004, Table 2.

TABLE 3.8 : THE EVOLUTION OF THE "BAD" (i.e. "RISK MANAGEMENT") LOANS OF THE JAPANESE DEPOSIT-TAKING SECTOR, 1992-2003

Date	"Bad" Loans Outstanding **(¥ billion)**	**Stock of Specific Provisions Outstanding (¥ billion)**	**Estimate of "Problem Loans to be Disposed of"[1] (¥ billion)**
End of March 1992	7,000-8,000[2]	--	--
End of March 1993	8,400[2]	--	--
End of March 1994	10,500[2]	--	--
End of September 1994	13,300[2]	--	--
End of March 1995	11,640[2]	--	--
End of September 1995	38,086[3]	6,961	18,587[4]
End of March 1996	34,799[5,6]	12,530[5]	8,305[5]
End of September 1996	29,228[7,8]	9,948[7]	7,303[7]
End of March 1997	27,900[9,10]	12,343[9]	4,685[9]
End of September 1997	28,078[11,12]	13,993[11]	4,348[11]
End of March 1998			
Under "old" disclosure Standards	24,979[13,14]	N.A.	N.A.
Under "new disclosure" Standards	35,207[13,14]	19,035[13]	1,583[13,15]
End of March 1999	38,656	14,802	N.A.
End of March 2000	41,367[16]	11,500[16]	N.A.
End of March 2001	43,448[17]	10,039[17]	N.A.
End of March 2002	53,049[18]	10,375[18]	N.A.
End of March 2003	45,676[18]	8,569[18]	N.A.

Notes:

1. This figure represents an estimate by the Ministry of Finance of the scale of loans for which possible losses have not been provided nor that are likely to be covered by collateral (i.e. loan losses considered "irrecoverable" and not provided for).
2. Ministry of Finance estimate of "nonperforming loans" for the 21 largest banks. Figures include claims against customers who went bankrupt and claims on which interest payments were more than six months overdue due to the suspension of interest payments, but *exclude* "restructured loans" (i.e. those on which interest payments have been cut) and the bad debts of affiliates.
3. Figures include "restructured loans" (i.e. loans on which interest rates have been reduced to below the ruling official discount rate) for the first time and now cover all Japanese deposit-taking financial institutions (i.e. city banks, long-term credit banks, trust banks, regional banks and co-operatives).
4. The figure is *inclusive* of possible losses (estimated at ¥7,700 billion) resulting from exposure to the eight *jusen* companies.
5. The figures *exclude* the Kizu Cooperative (with about ¥1,190 billion in problem loans), the Fukui Prefecture First Credit Cooperative (¥2.6 billion), the Osaka Credit Cooperative (¥270 billion), and Taiheiyo Bank (¥330 billion).
6. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help (including forgiving loans), estimated at ¥3,795 billion for all "major" banks (i.e. excluding regional banks and co-operatives) at end of March 1996.
7. Loans to *jusen* companies are *excluded*, as are the Kizu Credit Cooperative (with approximately ¥1,190 billion in problem loans), the Osaka Credit Cooperative (¥270 billion), the Kenmindaiwa Credit Cooperative (¥15 billion), and Sanyo Credit Cooperatives (¥17 billion).
8. The figure *excludes* loans to borrowers to which the lending bank is extending help (including forgiving loans), estimated at ¥3,724 billion for all "major" banks (i.e. excluding regional banks and co-operatives) at end of September 1996.
9. The figures *exclude* the Hanwa Bank (with around ¥190 billion in problem loans), the Sanpuku Credit Cooperative (¥26 billion), and the Hanshin Labor Credit Cooperative (¥3.5 billion).

10. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help (including forgiving loans), estimated at ¥3,373 billion at end of March 1997 for all "major" banks (i.e. excluding co-operatives but *including* regional banks for the first time).
11. The figures *exclude* the Hokkaido Takushoku Bank, Hanwa Bank, Hanshin Labor Credit Cooperative, Tokai Credit Cooperative, Toki Credit Cooperative, Kitakyushu Credit Cooperative, Kanagawa Credit Cooperative, Tanabe Credit Cooperative, and the Choginosaka Credit Cooperative.
12. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help, estimated at ¥3,084 billion at end of September 1997 for all major banks (as defined in note 10).
13. The figures *exclude* the Hokkaido Takushoku Bank, Tokuyo City Bank, Kyoto Kyoei Bank, Naniwa Bank, Fukutoku Bank, Midori Bank, and 32 credit companies whose assets and liabilities have been transferred to other institutions.
14. The figure *excludes* loans to borrowers to which the lending bank(s) is extending help, estimated at ¥2,015 billion at end of March 1998 for all Japanese deposit-taking institutions.
15. The figure was provided privately to me by the FSA.
16. The figures *exclude* the Nippon Credit Bank.
17. The figures *include* the Nippon Credit Bank but *exclude* the Tokyo Sowa Bank, Niigata Chuo Bank and bankrupted co-operatives.
18. The figures *exclude* financial institutions which were declared bankrupt.

Sources: Hall, 2000; Financial Supervisory/Services Agency (various).

TABLE 3.9 : TRENDS IN THE JAPANESE BANKING SECTOR'S NPLs, AS DEFINED UNDER THE FINANCIAL RECONSTRUCTION LAW, 1999-2003 (¥ billion)

		End-Mar.'99	**End-Mar.'00**	**End-Mar.'01**	**End-Mar.'02**	**End-Mar.'03**	**End-Sept.'03**
NPLs of the:							
"Major Banks"[1] (i.e. City Banks, Long-term Credit Banks and Trust Banks)	Bankrupt or *De facto* Bankrupt	5,366	4,080	3,697	3,529	2,210	2,221
	Doubtful	12,318	10,840	9,170	12,979	6,774	6,329
	Special Attention	4,261	5,438	7,141	11,877	11,696	9,191
	Sub-Total	21,945 (21,945)[2]	20,358 (18,493)	20,080 (18,032)	28,385 (26,782)	20,680 (20,244)	17,742 (17,458)
Regional Banks[3] (i.e. Regional Banks and Regional Banks II)	Bankrupt or *De facto* Bankrupt	4,955	3,706	3,964	3,875	3,537	3,371
	Doubtful	5,097	5,408	5,864	6,336	6,239	5,998
	Special Attention	1,946	2,333	3,794	4,611	4,884	4,524
	Sub-Total	11,998	11,447	13,622	14,822	14,660	13,893
All Banks	Total NPLs	33,943	31,805	33,630	43,207	35,339	31,635

Notes:
1. Figures for the Shinsei Bank and Aozora Bank are excluded for end-Mar.'99, and figures for the Aozora Bank are also excluded for end-Mar.'00. Both banks' figures have been included since.
2. Figures in parentheses exclude the Shinsei Bank and Aozora Bank.
3. Figures for the Saitama Resona Bank are included.

Source: FSA, 2004.

TABLE 3.10 : JAPANESE BANKS' NON-PERFORMING LOANS,[1] 1997-2003

Bank Grouping	**Date (end-March)**						
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
City Banks	3.6	4.8	5.2	15.0	5.4	9.4	7.8
Trust Banks	6.0	8.4	11.0	8.7	7.5	9.5	7.5
Long-term Credit Banks	5.4	10.0	9.1	9.0	10.0	9.6	6.2
Regional Banks	2.4	3.7	4.9	5.6	7.0	7.7	7.7
Regional Banks II	3.8	5.3	5.5	6.7	8.2	9.0	8.9
All Banks	3.7	5.4	5.8	6.1	6.6	8.9	7.8

Notes:
(1) "Risk management loans", gross of provisions, as a percentage of total loans.

Source: IMF, 2003 (main text, p.14, and 'Supplementary Information', p.10).

TABLE 3.11 : RESULTS OF IMF STRESS TESTS USING PUBLISHED END-MARCH 2002 DATA

Type of Stress Test	**Nature of Shock**	**Average Impact on Institutional Groupings[1]**		
		City Banks	**Regional Banks**	**Cooperative Central Banks**
Market risk				
: equity	20% decline in prices	37 (102)	11 (15)	3 (3)
: interest rate	100 basis points increase in yields	17 (43)	16 (22)	49 (51)
Credit risk	3% credit loss on loan book	54 (140)	41 (63)	38 (39)

Notes:
(1) In terms of the percentage loss of shareholder equity which results (figures in parentheses represent the loss as a percentage of shareholder equity *excluding* deferred tax assets).

Source: IMF, 2003 ('Summary of IMF Staff Stress Test Results', Box 4, p.20).

TABLE 3.12 : RESULTS OF IMF STRESS TESTS USING PUBLISHED END-MARCH 2003 DATA

Type of Stress Test	**Nature of Shock**	**Average Impact on Institutional Groupings[(1)]**		
		City Banks	**Regional Banks**	**Cooperative Central Banks**
Market risk				
: equity	20% decline in prices	44 (100)[(2)]	9 (13)	3 (3)
: interest rate	100 basis points increase in yields	33 (98)[(2)]	22 (30)	72 (76)
Credit risk	3% credit loss on loan book	94 (232)[(2)]	45 (65)	35 (37)

Notes:
(1) In terms of the percentage loss of shareholder equity which results (figures in parentheses represent the loss as a percentage of shareholder equity *excluding* deferred tax assets).
(2) Average excludes two institutions in which DTAs exceed shareholder equity.

Source: IMF, 2003 ('Supplementary Information', Box 1, p.3).

