Injection of Public Funds and Bank Management

Shinichi Iimura

On March 31, 1999, public funds amounting to 7,459.2 billion yen were injected into the 15 major banks in Japan that applied. This was done though the purchase of preferred stock, etc. by the Resolution & Collection Bank. Based on the plans to achieve sound banking operations already submitted by these recipient banks, they are now approaching the restructuring stage under government supervision. In this report, we will study the process and implication of the injection of public funds and consider objectives and problems down the road.

1. The Process to the Injection of Public Funds and the Implications

1) Process

The Financial Reconstruction Commission (Figure 1) was established on December 15, 1998, and decided on the following two main points as its Fundamental Operational Policies. One is to complete the objective of effecting disposition of the bad debt of the major banks in the term to March 1999 and the other is to reconstruct the financial system giving it solid competitiveness by March 2001. The supreme objective of the Commission is to achieve the stabilization of the financial system through the injection of public funds into the major banks (Table 1).

The finalization of the Financial Reconstruction Law and Early Normalization Law[1] was achieved in October 1998. This created a systematic framework for handling the failure of financial institutions and an early achievement of soundness. The market's interest is focused on whether the Financial Reconstruction Commission will be able to exercise leadership in terms of the immediate problems to be faced. These include the promotion of temporary government management of the LTCB (Long-term Credit Bank) and Nippon Credit Bank, the deciding of conditions for injection of funds and the actual injection of public funds.

With the exception of Bank of Tokyo-Mitsubishi, which resolutely refuses to countenance government intervention in the management of private sector banks, at first, most of the major banks expected to make an application for these funds were reluctant to do so. This was due to their fear of being required to take responsibility for the management they had shown if they accepted an injection of public funds. The maximum amount of funds requested only reached about 500 billion yen, and this irritated the Financial Reconstruction Commission. Thus, it announced publicly that the banks would not have to accept responsibility for their

1 For details, see "Financial Reconstruction and Normalization Laws" by Shinichi Iimura, Capital Research Journal, Spring 1999

actions (November 6, 1998) and made frequent requests that the applications for funds should be revised upwards.

On October 23, 1998 the LTCB was declared bankrupt in real-terms under Act 36 of the Financial Reconstruction Law. On December 13, 1998, it was decided to put under temporary government management over Nippon Credit Bank which had unsuccessfully attempted to enter into an alliance with the Chuo Trust and Banking Company to find a way of continuing to exist. As a result of these two events, it became certain that a change had occurred in the stance of the financial authorities and that they had given up the convoy system (a system in which all banks act in unison). The major banks were superficially considered to be sound. However, a mood evolved in which they had no option but to request an upward revision of their applications for funds. This was to achieve a solution to the disposition of bad debts as quickly as possible and to seek strategies to continue to exist including realignment.

In January 1999, the Financial Reconstruction Commission announced quantitative standards for writing off bad debts and boosting reserve funds as a condition for boosting their capital.

The standards applied this time to the banks receiving injections of public funds are at levels higher than those in the Financial Inspection Manual[2] which requires strict debtor standards and writing off reserve standards higher than those applied in the U.S. (The reserve fund for writing off bad debts must be 15% in the case of debts with insufficient collateral in category II and 70% in the case of debts with insufficient collateral in category III). If disposition of bad debts were to be carried out based on these standards, the banks would fall into a state where they had inadequate funds. This means that if the increase in capital is not made through the injection of public funds and efforts by the banks, they will not longer be able to function.

Through the application for additional funds taking into consideration the latent loss on securities, banks making an application for about 1 trillion yen appeared. In line with this, in the preliminary screening stage conducted from January 26, 1999, the Financial Reconstruction Commission made strong demands for the implementation of restructuring and realignment in the face of ridicule that this constitutes government intervention in the private sector.

Thus, this request for injection of public funds means that the banks must make efforts in areas such as planing ways of achieving sound operations extending from the sale of the head office and recreational facilities to the abolition of their advisor and consultant systems. After the real-term collapse of the state-run long-term credit bank system, there was a basic agreement on a merger between the Mitsui Trust & Banking and Chuo Trust & Banking, a move said to have been orchestrated by the Financial Reconstruction Commission. This has induced an alliance based on the merging of the trust divisions of Toyo Trust & Banking and the trust division of Sanwa Bank Group. In addition, Fuji Bank has made Yasuda Trust & Banking into a subsidiary company. Thus a wave of mergers and alliances in the trust bank sector has been promoted very rapidly.

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2 For details, see "Management of Financial Institutions Faces Changes "by Shinichi Iimura, Capital Research Journal, Summer 1999

As a result, on March 4, 1999, the 15 major banks made official applications for the injection of public funds amounting to 7,459.2 billion yen. On March 14, 1999, an official decision was made on the conditions for the injection of public funds and the implementation of the fund injection was carried out. At the end of that month public funds were actually injected into the banks in the form of the purchase of preferred stocks and subordinated debentures by the Resolution & Collection Bank. In addition to this, the efforts of the banks themselves generated over 2.6 trillion yen. Thus, during fiscal 1998, the capital of the banks was increased by over 10 trillion yen (Table 2).

Table 1 Trends in the Financial Reconstruction Commission

December 15, 1998	Establishment of the Financial Reconstruction Commission
January 20, 1999	Announcement of basic operational policy
January 25, 1999	Announcement of thinking on writing off and reserves when making a capital increase
January 26, 1999	Commencement of preliminary screening This involved a screening process on the written plans to achieve sound operations submitted by the 15 major banks
February 12, 1999	Completion of preliminary screening A provisional decision was made on the suitability of the 15 major banks to receive an injection of public funds
March 4, 1999	The 15 banks made an official application after completion of preliminary screening
March 8, 1999	The presidents of the 15 applicant banks were interviewed
March 12, 1999	Official agreement on the injection of public funds into the 15 applicant banks
March 30, 1999	The government paid a total of 7,459.2 billion yen to the 15 banks qualified to receive the funds
March 31, 1999	The 15 qualified banks increased their capital by issuing preferred stock, etc.

Source: Compiled by Nomura Research Institute based on various media reports.

Table 2 Amount of Public Funds Injected into Each Bank and the Capital Increase Situation

Unit: 100 million yen

	Public Funds					
		Subordinated debentures/ loans	Preferred stock			
				Corporate bond type	Convertible type	Time to commencement of convertibility
Dai-Ichi Kangyo (DKB)	9,000	2,000	7,000	3,000	4,000	5 years, 4 months/ 6 years, 4 months
Sumitomo	5,010	0	5,010	0	5,010	3 years, 1 month/ 7 years, 4 months
Sanwa	7,000	1,000	6,000	0	6,000	2 years, 3 months
Sakura	8,000	0	8,000	0	8,000	3 years, 6 months
Fuji	10,000	2,000	8,000	3,000	5,000	5 years, 6 months/ 7 years, 6 months
Tokai	6,000	0	6,000	0	6,000	3 years, 3 months/ 4 years, 3 months
Asahi	5,000	1,000	4,000	0	4,000	3 years, 3 months/ 4 years, 3 months
Daiwa	4,080	0	4,080	0	4,080	3 months
IBJ	6,000	2,500	3,500	0	3,500	4 years, 3 months/ 4 years, 5 months
Mitsubishi Trust & Banking	3,000	1,000	2,000	0	2,000	4 years, 4 months
Sumitomo Trust & Banking	2,000	1,000	1,000	0	1,000	2 years
Toyo Trust & Banking	2,000	0	2,000	0	2,000	3 months
ChuoTrust & Banking	1,500	0	1,500	0	1,500	3 months
Mitsui Trust & Banking	4,002	1,500	2,502	0	2,502	3 months
Yokohama	2,000	1,000	1,000	0	1,000	2 years, 4 months/ 5 years, 4 months
Total	74,592	13,000	61,592	6,000	55,592	

Source: Compiled by Nomura Research Institute based on various media reports.