TABLE 4.1 : THE INSTITUTIONAL STRUCTURE OF BANKING REGULATION AND SUPERVISION IN JAPAN

Prime Minister's Office

Financial Services Agency[1]
Functions:
- licensing of private financial Institutions
- inspection and supervision of financial institutions
- resolution of problem banks,[2] securities firms and insurance companies
- financial crisis management
- regulation of financial markets[3]
- financial system planning

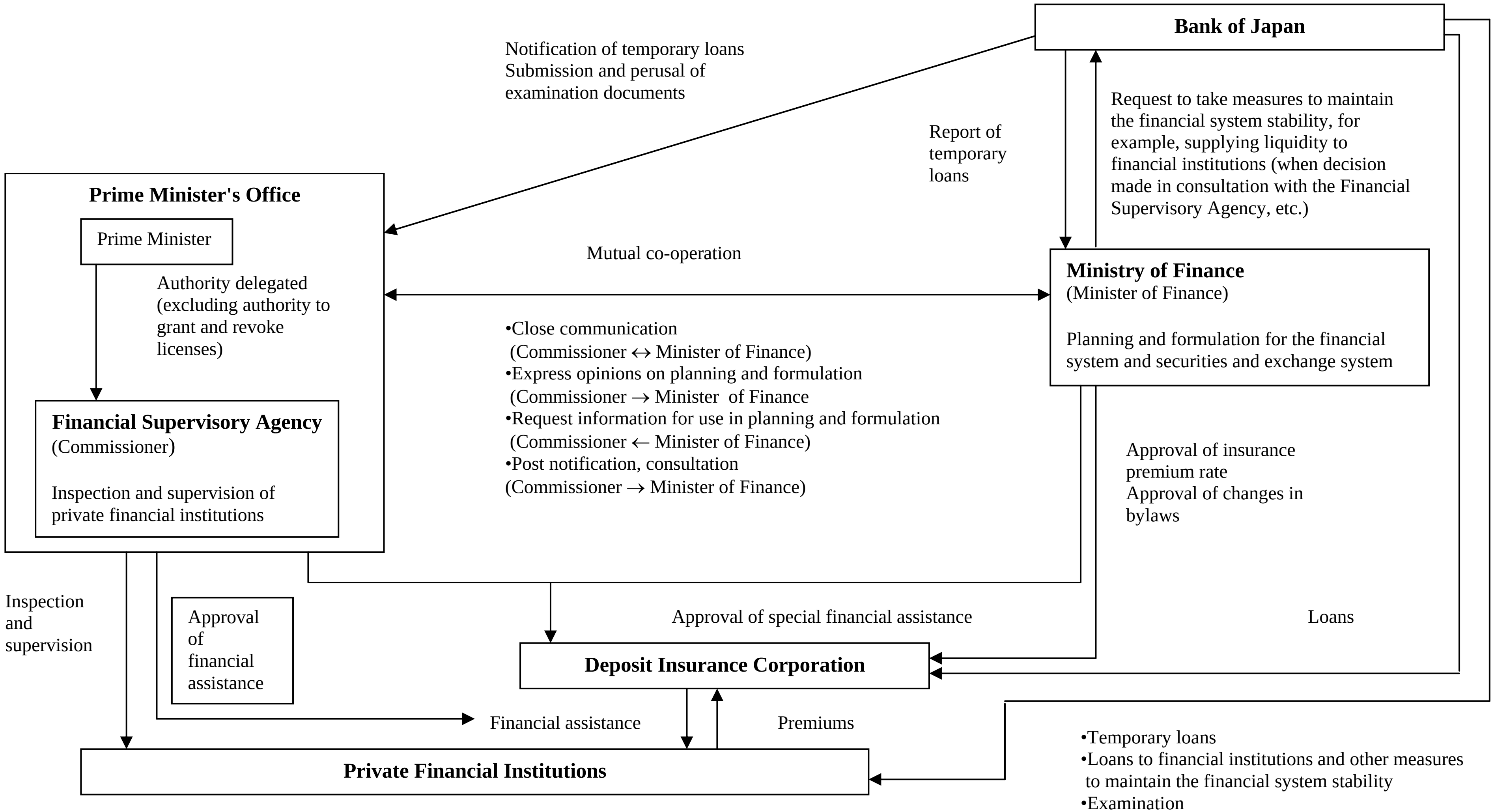
Bank of Japan
Functions:
- on-site examination of client financial institutions holding current accounts with it
- liquidity assistance to promote financial stability

Deposit Insurance Corporation
Functions:
- depositor protection
- to promote financial stability

Notes:
(1) An agency, under the Cabinet Office, which began operations in July 2000 following the assumption of the financial planning responsibilities previously performed by the Financial Planning Bureau of the Ministry of Finance, and the licensing, inspection and supervision functions previously performed by the Financial Supervisory Agency. It also absorbed the Financial Reconstruction Commission in January 2001.
(2) This also involves the Resolution and Collection Corporation and, in the near future, will also embrace the Banks' Shareholding Acquisition Corporation.
(3) Carried out through the Securities Exchange Surveillance Commission, which was absorbed from the Ministry of Finance by the old Financial Supervisory Agency on its inauguration in 1998.

Source: Hall, 2003a, Figure 2.

TABLE 4.2 : RELATIONSHIPS BETWEEN THE FINANCIAL SUPERVISORY AGENCY, THE MINISTRY OF FINANCE, THE BANK OF JAPAN AND THE DEPOSIT INSURANCE CORPORATION IN 1998



Source: Hall, 2003a, Figure 1.

TABLE 5.1 : JAPAN'S VERSION OF PROMPT CORRECTIVE ACTION

Class of action	**Capital adequacy Ratio trigger**		**Action to be taken**
	BIS Standard[1]	**Adjusted**[2] **national standard**[3]	
1	Less than 8%	Less than 4%	To order the formulation and implementation of a management improvement plan
2	Less than 4%	Less than 2%	To order such measures or implement such restrictions as: • formulation of a plan to increase capital • restraint on the increase of total assets or reduction of total assets • prohibition on entering new business fields • curtailment of current business operations • prohibition on opening new offices and curtailment of offices currently operated • curtailment of business activities of subsidiaries and overseas affiliated companies, and prohibition on establishing such entities • restraint or prohibition on paying dividends • restraint on paying bonuses to directors and other senior officers • restraint or prohibition on taking deposits at high interest rates
3	Less than 2%	Less than 1%	To order reductions in businesses, a merger or closure
4	Less than 10%	Less than 0%	Usually,[4] to order the suspension of some or all of the business activities[5]

Notes:

(1) To be adopted by banks operating overseas whether through branches or subsidiaries.

(2) The original 'national standard' ratio was calculated as the sum of capital plus certain reserves as a percentage of the daily average of total assets less some special reserves. Under the subsequent revisions, the numerator included debt raised through the issue of subordinated debentures but excluded special reserves and unrealised gains on securities holdings. Moreover, the denominator was eventually represented by the 'total of weighted risk assets', as calculated under the BIS 'rules' (*see* Hall, 1993, p.189).

(3) To be adopted by those banks without foreign branches or subsidiaries.

(4) These actions, however, cannot be taken in the following cases: (i) if the net value of assets, as with unrealised gains of the financial institution, is positive; and (ii) even when the net value of assets, as with unrealised gains, is negative but is expected to become positive once allowance is made for implementation of management improvement plans and other specific measures, the rates of business income and expenditure, profitability and bad debt ratios.

(5) A business suspension can also be ordered, even when a financial institution does not belong to this class, when the net value of assets, including unrealised losses, is negative (or when it is clearly expected to become negative) or because of a lack of liquidity.

Source: Hall, 2003a, Table 2.

TABLE 5.2 : IMF'S RECOMMENDED ACTION PLAN TO IMPROVE JAPAN'S OBSERVANCE OF THE BASEL COMMITTEE'S "CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION"

Reference Principle		**Recommended Action**
CP 1.2	Independence	Consider setting up a board for the FSA (as with the SESC) to help ensure visible autonomy and accountability. To guarantee budgetary independence, the supervised institutions should be charged by the FSA for the costs of supervision.
CP 1.6	Information sharing	Formalise arrangements for regular exchange of information with the Bank of Japan. An obligation for external auditors to inform the supervisor of any material finding should be embodied in law.
CP 2	Permissible activities	Extend full supervisory authority of the FSA to GFIs.
CP 4	Control of banks	Need for FSA approval of an increase in a significant holding.
CP 5	Investments by banks	Need for FSA approval of amount of investments in relation to the bank's capital.
CP 6	Capital adequacy	Change definition of capital to limit inclusion of DTA. General provisions for Category II assets should not be in Tier-2. The capital adequacy ratio for domestic banks should be at least eight per cent.
CP 8	Loan evaluation and loan-loss provisioning	Loans should be valued on the basis of the net present value of expected recoveries.
CP 9	Large exposure limits	Limits should be reduced.
CP 11	Country risk	Country risk should be regularly reported and supervised.
CP 15	Money laundering	New customer identification law will need to be applied effectively.
CP 19	Validation of supervisory information	Need for the FSA to have the authority to appoint, or oppose the appointment of, an external auditor.
CP 21	Accounting standards	Need for the FSA to have the right to revoke the license of an external auditor.
CP 24	Host country supervision	Need for recognition in the law of the rights of supervisors to exchange information.
CP 25	Supervision over foreign banks' establishments	Introduce more formalised arrangements for the exchange of information with foreign supervisors.

Source: IMF, 2003, Appendix I, pp.27-28.