Figure 1 The Framework of the Financial Reconstruction Law and Early Normalization Law and Actual Measures

2. The Implications of the Injection of Public Funds

1) The resolution of the credit crunch and the problem of inadequate bank capital - Conflicting objectives

The plan to stabilize the financial sector of March 1998 designed to alleviate the credit crunch and achieve sound financial state of the banks through the injection of public funds into the 21 major banks ended in failure. However, the aversion to public funds dating back to the housing loan companies of 1995 has been overcome, and this has opened up the way to the injection of public funds, a development that has won qualified approval. In the subsequent one year, frameworks have been created for dealing with failures and an early return to normalcy based on the Financial Reconstruction and Early Normalization laws. In addition, gathering together the massive amount of 60 trillion yen in funds is an important step toward ensuring stability in Japan's financial systems.

The reasons for the failure of the previous plan to inject public funds are as follows. The LTCB and Nippon Credit Bank, designated as supposedly sound banks, had to be placed under special public administration. As a result, the financial crisis management investigation committee did not function (Usually known as the Sazanami Committee), and criticism was leveled at the role of the Ministry of Finance administration in creating the right financial environment.

However, more importantly, it was not possible to achieve the initial objective of alleviating the tight credit squeeze. At that time, it was announced that, if public funds amounting to 1,815.6 billion yen were injected, in theory, this should generate lending power equivalent to 12.5 times this amount (BIS standard of 8%). However, it was not possible to confirm the effectiveness of this measure. For the subsequent alleviation of the tight credit squeeze, it was unavoidably necessary to rely on the special guarantee system of 20 trillion yen extended by the Credit Guarantee Association established in October 1998.

This fact shows that it is not possible to simultaneously solve the problems of tight credit and insufficient capital. The banks have been suffering from insufficiency of capital due to the protracted disposition of bad debts. Trying to solve the tight credit squeeze under these conditions would only result in dragging the capital adequacy ratio, pumped up by an injection of public funds, back down to the level prior to the fund injection. However, the banks are not inclined to bring down their capital adequacy ratio by an increase in lending. The preferred stock and subordinated debentures issued at the time of the injection of public funds are to be held by the government. In order for the banks to be set free from state control, the only option open is to effect a rapid redemption or repayment of the debt funds. However, if the capital adequacy ratio drops to a level prior to the injection of capital when preferred stocks are sold on the market, the price of the preferred stock falls sharply. The reason for this is that the capital adequacy ratio represents the trustworthiness of the bank at that time. Regarding subordinated debentures, if the banks contemplate rapid redemption, they may well tend to retain the revenues internally for redemption payments and not use the funds for new lending. In view of this, unless the public funds injected are limited to lending purposes, the effects in terms of alleviating the tight credit situation (credit crunch) will be slight. Thus, there were limitations to the simultaneous efforts to solve the irreconcilable problems of insufficient capital and the alleviation of the tight credit stance.

The fact that the authorities were vague about this incompatibility of objectives led to the failure of the financial stabilizing scheme of March 1998.

As a result, a condition for the injection of public funds this time is that the amount of increase in lending must be made clear. On November 10, 1998, the center for preparation for the establishment of the Financial Reconstruction Commission imposed conditions for the injection of public funds. These include clearly showing the implementation of measures to avoid a decrease in lending (in particular, in principle, it is required that the banks increase the amount of loans outstanding to small and medium companies). This is incorporated in the screening standards of the "Basic policy when implementing evaluation of assets." Based on this, the increase in lending will amount to a total of about 6.7 trillion yen as of the end of March 2000 (of this 3 trillion is earmarked for small and medium companies). This has been included in the plans for achievement of sound banking operations submitted by all the banks.

However, even if an increase in lending is make compulsory, the banks are expected to behave as mentioned above. Thus, there is a strong possibility that borrowing will be made difficult through a real-term increase in interest rates such as an increase in the interest on loans equivalent to the premium on preferred stock, etc. or the application of appropriate interest rates matched to credit risks. So, in the final analysis, the solving of the tight credit squeeze and the insufficient capital problem are incompatible. In order to achieve stability in the current financial system it was necessary to engage in ways of solving the insufficiency of capital of the banks. Thus, it was necessary to undertake the solving of the tight credit situation with the support of the special guarantee framework system.

At the time of the previous injection of public funds, the Japan premium unexpectedly showed a rise. This shows that observers did not feel that these measures would lead to stability of the financial system. However, this time since the beginning of 1999, the Japan premium has shown a rapid move towards being eliminated and the stock price level rose swiftly to recover from 13,000 to the 16,000 yen level. This is seen as having contributed to an increase in confidence in the monetary authorities. That is to say, the monetary authorities are seen to have worked within the range hoped for by the market under the new rules laid out by the Financial Reconstruction and Normalization laws. This is the major difference between this fund injection and the previous one.

It is still too soon to say that confidence has built up in the management of the banks involved.

2) The Capital Inadequacy Problem of the Major Banks - The Reason Why Public Funds Are Needed

The capital of the major banks has been increased by a total of about 10 trillion yen which includes 7,495.2 billion yen in public funds. However, questions have emerged as to the appropriateness of the amount injected and if a further injection will be necessary. Here we will consider to what extent net worth (equity capital) has been pulled down by the writing off of bad debt and provision of reserves and just how much public funds need to be injected into the banks to reach the capital adequacy ratio level they need to attain.

Figure 2 gives an image of the amount the 17 major banks have to write off, the degree their net worth will be pulled down and the amount of funds that need to be injected to reach

the capital adequacy ratio level aimed for. This is based on data from the interim settlement term in September 1998. At the end of September 1998, the Financial Supervisory Agency released the amounts indicated in the self-assessment of the banks. Of this, the total of the II to IV categories amounted to 44.2 trillion yen. The problem is whether the amounts shown in these self-assessments can be trusted and how much money is required for write off and reserves. This time, we have provisionally assumed that 15 trillion yen will have to be written off. This estimate is not excessively large when the following are taken into consideration. The amount of bad debts increases every time there is a change in the rules regarding information disclosure. The gap between self-evaluation of the two banks that came under special public administration and the final amount of bad debts has increased. It addition, we should take into consideration the amount of bad debts scheduled to be disposed of by Bank of Tokyo-Mitsubishi and Nippon Trust Bank. Moreover, from next term onwards, additional write off will be necessary due to the increase in the amount of bad debts and the possibility of additional losses in line with the final disposition of the special credit depreciation account. Taking this into consideration, if this is written off in one lump sum, there is a fair possibility that 15 trillion yen will not be enough.

On the other hand, the equity capital (net worth) is made up of internal reserves, latent profits on stock and the reserves for bad debts. Internal reserves are composed of capital, payments received for new stocks and legal reserves. As of the intermediate settlement in fiscal 1998, internal reserves stood at 11 trillion yen. The latent profit on stocks had become a latent loss of 2.

2 trillion yen. The reserves for bad debts amounted to 10.6 trillion yen according to interim financial statements released by the Federation of Bankers Associations of Japan. The 15 trillion yen we have assumed for writing off purposes is considered as the decrease in total lending, and if we deduct (allow) the same amount as risk assets, BIS rule capital adequacy requirement would become 28.8 trillion yen. Consequently, the BIS capital adequacy ratio would fall to 8.3%.

If the banks all seek to maintain a capital adequacy ratio of over 11% through this fund injection, it means that an injection of funds amounting 9.8 trillion yen is necessary. If the banks implement write off and reserve provisions to the value of 20 trillion yen, the BIS capital adequacy ratio would fall to 7.0%, and an injection of funds to the value of 14.1 trillion yen would be necessary. It is often pointed out that if the disposition of bad debts had been carried out prior to the injection of public funds, there would be some major banks with a level below the international standard of 8%. It is fair to say that the banks should have first carried out an adequate write off of bad debts using their own funds, and then taken a look at their capital adequacy ratios. Based on this, they should have then accepted an injection of public funds to make up the amount required to bring them back up to standard. In reality, it is unclear as to if the banks that accepted injections of public funds were rally sound and whether they suffered from inadequate capital or not.