TABLE 6.1 : THE IMF'S "KEY POLICY RECOMMENDATIONS" FOR RESTORING THE HEALTH OF THE JAPANESE BANKING SECTOR

Asset quality and bank capital

Further strengthen banks' provisioning for NPLs, including by extending the use of forward-looking expected loss estimates.
Required provisions to be a tax deductible cost.
Limit the use of deferred tax assets in calculating bank capital.
General provisions in respect of "Category II" loans should be excluded from Tier 2 capital.

Bank recapitalisation

Encourage banks to raise from the markets the additional capital needed to meet requirements due to the stricter treatment of deferred tax assets and provisioning.
Recapitalise those systemically important banks that are unable to raise sufficient capital in the market to at least eight per cent.
Require recapitalised banks to bring in new management and meet profitability targets (targets for SME lending to be discontinued).
Gradually raise the minimum capital requirement for domestic banks to at least eight per cent.
Wind-down (or merge) non-viable banks.

Bank governance

Require banks to adopt corporate governance reforms consistent with the Basel Committee's guidelines, including outside directors and a board audit committee.

Corporate restructuring

Encourage banks to set up subsidiary "work-out" companies (already in train).
Develop further the market for distressed debt by having the Resolution and Collection Corporation (RCC) and the Industrial Revitalization Corporation of Japan (IRCJ) serve as a catalyst for transferring impaired assets from the banks to the private sector (already in train).

Supervision

Reform the governance of the supervisory process to give the FSA full operational autonomy and confine its responsibilities to supervision.
Provide additional resources to the FSA and continue to enhance its human capital.
FSA to make greater use of external auditors of financial institutions.
FSA to formalise the arrangements for information exchanges with the BoJ and other regulatory bodies.

Government involvement in the financial sector

Reduce government involvement in the financial sector by restricting the activities of the postal savings and insurance schemes and the government lending agencies.

Source: Adapted from IMF, 2003, Box 2, p.7.

THE APPENDIX: DEPOSIT INSURANCE ARRANGEMENTS OPERATING IN JAPAN

The Role of the Deposit Insurance Corporation of Japan (DICJ)

The DICJ was established on 1 July 1971 as an operating agency of Japan's deposit insurance system under the Deposit Insurance Law of April 1971. Its objectives are "to protect depositors and other parties, secure the intermediary functions of failed financial institutions in the payment and settlement system, and maintain an orderly financial system". It does this by: providing for the payment of deposit insurance claims and the purchase of deposits and other claims in the event that repayment of deposits is suspended by financial institutions; providing appropriate financial assistance to facilitate mergers or other resolutions of failed financial institutions; providing for financial administration for failed financial institutions; providing for the succession of business of failed financial institutions; and establishing a system of appropriate measures to be taken in a financial crisis.

The functions of the DICJ have grown recently as a result of various amendments to the Deposit Insurance Law and enactment of new laws relating to the financial system [e.g. the "Financial Revitalization Law" and the "Early Strengthening Law" of 1998 - *see* Hall, 1999] to embrace, for example, additional funding relating to the resolution of failed financial institutions, including tasks concerned with financial administration and the operation of a bridge bank, and capital injection as a temporary measure for the revitalisation of the financial system.

The current operations of the DICJ embrace the following:

1. *Collection of insurance premiums* – the current insurance premium rate is 0.09% for "payment and settlement deposits" and 0.08% for "general deposits" [the payment of a "special" premium rate (of 0.036%) introduced in June 1996 ceased at the end of March 2002 – *see* Hall, 1999].

2. *Reimbursement of insured deposits and other money* – in principle, up to the *de jure* limit of ¥10 million in principal plus interest per depositor per financial institution unless alternative arrangements are in place. Under the "blanket guarantee" arrangements introduced in June 1996, for example, *all* deposits were fully protected until end-March 2001. Since then, the Deposit Insurance Law has been amended to allow for continuation of blanket coverage for certain types of deposits in accordance with the following schedule: for the period until end-March 2002 all deposits enjoyed full protection; from 1 April 2002 until end-March 2005, "specific deposits" (i.e. current deposits, ordinary deposits and specified deposits) will continue to enjoy full protection although "other deposits" (e.g. time deposits and instalment savings) will only be subject to the ¥10 million level of protection operated earlier; from 1 April 2005 onwards, all deposits other than "payment and settlement deposits" satisfying certain conditions (i.e. they bear no interest, are redeemable on demand and normally provide payment and settlement services), which will continue to enjoy full protection, will only be covered up to the limit of ¥10 million per depositor per financial institution. In March 2002, an additional ¥10 trillion was added to the ¥17 trillion available to reimburse depositors of failed institutions.

3. *Provision of financial assistance*. In the event of institution failure, financial assistance can be provided to an assuming financial institution and/or a bank holding company that purchases the assets and assumes the liabilities of/or merges with the failed financial institution. The financial assistance may take the form of a monetary grant, loan or deposit of funds, purchase of assets, guarantee or assumption of debts, subscription of preferred stock or loss sharing. As of 18 June 2003, financial assistance had been provided in 180 cases – *see* Table A1 – involving grants totalling ¥18.7 trillion and asset purchases of ¥6.3 trillion. For the first time in 12 years, no DTIs failed in fiscal 2002 – *see* Table A2.

   Financial assistance may also be provided in "financial crisis" situations – *see* below – and to strengthen the capital bases of financial institutions (under the "Early Strengthening Law" of 1998 which superseded the "Financial Function Stabilisation Law" of February 1998). Capital injections made through the latter route, through (RCC) purchases of preferred stock and/or subordinated bonds (or loans), amounted to ¥1.82 trillion in March 1998 (*see* Table A3) (¥844.6 billion has since been repaid), with ¥8.6 trillion subsequently being made (as of 9 May 2003) (¥300 billion has since been repaid) under the Early Strengthening Law – *see* Table A4.

   Assistance provided in "financial crisis" situations has resulted in the DICJ (through the RCC) subscribing ¥1.96 trillion to the preferred and common shares of Resona Bank, in response to an application from the bank, in June 2003 [under Article 102, para.1(1), of the Deposit Insurance Law of May 2000 which put on to a permanent footing the temporary financial crisis management provisions introduced in 1998 and scheduled for expiry at end-March 2001].

   Finally, the DICJ (again, through the RCC) can provide (until end-March 2005) financial assistance, *via* asset purchases, to "sound" financial institutions under Article

53 of the "Financial Revitalization Law" of 1998; and, under the "Special Measures Law for the Promotion of Organizational Restructuring" of 2003, the DICJ can inject capital into financial institutions pursuing organisational restructurings through mergers, etc. Assistance through the former route has been provided to 170 institutions since April 1999 (as of end-March 2003) with ¥260.6 billion being paid for assets with principal totalling ¥3.39 trillion – *see* Table A5. And the first call on funds under the latter law was made in April 2003 when Kanto Bank and Tsukuba Bank merged to form the Kanto Tsukuba Bank.

4. *Purchases of deposits and other claims*. The DICJ is empowered to purchase deposits and other claims not covered by deposit insurance (e.g. the principal of insurable deposits in excess of ¥10 million, plus accrued interest, or non-insurable foreign currency deposits, plus accrued interest) from financial institutions that have been subject to an insurable contingency, in response to requests from depositors, etc. If the amount recovered by the DICJ from purchased deposits and other claims (excluding the expenses incurred in the purchase) exceeds the "estimated proceeds payment" (i.e. the amount due to depositors) the surplus is refunded to the depositors by way of a "settlement payment" (*see* DICJ, 2004, p.xxi).

5. Operation as a "*financial administrator*". When a financial institution fails and the Commissioner of the FSAJ issues an "order for management" (i.e. orders that the business or assets of the financial institution be placed under the management of a financial institution), the DICJ may be appointed as a financial administrator (under Article 78, para.2, of the Deposit Insurance Law). This involves, *inter alia*, the execution of the operations of the failed institutions, the selection of assuming financial institutions and the smooth transfer of business, and the pursuit of liability

against former executives of the failed financial institutions. Management of the failed institutions has to end within one year of the date of issue of the management order, through transfer of the institution's business or other means, although a year's extension to this deadline may be granted, subject to the approval of the Commissioner of the FSAJ. Between fiscal 1999 and fiscal 2002, the DICJ operated as a financial administrator for a total of 10 DTIs.

6. The operation of *bridge banks*. The DICJ is empowered to establish bridge banks, as its own subsidiaries, which provisionally assume the business of failed financial institutions under management in order to provisionally maintain and continue their operation until a private sector counterpart can be identified and the business transfer transaction completed (in principle, within two years from the date of the management order, with the possibility of a further year's extension). The business transfer can be completed through merger of the bridge bank, transfer of its business, transfer of shares, dissolution through a resolution at a shareholders' general meeting, or by other means. The DICJ may also provide loans to and guarantee the borrowings of the bridge bank, and compensate for any losses incurred in conducting operations, as stipulated in Cabinet Orders. The Bridge Bank of Japan (BBJ), the first bridge bank to be set up, was duly established as a 100 per cent subsidiary of the DICJ in March 2002 to take over the operations of Ishikawa Bank and Chubu Bank.