In any case, there is a strong possibility that these major banks are suffering from inadequate capital levels as mentioned above. It is because of this that these banks need an increase in capital through injection of public funds and efforts on their own part. However, unless there are strict standards for classification of bad debts and adequate information disclosure, it is not possibly to verify if the amount of about 7.5 trillion yen is going to be sufficient.

One year ago, LTCB and Nippon Credit bank were considered to be sound. However, in reality they had an excess of liabilities over assets and once again they received injections of public funds. It is important to note that none of the 15 major banks can now be allowed to fail. Thus, even if some banks have an inadequate capital level in real terms, it is not possible to implement additional injections of public funds except in the case of bringing about realignment.

Figure 2 The Capital Inadequacy Problems of the 17 Major Banks

Unit: trillion yen

The amount of writing off the 17 major banks must carry out.	15.0	Disposition capacity of the 17 major banks	19.4
(Self-evaluation	44.2)	Internal reserves	(11.0)
		Latent assets	(- 2.2)
		Reserves for bad debts	(10.6)

* As of the interim term to September 1998, latent assets stood at minus 2.2 trillion yen. (Nikkei stock average 13,406 yen)
* Internal reserves (capital + payments received for new stocks + legal reserves)
* The self-assessment amount is the total of category II to category IV in the interim term to September 1998.

Unit: trillion yen

Before writing off		After writing off	
Total loans extended	319.0	Total loans extended	304.0
Risk assets	375.6	Risk assets	357.9
BIS equity capital	36.2	BIS equity capital	29.6
BIS capital adequacy ratio	9.6%	BIS capital adequacy ratio	8.3%

*In the above, we have considered the amount that has to be written off as a minus factor for the total credit amount.
The decrease in risk assets has been linked to the decrease ratio of total credit.
*The decrease in BIS equity capital has been made the same amount as the decrease in internal reserves.

Unit: trillion yen

(1) Wishes to maintain a BIS capital adequacy ratio of 9.5%	Required injection of public funds/Amount raised by own efforts	4.4
(2) Wishes to maintain a BIS capital adequacy ratio of 10.0% Required injection of public funds/Amount raised by own efforts	Required injection of public funds/Amount raised by own efforts	6.2
(3) Wishes to maintain a BIS capital adequacy ratio of 11.0% Required injection of public funds/Amount raised by own efforts	Required injection of public funds/Amount raised by own efforts	9.8

Source: Compiled by Nomura Research Institute based on data from the Federation of Bankers Associations of Japan and data released by the Financial Supervisory Agency.

3. Plans to achieve sound operations

1) Outline

At the time of applying for an injection of public funds, the 15 major banks were obliged to submit plans to achieve sound operations (operational normalization plans) under Article 7 of the Early Normalization law. These plans to achieve sound operations include the conditions for issuing preferred stock, measures to rationalize operations, measures to achieve a responsible management system, measures to avoid an outflow of profits such as dividends and measures to facilitate a smooth flow of credit. Figure 3 shows an outline of the plans of the major banks to achieve sound operations.