7. Operations taken in *response to financial crisis*. If the failure of a financial institution poses an extremely serious threat to the stability of the financial system and local and/or national economies, the Prime Minister may invoke the provisions of the law (Article 102) and order the DICJ, on the advice of the Financial System Management Council, to take one or more of the following actions:

(i) purchase the shares, etc. of specified financial institutions which have neither failed nor been deemed insolvent;

(ii) provide financial assistance to failed financial institutions and/or financial institutions with a capital deficit in excess of the pay-out cost; and

(iii) acquire all the shares of failed financial institutions with a capital deficit (i.e. temporary nationalisation).

In case (ii), an order for management by a financial administrator has to be issued immediately ; and in scenario (iii), the FSAJ would appoint new directors and auditors of the bank under "special crisis management", and they may proceed with necessary civil and criminal procedures to clarify the managerial liability of its former executives. This arrangement should be ended as soon as possible by transferring the business to an assuming financial institution, etc.

Type (i) action, as noted above, occurred for the first time in June 2003 when ¥1.96 trillion was injected into Resona Bank. And type (iii) action was taken in respect of the Long-Term Credit Bank and Nippon Credit Bank in 1998, both of which were subsequently transferred to new private sector owners in 2002 (i.e. to the Ripplewood Group and a local consortium led by Softbank respectively), and again in November 2003 in respect of Ashikaga Bank.

8. *On-site inspections* of financial institutions. The DICJ is authorised, under Article 137, para.6, of the Deposit Insurance Law, to carry out such on-site inspections if the Prime Minister/FSA deem it necessary to ensure that the provisions of the law are implemented efficiently. The scope of the inspections includes: (i) checking to see if the payment of insurance premiums is being made properly; (ii) checking if adequate measures have been taken to prepare databases and improve information systems for aggregating deposits held by the same depositors; and (iii) identifying the estimated

amounts that can be repaid on deposits and other claims when a financial institution fails. An inspection department was duly established by the DICJ in July 2003 to enhance its inspections, which began in January 2003.

9. *Asset investigations*. The DICJ, in conjunction with the RCC, carries out asset investigations when it believes the assets of debtors are likely to be concealed. In fiscal year 2002, for example, the DICJ investigated 296 cases and uncovered ¥48 billion in hidden assets of debtors. This will further add to the list of criminal suits being brought against the executives of failed financial institutions.

Group Structure of the DICJ

The DICJ Group comprises the DICJ and three fully-owned subsidiaries, namely:

(i) the *Resolution and Collection Corporation* (RCC) [established as a 100 per cent subsidiary, limited company on 1 April 1999 as a result of the merger between the Housing Loan Administration Corporation (HLAC) and the Resolution and Collection Bank (RCB) in October 1998]. The purpose of the RCC is:

- the recovery of loans transferred from the former *jusen* companies (*see* Hall, 1999) (using its *Jusen* account);
- the purchase and collection of NPLs from failed financial institutions (using its RCB account);
- the purchase and collection of NPLs (classified as 'in danger of bankruptcy" or worse) from sound financial institutions (using the so-called 'Article 53' account, denoting the article of the Financial Revitalization Law authorising such activities);

- subscribing to financial institutions' shares to enhance their capital adequacy;
- the pursuit of civil and criminal liabilities of former executives and debtors of failed financial institutions;
- to act as a servicer under the license of the Minister of Justice;
- to act as an arranger for private corporate reconstruction funds and trust-related activities; and
- to purchase and collect NPLs from the agriculture and fishery co-operative institutions entrusted by the Savings Insurance Corporation.

In fiscal 2002, the RCC recovered ¥924.3 billion of debts, disposed of 650 properties worth ¥31.7 billion in aggregate, executed real estate securitisations totalling around ¥40 billion and sold other claims totalling ¥611.6 billion. This brought cumulative totals since 1996, the date such operations began, to ¥228 billion for the value of properties sold, and to ¥873.3 billion for the principal value of other claims sold.

(ii) *The Bridge Bank of Japan, Ltd.* (BBJ). As noted above, the BBJ was established, under Article 92 of the Deposit Insurance Law, as a 100 per cent subsidiary of the DICJ, in March 2002.

(iii) *The Industrial Revitalization Corporation of Japan* (IRCJ).

The IRCJ was established, as a fully-owned subsidiary of the DICJ, on 16 April 2003. Its capital has since been increased by further capital injections from the DICJ (raising its stake from ¥49.4 trillion to ¥49.8 trillion) and the Norinchukin Bank (¥750 million). Its operations are supported by a ¥10 trillion government guarantee.

The purpose of the IRCJ, which began operations in May 2003 and has a fixed life-span of five years, is to revitalise the business of ailing corporations in co-operation with their main financing banks. It does this mainly by purchasing the claims on such corporations, which the IRCJ believes can be successfully turned around, from financial institutions other than their main financing banks at appropriate "market prices". Through such revitalisation activities, which protect the flow of normal commercial credit, the IRCJ hopes not only to stimulate economic activity but also to assist the banks in their disposal of bad debts. Any assets acquired by the IRCJ, which are of a higher quality than those acquired by the RCC, have to be disposed of within three years, the main buyers being commercial banks, investment banks, private equity funds and business "sponsors" with an interest in seeing the company flourish as a going concern. Companies selected for assistance from the IRCJ have to meet productivity targets and restore financial soundness within three years of the decision to support them. Usually, current management is required to resign; and shareholders are likely to suffer a dilution of their interests.

The comparative advantages enjoyed by the IRCJ in the distressed debt work-out market embrace the following: ability to act quickly as a neutral and fair third party in helping financial creditors to resolve disputes without resorting to the legal system (the ability to purchase debts facilitates this process by reducing the number of creditors involved which, in the case of Kanebo, comprised over 100 non-main banks); availability of specialist expertise (lawyers, accountants, work-out business experts, etc.); advantageous tax treatment for the parties involved (e.g. booking losses on debt write-offs and asset reappraisal, offsetting debt forgiveness against profits, etc.); availability of finely-priced assistance (e.g. loans, equity participation) because of the government guarantee; and improved debtor classification for assisted companies (close liaison with the FSA allows banks to remove loans to IRCJ-assisted companies from the 'need attention' category, thereby reducing loan loss provisioning and boosting capital adequacy and profitability).

TABLE A1 : FINANCIAL ASSISTANCE PROVIDED BY THE DICJ FOR THE FISCAL YEARS 1992-2002

Fiscal Year	Number of Cases	Assistance Provided (¥ billion)			
		Grants	Asset Purchases	Other	Total
1992	2	20.0	-	8.0	28.0
1993	2	45.9	-	-	45.9
1994	2	42.5	-	-	42.5
1995	3	600.8	-	-	600.8
1996	6	1,316.0	90.0	-	1,406.0
1997	7	152.4	239.1	4.0	395.5
1998	30	2,684.5	2,681.5	-	5,366.0
1999	20	4,637.1	1,304.4	-	5,941.5
2000	20	5,156.1	850.1	-	6,006.2
2001	37	1,642.6	406.4	-	2,049.0
2002	51	2,370.7	794.9	-	3,165.6
1992-2002	180	18,668.7	6,366.3	12.0	25,046.9

Source: DICJ, 2004, p.23.

TABLE A2 : DEPOSIT-TAKING INSTITUTION FAILURE IN JAPAN FOR THE FISCAL YEARS 1991-2002

Fiscal Year	Deposit-Taking Institution Failure			
	Banks	Shinkin Banks	Credit Corporations	Total Number of Failed DTIs
1991-1994	1	2	5	8
1995	2	0	4	6
1996	1	0	4	5
1997	3	0	14	17
1998	5	0	25	30
1999	5	10	29	44
2000	0	2	12	14
2001	2	13	41	56
2002	0	0	0	0
1991-2002	19	27	134	180

Source: DICJ, 2004, p.1.

TABLE A3 : CAPITAL INJECTIONS BY THE DICJ MADE UNDER THE "FINANCIAL FUNCTION STABILIZATION LAW" OF 1998 (as of 9 May 2003)

Recipient Institution	**Date of Capital Injection**	**Nature of Assistance Provided (¥ billion)**		**Total Sum Injected (¥ billion)**
		Purchase of Preferred Stock	**Subordinated Bond Purchases/Loans**	
Mizuho (formerly Dai-Ichi Kangyo Bank)	March 1998	99.0	--	99.0
Mizuho (formerly Fuji Bank)	"	--	100.0	100.0
Mizuho (formerly Industrial Bank of Japan)	"	--	100.0	100.0
Mizuho (formerly Yasuda Trust and Banking)	"	--	150.0	150.0
SMFG (formerly Sakura Bank)	"	--	100.0	100.0
SMFG (formerly Sumitomo Bank)	"	--	100.0	100.0
MTFG (formerly Tokyo Mitsubishi Bank)	"	--	100.0	100.0
MTFG (formerly Mitsubishi Trust and Banking)	"	--	50.0	50.0
UFJ Holdings (formerly Sanwa Bank)	"	--	100.0	100.0
UFJ Holdings (formerly Tokai Bank)	"	--	100.0	100.0
UFJ Holdings (formerly Toyo Trust and Banking)	"	--	50.0	50.0
Resona Holdings (formerly Asahi Bank)	"	--	100.0	100.0
Resona Holdings (formerly Daiwa Bank)	"	--	100.0	100.0
Sumitomo Trust and Banking	"	--	100.0	100.0
Mitsui Trust Holdings	"	--	100.0	100.0

(formerly Mitsui Trust and Banking)				
Mitsui Trust Holdings (formerly Chuo Trust and Banking)	"	32.0	28.0	60.0
Bank of Yokohama	"	--	20.0	20.0
Hokuriku Bank	"	--	20.0	20.0
Ashigin Group (formerly Ashikaga Bank)	"	--	30.0	30.0
Shinsei Bank	"	130.0	46.6	176.6
Aozora Bank	"	60.0	--	60.0

Source: DICJ, 2004, p.26.

TABLE A4 : CAPITAL INJECTIONS BY THE DICJ MADE UNDER THE "EARLY STRENGTHENING LAW" OF 1998 (as of 9 May 2003)

Recipient Institution	**Date of Capital Injection**	**Nature of Assistance Provided (¥ billion)**		**Total Sum Injected (¥ billion)**
		Purchase of Preferred Stock	**Subordinated Bond Purchases/Loans**	
Mizuho (formerly Dai-Ichi Kangyo Bank)	March 1999	700.0	200.0	900.0
Mizuho (formerly Fuji Bank)	March 1999	800.0	200.0	1,000.0
Mizuho (formerly Industrial Bank of Japan)	March 1999	350.0	250.0	600.0
SMFG (formerly Sakura Bank)	March 1999	800.0	--	800.0
SMFG (formerly Sumitomo Bank)	March 1999	501.0	--	501.0
UFJ Holdings (formerly Sanwa Bank)	March 1999	600.0	100.0	700.0
UFJ Holdings (formerly Tokai Bank)	March 1999	600.0	--	600.0
UFJ Holdings (formerly Toyo Trust and Banking)	March 1999	200.0	--	200.0
Resona Holdings (formerly Daiwa Bank)	March 1999	408.0	--	408.0
Resona Holdings (formerly Asahi Bank)	March 1999	400.0	100.0	500.0
MTFG (formerly Mitsubishi Trust and Banking)	March 1999	200.0	100.0	300.0
Sumitomo Trust and Banking	March 1999	100.0	100.0	200.0
Mitsui Trust Holdings (formerly Mitsui Trust and Banking)	March 1999	250.3	150.0	400.3
Mitsui Trust Holdings (formerly Chuo Trust and Banking)	March 1999	150.0	--	150.0
Bank of Yokohama	March 1999	100.0	100.0	200.0

Ashigin Group (formerly Ashikaga Bank)	September 1999 November 1999	75.0 30.0	-- --	75.0 30.0
Hokuriku Bank	September 1999	75.0	--	75.0
Bank of the Ryukyus	September 1999	40.0	--	40.0
Momiji Holdings (formerly Hiroshima-Sogo Bank)	September 1999	20.0	20.0	40.0
Kumamoto Family Bank	February 2000	30.0	--	30.0
Hokkaido Bank	March 2000	45.0	--	45.0
Shinsei Bank	March 2000	240.0	--	240.0
Chiba Kogyo Bank	September 2000	60.0	--	60.0
Yachiyo Bank	September 2000	35.0	--	35.0
Aozora Bank	October 2000	260.0	--	260.0
Kansai Sawayaka Bank	March 2001	8.0	4.0	12.0
Higashi-Nippon Bank	March 2001	20.0	--	20.0
Resona Holdings (formerly Kinki Osaka Bank)	April 2001	60.0	--	60.0
Gifu Bank	April 2001	12.0	--	12.0
Fukuoka Bank	January 2002	70.0	--	70.0
Wakayama Bank	January 2002	12.0	--	12.0
Kyushu Shinwa Holdings (formerly Kyushu Bank)	March 2002	30.0	--	30.0

Source: DICJ, 2004, pp.24-25.

TABLE A5 : DICJ ASSET PURCHASES (THROUGH THE RCC) FROM SOUND FINANCIAL INSTITUTIONS UNDER ARTICLE 53 OF THE "FINANCIAL REVITALIZATION LAW" OF 1998 FOR THE PERIOD APRIL 1999 – END-MARCH 2003

Institutions Assisted	Number of Institutions	Principal of Claims (¥ billion)	Purchase Price (¥ billion)
City, Long-Term Credit and Trust Banks	12	2,419.8	210.7
Regional Banks	57	447.4	30.0
Regional Banks II	38	396.9	9.8
Co-operative-type DTIs	63	127.9	10.2
Total	170	3,392.0	260.6

Source: DICJ, 2004, p.29.

END-NOTES

1 The Shinkin Central Bank, formerly known as the Zenshinren Bank, is the national federation of *shinkin* banks; the Rokinren Bank is the central national organisation for labor banks; and the Norinchukin Bank is the central cooperative bank for the agriculture, forestry and fisheries industries. [For further details of the operations of these and other specialist cooperative-type institutions *see* Japanese Bankers' Association, 2001, Chapter 1.]

2 Comprising the Bank of Tokyo-Mitsubishi, Mizuho Bank, Mizuho Corporate Bank, Resona Bank, Saitama Resona Bank, UFJ Bank, and Sumitomo Mitsui Banking Corporation. The number will fall to six when the Bank of Tokyo-Mitsubishi merges with UFJ Bank during 2005.

3 Comprising Mizuho Holdings, the Sumitomo Mitsui Financial Group, the Mitsubishi Tokyo Financial Group, UFJ Holdings and Resona Holdings. The number will fall to four on completion of the merger of MTFG and UFJ Holdings during 2005.

4 The bank, which was Japan's tenth largest regional lender, was nationalised following the bank's auditors' decision not to allow the bank to count any of its deferred tax assets (which amounted to 186 per cent of Tier 1 capital) as capital, causing its capital adequacy ratio to fall to –3.7 per cent at end-September 2003 [the minimum required of "domestic" operators is 4 per cent]. Liabilities were also found to have exceeded assets by ¥102 billion. The nationalisation route, rather than allowing outright failure, was adopted because of concerns for the regional economy as the bank accounted for nearly 50 per cent of bank lending and deposits in its home prefecture of Tochigi. The action taken may also presage further nationalisation/rescue of similarly-placed regional banks in advance of the restoration of the deposit insurance cap of ¥10 million per deposit at end-March 2005 to all bar certain 'Payment and Settlement' deposits. [For further details *see* the text below.]

5 For example, in April 2000 the Mitsui Trust and Chuo Trust merged to form the Chuo Mitsui Trust, which went on to merge with Sakura Trust in February 2002 to form the Mitsui Trust Holdings. Similarly, three trust banks – Mitsubishi Trust, Nippon Trust and Tokyo Trust – were merged to create the Mitsubishi Trust in October 2001.

6 Data released in May 2004, however, suggested sustainable recovery may now be in place. Real GDP was shown to have grown at an annualised rate of 5.6% in the first quarter of 2004, taking its growth in fiscal 2003 to 3.2%. Nominal GDP growth of 3.2%, at an annualised rate, was also recorded for the first quarter of 2004, taking fiscal 2003 growth to 0.7%, the first positive annual growth rate recorded for three years. Equally reassuring was the revelation that the two-year expansion was fuelled not only by an expansion in exports but also by growth in domestic consumer demand, with household consumption growing, for the fifth consecutive month, in March 2004, taking annualised growth in the first quarter of 2004 to 4.1%. Together with other figures showing a rise in corporate profitability, declining corporate bankruptcies and a fall in unemployment – a three-year low of 4.7% was recorded in March 2004 – commentators are finally suggesting the real economy may have "turned the corner" after a number of "false dawns" since the latter part of the 1990s.

7 Although there has been a strong market recovery since the end of fiscal 2002, taking the Nikkei 225 index back above the 10,000 level (compared with a peak of around 40,000 recorded in the late 1980s) and the Topix index back above the 1,000 level.

8 There are some signs, however, that the worst may be over. Data released in December 2003 revealed that the Consumer Price Index *rose* by 0.1 per cent in the year to October 2003, ending five years of price deflation.

9 Although this creates something of a "double-edged sword" for most banks, as it opens up traditional markets to competitors as well as providing new opportunities – the biggest "losers" were always going to be the Long-term Credit Banks given the undermining of their limited franchise (Hall, 1998b and 1999b), a view endorsed by the subsequent nationalisation of the Long-Term Credit Bank (now called the Shinsei Bank) and the Nippon Credit Bank (now known as the Aozora Bank) in 1998 - the benefits are now beginning to materialise. These have arisen, in particular, because of the gradual extension of the scope of permissible business activities. For example, under the Financial System Reform Act of 1992 (which took effect in April 1993), banks are allowed to conduct *securities business* either through trust bank subsidiaries or, since February 2002, by themselves subject to permission from the Prime Minister. And, under the Financial System Reform Act of 1998, banks were allowed to conduct *insurance business* through wholly-owned subsidiaries from October 2000. Moreover, subsequent revisions to the Insurance Business Law have made it possible for banks to engage by themselves in retail sales of certain kinds of insurance products since April 2001, with the scope of permissible products being further expanded in October 2002. Finally, it is worth noting that Japanese banks have been allowed to establish bank holding companies, which may own securities and other finance subsidiaries, since March 1998; and

since 1998, under the 'Big Bang' reform package, they have been allowed to sell investment trusts (i.e. mutual funds) over-the-counter.

[10] The Resona Holdings group was the exception but hardly surprisingly so given the government's rescue of Resona Bank in May 2003 through a capital injection of ¥1.96 trillion. This controversial rescue – the bank was found to be insolvent in October 2003 and many believe that the authorities knew it was insolvent at the time of the rescue – followed the FSA's declaration that the bank was undercapitalised (its auditors refused to recognise more than three years of Deferred Tax Assets as capital, resulting in the capital adequacy ratio falling to around 2 per cent, well below the 4 per cent minimum required of 'domestic' bank operators in Japan) but solvent. The rescue means that the Deposit Insurance Corporation, on behalf of the government, now owns over 50 per cent of the bank's ordinary shares and controls over 70 per cent of the bank's voting rights following an earlier acquisition of ¥1.2 trillion of (unconverted) preference shares under a DIC-assisted merger between Daiwa Bank and Asaki Bank (which resulted in the creation of the Resona Bank) in March 2003.

[11] Using the Financial Reconstruction Law definition of NPLs (Hall, 2003b), the banking sector's outstanding NPLs amounted to ¥35.3 trillion at end-March 2003, with the 'major banks' contributing ¥20.9 trillion to the total (Bank of Japan, 2003a).

[12] Although UFJ Holdings subsequently announced (in May 2004) that it would make a net loss of at least ¥300 billion in fiscal 2003, largely due to higher-than-expected loan loss reserves. This downward revision of its profits forecast, taken after heeding the advice of its external auditors, followed an earlier downwards revision announced in April 2004 to take account of the higher loan loss provisioning necessitated by an FSA inspection. This resulted in the bank lowering its net profits forecast for fiscal 2003 from the figure of ¥135.1 billion announced in September 2003 to ¥125 billion. The latest revision means that the bank has breached the so-called "30 per cent" rule whereby the FSA, in respect of banks in receipt of capital injections from public funds, can take disciplinary action if actual net profits fall by 30 per cent or more in comparison with projections submitted to the FSA at the interim reporting date, for two consecutive years. The presidents of the holding company and the core bank are duly expected to resign.

[13] In the event, five of the top seven banking groups posted profits for fiscal 2003; the odd ones out were UFJ Holdings and Resona Holdings. Mitsubishi: Tokyo Financial Group posted the largest net profit, of ¥561 billion, followed by the Mizuho Financial Group (¥407 billion) and SMFG (¥330 billion). UFJ's net loss came in at ¥402 billion, compared with Resona's net loss of ¥1.66 trillion. This compares with the fiscal 2002 results which revealed that (Bank of Japan, 2003c): the banking sector made a net loss of ¥4.9 trillion (¥4.6 trillion for the 14 major banks); operating profits from core business had fallen by ¥0.4 trillion, to ¥5.2 trillion, compared with the previous year (the major banks' figure decreased by ¥0.5 trillion to ¥3.4 trillion); net fee and commission income had increased by only ¥0.1 trillion, to ¥1.7 trillion, during the year (the major banks' figure was unchanged at ¥0.9 trillion); net interest income had fallen by ¥0.8 trillion, to ¥9.7 trillion, over the year (a fall of ¥0.7 trillion, to ¥5.2 trillion, was recorded by the major banks); general and administrative expenses had decreased by ¥0.3 trillion, to ¥6.8 trillion, over the year (a decrease of ¥0.2 trillion, to ¥3.5 trillion, was recorded by the major banks); the interest margin on lending had remained virtually flat (at about 150 basis points for the major banks) throughout the year, causing the "effective" margin (after deducting the realised credit cost ratio and the general and administrative expense ratio) to remain negative.

[14] This derives from syndicated lending (growth in which the BoJ has sought to promote by publishing relevant data on its website since December 2003), asset management and investment banking activities as well as the sale of retail investment products.

[15] Banks are required to reduce their holdings of stocks to less than or equal to Tier 1 capital. This has been helped by the Bank of Japan's share-buying activities (it has committed up to ¥3 trillion for this purpose – *see* below) and, prior to this, by the (less successful activities of the) Banks' Shareholding Acquisition Corporation (*see* endnote 36).

[16] Fukao (2003) notes that, at end-March 2003, the banks held ¥1 trillion of surplus notes and ¥0.9 trillion of subordinated loans of life companies; the 10 major life companies in turn held ¥1.1 trillion of bank shares and ¥4.4 trillion of subordinated loans.

Moreover, it is not clear that all the bank issues of preference shares and other interest-bearing securities which currently feature in Tier 1 capital should be allowed to; a portion, at least, should feature in Tier 2 capital, in line with BIS rules (*see* Hall, 1989, chapter 8).

[17] Despite the third round of "special inspections" (*see* below) carried out by the FSA (FSA, 2004b) demonstrating a narrowing of the gap between the major banks' approaches and those deemed appropriate by the FSA – although UFJ's figure for bad loans posted at end-September 2003 had to be increased by another ¥1 trillion – it is not clear that the regional banks have yet fallen into line.

Moreover, recent events at Resona and UFJ call into question the FSA's assumption that the major banks' assessment of the quality of loans to large borrowers has become standardised.

18 Fukao (2003) suggests such under-provisioning at end-March 2003 amounted to ¥5.4 trillion.

19 This issue came to the fore again when the IRCJ revealed huge discrepancies between its valuation of Mitsui Mining's assets and the banks' own estimates of the value of their collateral backing loans to the company.

20 Although, in respect of DTAs, the interim results posted at end-September 2003 indicated that the major banks had reduced their reliance on DTAs as a form of Tier 1 capital, the ratio falling to an average of 43 per cent from the 55 per cent figure recorded at end-March 2003. And further falls were reported for the full year of fiscal 2003 by a number of banks (e.g. MTFG, 15 per cent; Mizuho 33 per cent), although UFJ's and SMFG's ratios remained uncomfortably high at 63 per cent and 45 per cent respectively.

21 As of end-May 2004, 14 companies were under the wing of the IRCJ, covering the industrial, construction and retail sectors. The biggest support operation concerned the household products firm Kanebo, which received ¥366 billion of financial assistance from the IRCJ. Of the ¥10 trillion funding available, just under ¥1 trillion had been spent; and, given the time constraints on its operations, new cases will have to be notified to the IRCJ by the end of 2004 if assistance is to be forthcoming.

22 For earlier measures, involving the DIC's capital injections of 1998/9 and the RCB/HLAC, *see* Hall, 2003a.

23 Previously, the RCC was only permitted to purchase the banks' "bad" loans and, even then, only did so at a steep discount (96 per cent, on average) to book value, to ensure it avoided making a loss, thereby reducing the banks' incentive to sell. Subsidies, therefore, may have to be provided to encourage voluntary sales of doubtful loans.

24 i.e. those whose stock prices, external ratings or other indicators had been experiencing significant adverse charges.

25 The original plan was to begin these in January 2002 but it appears that the earlier start was triggered by the failure of the retailer Mycal and subsequent revelations that the banks had only set aside minimum provisions to cover their liabilities as they did not regard such loans as being at high risk [i.e. they were classified as either Category I or Category II (rather than Category III) loans].

26 *See* BoJ (2003a) for further details.

27 Following up on previous inspections, 161 borrowers were initially reviewed but this number increased to 169 after taking account of corporate separation, etc. .46 were subsequently excluded having gone bankrupt or been removed from banks' balance sheets or otherwise requiring little need for further follow-up inspections. This left 123, to which 10 new names were added.

28 To soften the impact of the clean-up operation in the real economy, a raft of anti-deflation measures were introduced simultaneously. These entailed further easing on both the fiscal - tax cuts of at least ¥1 trillion would be made alongside some additional public spending – and monetary – the BoJ agreed to increase its monthly purchases of Japanese government bonds from ¥1 trillion to ¥1.2 trillion, and to increase its target for excess liquidity in the banking system by ¥5 trillion to a target range of "¥15 trillion to ¥20 trillion" (later raised, in stages, to "¥30 trillion to ¥35 trillion") – fronts. New measures were also introduced to expand loans to SMEs on a "safe" basis, a process further promoted by the BoJ through its decision to purchase up to ¥3 trillion of securities linked to SME receivables.

29 By, for example, promoting the development of asset securitisation, thereby freeing up capital to be used for the disposal of NPLs and, in its money market operations, recognising loans held by the IRCJ as eligible collateral, thereby helping to stimulate greater use of the IRCJ.

30 As noted above, such an approach was enforced by the FSA *via* its special inspections regime.

31 Other measures envisaged embraced rigorous examination of borrowers' reconstruction plans and the banks' assessment of collateral, more special inspections by the FSA, strengthening administrative measures against inadequate correction of self-assessment, and requiring bank management to make declarations regarding the accuracy of financial statements.

32 A practical guideline on the issue, however, was subsequently issued by the Japanese Institute of Certified Public Accountants in February 2003,

33 To soften the impact of this increase on bank capital adequacy and profitability the FSA was also mandated to seek the tax deductibility of specific provisions set aside against possible future loan losses, the norm elsewhere in the world. The idea was subsequently rejected by the tax authorities on the grounds that it would be unfair to discriminate against non-financial concerns, which would not enjoy the concession; moreover, there was a concern that such a move would simply represent a device for delivering a back-door infusion of state capital. Of equal importance, though not explicitly stated, no doubt was the anticipated loss of revenue that would result to the tax authorities at a time of deepening fiscal crisis.

[34] The "triggers" for conversion were duly revealed on 4 April 2003; they relate to breaches of minimum levels of capital adequacy and profitability, and the non-payment of dividends. Performance targets for recipients of the 1998/99 capital injections were also announced by the FSA in August 2003, thereby establishing a link between earnings, targets, management responsibility and bank restructuring. The FSA also threatened to issue banks with "business improvement orders" where necessary. At the same time, Mizuho, SMFG and seven regional banks were criticised for missing SME lending targets, initially set to prevent a credit crunch, stem the rise in unemployment and curtail corporate bankruptcies. The problem with this approach, however, is that it flies in the face of bank attempts to reduce risk-weighted assets and raise asset quality in the wake of capital adequacy constraints.

[35] Although the MJFG did aggressively use the RCC to dispose of around ￥660 billion of NPLs in fiscal 2002.

[36] The main purpose was to stabilise the banking system's capital base by making it less vulnerable to stock market volatility. And, to minimise the dampening effect caused by the banks' unwinding of cross-shareholdings, a new government-run body, the Banks' Shareholding Acquisition Corporation (BSAC) was set up to buy, at "market" prices, those shares which banks voluntarily wished to dispose of in this way. Financed by the banks (those using its services would have to contribute 8 per cent of the value of shares sold to it) and borrowings from private sector institutions, the new body, which was established on 30 January 2002, is able to purchase up to ￥2 trillion (if necessary, the figure can be raised) of shares over a five-year period. After 10 years, the Corporation is to be wound up, with any losses falling, in the first instance, on the member banks and, if they exceed member banks' contributions, subsequently on the government.

[37] The BoJ was also cognisant of the relative failure of the BSAC, not least because of the costs imposed on participating banks.

[38] Through, for example, the adoption of the new Bankruptcy Law, which replaced the 1922 law, passed in May 2004.

[39] The IMF is less concerned with co-operation in crisis situations, which it asserts works well, but rather with pre-crisis situations where more formalisation of relationships, involving the exchange of information, should result in increased cost-effectiveness for the supervisory process (IMF, 2003, pp.31-32).

[40] The FSA/BoJ argue in their response to the IMF that, despite the existence of statutory barriers (i.e. confidentiality obligations) to the full exchange of information, these do not prevent effective exchanges of necessary information between the two bodies. They therefore see no need for the formalisation of their working relationship (IMF, 2003, Appendix 1, p.66, para. 124). The FSA, however, acknowledge the need for more MoUs with overseas regulators, a process in which they are actively engaged (IMF, 2003, p.48, para.55).

[41] The FSA argues in its reply to the IMF that current arrangements maximise the autonomy of the FSA within the confines of democratic control based on Japan's Constitution. Further independence from the Cabinet would require changing the Constitution, they imply (IMF, 2003, p.48, para.53).

[42] The bailout of Resona Bank – *see* below – the subject of much debate inside and outside the Diet, epitomises, for many, the politicisation of the FSA which resulted in the bank receiving an infusion of state capital under the "Financial Crisis Management" procedures even though it was subsequently found to be insolvent. The FSA's behind-the-scenes activities with both the government and the bank's auditors were all called into question.

[43] Tokio Marine, for example, resented being pressurised, under the threat of disciplinary action, into merging with the Asahi Mutual Life.

[44] As noted earlier, it has to be worrying that the FSA refused to allow the IMF access to supervisory information when carrying out its stress tests. The inevitable conclusion that most will draw from this episode is that the FSA had something to hide namely, that Japan's financial system is even more fragile than the published financial statements suggest.

[45] The IMF has also called on the Japanese government to write off the DICJ's deficit (￥3.4 trillion at end-March 2003) in order to enhance the credibility of Japan's deposit insurance arrangements (IMF, 2003, pp.32-2, para.81). And Fukao (Fukao, 2003) is concerned about the problems which can arise from the application of the "type 2" and "type 3" measures set out in Article 102 of the Deposit Insurance Law, as amended in May 2000, which relate to the "Financial Crisis Management" scenarios (*see* Appendix 1). In particular, he notes the generous treatment of both employees and subordinated debt holders that results, compared with normal bankruptcy procedures, thereby swelling the size of the publicly-funded bailout and further undermining market discipline. Moreover, like many others, he is concerned at the amount of discretion residing with the authorities with respect to the choice of which section of Article 102 is to be applied. The handling of the Resona Bank, which was deemed solvent at the time of rescue but found to

be insolvent within a few months of being recapitalised using state funds, highlights the problems only too well.

46 A critique of earlier developments is provided in Hall (1999c and 2003a).

47 The first £20,000 of all deposits, on a per bank per customer basis, are now fully protected under the scheme introduced in 2001 (*see* Hall, 2002).

48 The RCC has itself been criticised for the limited scale of its NPL purchases, the slowness with which it has sold repackaged debt on to the market (e.g. through auctions or securitisations) and its possible crowding out of the private sector. Certainly, in connection with the first criticism, purchases under the RCB account were limited. In large part, however, this was due to a general reluctance by banks to sell anything other than Yakuza-related NPLs (because, for example, of their relationships with borrowers, the low cost of carry of the loans under a near-zero interest rate policy and their limited ability to absorb losses given their weak capital positions) and, with respect to the RCC, a reluctance to accept the prices offered (typically, less than 10 per cent of book value). The situation has improved, however, since the RCC has been allowed to offer "fair" market prices and, in respect of Article 53 account purchases, to purchase NPLs at public auctions (possible since January 2002). By end-March 2004, ¥4.7 trillion had been spent purchasing assets with a face value of ¥21.8 trillion from 172 failed institutions; and, by the same date, ¥325 billion had been spent purchasing assets with a face value of ¥3.8 trillion from sound financial institutions.

With regard to the second criticism, the slow pace of disposal of purchased debt, it should be appreciated that, at least in relation to the *Jusen* account transactions, the nature of the debt acquired (long-term housing loans) meant that recovery would always be slow, recognised in the 15-year lifespan given to the account. Moreover, in respect of sales more generally, the RCC is keen to limit its losses, as reflected in its recovery ratios, measured as the ratio of the total value collected from sales to the total outlay: for business conducted until end-March 2004, these ratios were 61.4 per cent, 86.7 per cent and 67.5 per cent (73.8 per cent overall average) for the *Jusen* account, the RCB account and the Article 53 account respectively.

Finally, with respect to possible crowding out, the comparatively-low prices offered by the RCC minimise the risk. Article 53 account purchases, for example, mainly comprise rural economy-related debts shunned by the market.

49 Originally there were two auditors but Asahi & Co., auditors to Asaki Bank, were sacked when they refused to allow Resona Bank to show any DTAs on their financial statement for March 2003.

50 Although Resona Bank, which resulted from the merger of Asahi and Daiwa Bank, in March 2003, is the fifth largest bank in Japan, it was forced to abandon overseas operations because of its inability to meet the 8 per cent capital adequacy threshold stipulated for all "internationally-active" banks by the Basel Committee on Banking Supervision in the famous "capital accord" of 1988.

51 The recapitalisation of the bank, which resulted in the government, through the DIC, owning over 50 per cent of the banks' ordinary shares and over 70 per cent of the voting rights because of the purchase of common stock and newly-issued preference shares (i.e. quasi-nationalisation resulted), later caused a political furore as an external audit undertaken in the Autumn revealed the bank's problem loans were much more serious than previously believed. This led Resona to report an interim loss of ¥1.76 trillion in October 2003 compared with an earlier forecast profit of ¥22 billion because of the identification of ¥1.2 trillion of additional NPLs and ¥400 billion of losses hidden at affiliated property companies. The audit strongly suggested that Resona was insolvent at the time of its rescue – May 2003 – meaning that the wrong section of the emergency legislation (i.e. para.1(1) of Article 102 of the Deposit Insurance Law of May 2000, which relates to the treatment of solvent institutions, instead of paras 1(2) or 1(3), which relate to insolvent institutions and involve financial administration or nationalisation – *see* Appendix 1) had been invoked and Resona had been wrongly rescued. The FSA strongly denied that it knew Resona was insolvent at the time of the request for assistance but it does beg the question: why didn't the FSA conduct an audit of Resona before deciding on the appropriate course of action?

52 On this occasion, not only to avoid a wider systemic crisis but also to protect the local economy as the bank accounted for nearly 50 per cent of bank lending and deposits in its home prefecture of Tochigi. By the end of fiscal 2003, however, the bank's estimated net worth had fallen to minus ¥679 billion with bad debts increasing (from ¥544 billion at the time of nationalisation) to ¥735 billion and its NPL ratio deteriorating (from 13.93%) to 20.31%.

53 The recommendation of the IMF (IMF, 2003, p.18, para.39) that DTAs be limited, as in the US, to 10 per cent of Tier 1 capital or one year's profits, whichever is the lower, seems a reasonable compromise. This would reduce the importance of auditors in the determination of capital adequacy although, as now (under guidance from the Japanese Institute of Certified Public Accountants) external auditors could still make their views known. Full exclusion of DTAs from regulatory capital – as is practised by Moody's, in

respect of their calculation of a bank's stand-alone economic capital, because of the conditional nature of its recognition, its tendency to fluctuate over time (due to weakened capabilities in earnings generation or change in projected effective tax rates) and the absence of mobility for conversion into cash through immediate transfer or sale to third parties (*see* Moody's 2003) – would seem a trifle harsh, given its recognition as capital under 'generally accepted accounting principles' and its (albeit limited) recognition by US regulators.

54 Fukao estimates that, between 1998 (when PCA began) and end-September 2002, the average degree of insolvency (measured by DIC assistance provided as a percentage of the total disclosed debt just before failure) for the 131 institutions which failed was 25.1 per cent (Fukao, 2003). And even big banks showed relatively high degrees of insolvency: Holkaido Takushoku Bank, 18.8 per cent; Long-Term Credit Bank, 11.6 per cent; Nippon Credit Bank, 29.3 per cent. Clearly, PCA was not exercised promptly enough, suggesting the trigger points for action are too low and/or the remedial action taken (mandatory and otherwise) has not been tough enough.

55 Currently, large exposures run by banks are limited to 25 per cent of capital per customer and to 40 per cent for a group of related customers. Exposures to shareholders are limited to 15 per cent of capital and to shareholders plus related parties, 25 per cent. These limits should be reduced to the Basel Committee's suggested levels.

56 The top seven banks' combined NPLs declined during fiscal 2003 to ￥14 trillion from ￥20.8 trillion a year earlier. The top five banking groups reported the following NPL ratios at end-March 2004: UFJ, 8.5 per cent; Resona Holdings, 6.7 per cent; SMBC, 5 per cent; Mizuho Holdings, 4.4 per cent; and MTFG, 2.9 per cent.

57 The bigger worry is UFJ Holdings which, despite agreeing to sell its personal trust business to Sumitomo Trust and Banking in May 2004 for ￥300 billion and its intention to sell its consumer finance subsidiary, Aplus, to help raise funds to assist in NPL disposal, will struggle to reach the magical 4 per cent figure by the end of fiscal 2004. And the disciplinary action taken against the management in the light of their abject failure to meet performance targets and their own internal forecasts for profitability, as well as their deliberate hiding of bad loan data from the FSA and their under-assessment of NPLs (40 per cent less than FSA estimates), is unlikely to help much in the short term. [In the event, MTFG came to the rescue by announcing, in July 2004, that it would merge with UFJ. The merger will start with the integration of their holding companies before March 2005, to be proceeded by the merger of their city bank operations, Bank of Tokyo-Mitsubishi and UFJ Bank respectively, and of their trust bank operations, presently conducted by Mitsubishi Trust and Banking and UFJ Trust Bank respectively. The latter move means UFJ reneging on its deal to merge its retail trust business with Sumitomo Trust and Banking, a decision that has led Sumitomo to assess its legal options for securing compensation.]

58 The FSA does appear – although the latest revelations at UFJ concerning its 40 per cent under-assessment of NPLs and the discovery of ￥800 billion of additional NPLs at Resona Bank within three months of its rescue do provide some food for thought – to have forced the major banks to adopt more realistic assessments of asset quality and hence provisions, at least in respect of their exposures to large companies, through its regime of special inspections. This can be seen in the narrowing of the gap between the aggregated self-assessments and those of the FSA. For example, following the first round of inspections, the major banks were found to have collectively under-recorded classified assets by 35.9 per cent and to have made insufficient write-offs and provisions by an amount equal to 47.1 per cent of the self-assessment figure (FSA, 2002c). Under the second round of special inspections, these underestimates had fallen to 10.1 per cent and 14.2 per cent respectively. And, according to the third and final round of special inspections, the under-recording had fallen further to 6.0 per cent and 8.7 per cent respectively. The attempt to standardise the major banks' approach to the assessment of asset quality in respect of loans to large corporations had clearly worked (at least beyond the confines of UFJ and Resona); and the enforced use of discounted cash flow techniques in the assessment/provisioning process has led to more realistic appraisals being made of the likely future prospects of the banks' large corporate borrowers.

59 A loss of ￥112.7 billion was recorded for the six-month period to end-September 2003. The losses arose from losses incurred on the sale and redemption of Japanese government securities, a fall in the value of its Japanese government bond portfolio and losses arising from its holdings of foreign (mainly US) government debt.

60 And removal of the BoJ's rights of inspection, allowing it to focus exclusively on monetary policy issues, might hasten the demise of the BoJ's ambitions in this area. [The arguments for and against removing banking supervision from a central bank's remit, and the UK's approach to this issue, are addressed in Hall, 2001.]

[61] Such a development should not be used by the banks as an excuse for slowing the move towards the risk-based pricing of loans, the enhanced screening and monitoring of credit risk, the restruction of their balance sheets and improved corporate governance (Oyama and Shiratori, 2001).

REFERENCES

Bank of England (2002), *Financial Stability Review*, London, December, pp.37-41

BoJ (2002), 'Japan's Non-performing Loan Problem', *Bank of Japan Quarterly Bulletin*, Tokyo, November

BoJ (2003a), 'Evaluating the Economic Value of Loans and the Implications: Toward Transformation of the Business Model of Banks and Non-bank Firms', *Bank of Japan Quarterly Bulletin*, Vol.11, No.3, August

BoJ (2003b), 'Review of On-site Examination Policy in Fiscal 2002 and Plans for Fiscal 2003', *Bank of Japan Quarterly Bulletin*, Vol.11, No.2, May

BoJ (2003c), *Review of Japanese Banks' Activities: Profits and Balance Sheets in Fiscal 2002*, Tokyo, 29 August [<http://www.boj.or.jp>]

Deposit Insurance Corporation of Japan (DICJ) (2004), *Annual Report 2002: April 2002 – March 2003*, Tokyo, February

Farrant, K. and Markovic, B. (2003), 'The Macroeconomic Impact of Revitalising the Japanese Banking Sector', *Bank of England Quarterly Bulletin*, Winter, pp.439-451

FSA (2001), *Summary Excerpts from the Government's Economic Measures*, Tokyo, April

FSA (2002a), *Measures for Developing a Stronger Financial System*, Tokyo, 12 April

FSA (2002b), *Statement by Heizo Takenaka, Minister for Financial Services, Regarding the Pay-off Problem*, Tokyo, 2 October

FSA (2002c), *Results of the Special Inspections on Major Banks*, Tokyo, 12 April

FSA (2003a), *Results of the Special Inspections and Other Measures*, Tokyo, 25 April

FSA (2003b), *Introduction of External Audit on the Calculation of Capital Adequacy Ratio*, Tokyo, 14 April

FSA (2004a), 'The Status of Non-Performing Loans as of end-September 2003', Tokyo, 30 January

FSA (2004b), *Results of the Special Inspections*, Tokyo, 27 April

Fukao, M. (2003), 'Weakening Market and Regulatory Discipline in the Japanese Financial System', Paper presented at the "Market Discipline" Conference co-sponsored by the BIS and the Federal Reserve Bank of Chicago (Chicago, 30 October – 1 November)

Hall, M.J.B. (1993), *Banking Regulation and Supervision: A Comparative Study of the UK, USA and Japan*, Edward Elgar Publishing

Hall, M.J.B. (1998a), *Financial Reform in Japan: Causes and Consequences*, Edward Elgar, Cheltenham

Hall, M.J.B. (1998b), 'Financial Reform in Japan: "Big Bang"', *Journal of International Banking Law*, Vol.13, No.2, pp.58-70

Hall, M.J.B. (1999a), 'Current Banking Problems in Japan: How Serious Are They and How Might They Be Resolved?', *Research in Financial Services: Private and Public Policy*, Vol.11, pp.3-33

Hall, M.J.B. (1999b), 'Japan's Big Bang: The Likely Winners and Losers', *Journal of International Banking Law*, Vol.14, No.7, p.204-216

Hall, M.J.B. (1999c), 'Deposit Insurance Reform in Japan: Better Late than Never?', *Journal of Financial Services Research*, Vol.15, No.3, September, pp.211-242

Hall, M.J.B. (1999d), 'Supervisory Reform in Japan', *Journal of Financial Regulation and Compliance*, Vol.7, No.3, pp.256-269

Hall, M.J.B. (1999e), *Handbook of Banking Regulation and Supervision in the UK*, 3rd edition, Edward Elgar

Hall, M.J.B. (2000), 'What is the Truth about the Scale of Japanese Banks' Bad Debts? Is the Situation Manageable?', *Journal of Financial Services Research*, 17(1), pp.69-91, Kluwer Academic Publishers

Hall, M.J.B. (2001), 'The Evolution of Financial Regulation and Supervision in the UK: Why we ended up with the FSA', *Banca Impresa Società*, Vol.XX, No.3, December, pp.377-412 [IL Mulino, Bologna]

Hall, M.J.B. (2002), 'Incentive Compatibility and the Optimal Design of Deposit Protection Schemes: An Assessment of UK Arrangements', *Journal of Financial Regulation and Compliance*, Vol.10, No.2, May, pp.115-134

Hall, M.J.B. (2003a), 'Banking Regulation and Supervision in Japan: Some Issues and Concerns', *Journal of Financial Regulation and Compliance*, Vol.11, No.1, pp.45-59

Hall, M.J.B. (2003b), 'The Resolution of the Japanese Banks' Bad Debt Problems: Can Koizumi Deliver on Time?', *Loughborough University Banking Centre Research Paper*, No.160/03, June

IMF (2003), 'Japan: Financial System Stability Assessment and Supplementary Information', *IMF Country Report No.03/287*, Washington, September

Japan Center for Economic Research (2003), *Profitability of Corporate, Banking and Life Insurance Sectors* (in Japanese), Financial Research Report No.8

Japanese Bankers' Association (2001), *The Banking System in Japan*, Tokyo, March

Japanese Bankers' Association (2003), *Japanese Banks, 2003*, Tokyo

MoF (1998), *Reform to the Financial Regulatory System*, Tokyo, April

Moody's Investors' Service (2003), *Special Comment: Status of DTA – an Effective Regulatory Forbearance Tool to Sustain Japanese Banks' Tier 1 Capital – May Face Ambiguity'*, Tokyo, October

Oyama, T. and Shiratori, T. (2001), 'Insights into the Low Profitability of Japanese Banks: Some Lessons from the Analysis of Trends in Bank Margins', Bank Examination and Surveillance Department Discussion Paper, *Bank of Japan*, November [<http://www.boj.or.jp>]