Figure 3 The Plans of Each Individual Bank to Achieve Sound Operations

			[Sumitomo]	[Fuji]	[Sakura]	[Tokai]	[DKB]	[Daiwa]	[Sanwa]
[Strategy]	High emphasis areas	Wholesale (Total finance)	○	○	○	Cutbacks	○		
		Middle	○	○	○	High emphasis	○	High emphasis	High emphasis
		Retail	○	○	High emphasis	High emphasis	○	High emphasis	High emphasis
		Investment bank operations (Fee business)	○	○	○	○			○
		Securities/derivatives operations	Strategic alliances			High emphasis			
		Asset management operations	Strategic alliances	Strategic alliances			Strategic alliances		
		Internet banking		○					
		In-store branches		○	○				
	Investment priorities	IT strategic investment		○			○		○
	High emphasis regions	Overseas	Cutbacks	Cutbacks	Cutbacks	Cutbacks	Cutbacks	Withdrawal	Specialization in Asia
		Domestic (Kansai - Osaka area)						High emphasis	
		Domestic (Kanagawa/Tokai -Nagoya area)				High emphasis			
		Domestic (Other areas)							
[Restructuring]	Cost cutting	Reduction of executives	○	○	○		○	○	○
		Reduction of employees	○	○	○	○	○	○	○
		Reduction of remuneration and wages		○	○	○	○	○	○
		Reduction of branches	○	○	○	○	○	○	○
		Reduction of recreation facilities	○	○	○	○	○	○	○
[Revenues]	Net operating profit (Average over past 3 years - rate of rise to March 2003 term)		101%	143%	144%	137%	124%	131%	116%
	Amount of increase in profit margin (interest rate spread) (Difference between the base line of March 1999 term and March 2003 term)		0.04%	0.38%	0.35%	0.42%	0.17%	0.54%	0.10%
[Others]		Alliances	Daiwa Securities	DKB		Asahi Bank	JP Morgan	Kinki Bank	Toyo Trust & Banking
		Mergers/spin off of subsidiaries		Yasuda Trust & Banking					
		Reconstruction of branch network	○						○
		Outsourcing	○			○	○	○	
		Financial holding companies							
		Others					Fuji Bank	Osaka Bank	

			[[Asahi]	[IBJ]	[Yokohama]	[Mitsubishi Trust]	[Sumitomo Trust]	[Toyo Trust]	[Chuo-Mitsui Trust]
[Strategy]	High emphasis areas	Wholesale (Total finance)	Cutbacks	High emphasis	Cutbacks	○			
		Middle	○	High emphasis	○	○		High emphasis	
		Retail	High emphasis	Cutbacks	High emphasis	○	High emphasis	High emphasis	High emphasis
		Investment bank operations (Fee business)		High emphasis			Cutbacks		
		Securities/derivatives operations		○					
		Asset management operations		○				High emphasis	
		Internet banking			○			○	
		In-store branches						○	○
	Investment priorities	IT strategic investment			○	○		○	
	High emphasis regions	Overseas	Cutbacks	Cutbacks	Withdrawal	Cutbacks	Cutbacks	Withdrawa	Withdrawa
		Domestic (Kansai - Osaka area)							
		Domestic (Kanagawa/Tokai -Nagoya area)			High emphasis				
		Domestic (Other areas)							High emphasis
[Restructuring]	Cost cutting	Reduction of executives	○	○	○	○	○	○	○
		Reduction of employees	○	○	○	○	○	○	○
		Reduction of remuneration and wages	○	○	○	○	○	○	○
		Reduction of branches	○	○	○	○	○	○	○
		Reduction of recreation facilities	○	○	○	○	○	○	○
[Revenues]	Net operating profit (Average over past 3 years - rate of rise to March 2003 term)		143%	93%	185%	39%	88%	157%	67%
	Amount of increase in profit margin (interest rate spread) (Difference between the base line of March 1999 term and March 2003 term)		0.14%	-0.04%	0.20%	-0.33%	-0.14%	0.11%	0.17%
[Others]		Alliances	Tokai Bank	Dai-ichi Mutual Life Insurance	Tokai Bank	4 Mitsubishi companies	Sumitomo Gr.	Sanwa Bank	
		Mergers/spin off of subsidiaries							
		Reconstruction of branch network				○		○	
		Outsourcing	○	○	○				
		Financial holding companies		○					
		Others		Nomura Securities		AIG			

Source: Compiled by Nomura Research Institute based on the plans of the major banks to achieve sound operations

The policies of each bank are different, but the following areas are common ground.

(1) The top class banks intend to maintain integrated financial services while switching their core operations to the medium-level and small and medium company markets and the retail market, all expected to be future profit sources.

(2) Intends to strengthen securities operations, derivatives operations and asset management operations through alliances with financial institutions both in Japan and overseas.

(3) They will seek out new directions for advance and new financing channels. However, they will not go as far as high emphasis investment in IT.

(4) They will engage in thorough restructuring (as mentioned later on in this report)

Although they proclaim a policy of "Selection and concentration," in fact they give the impression of being involved in everything.

Again, although the banks all say they will simultaneously engage in the following area, only a vague impression comes across. These comprise a reduction of operations to only

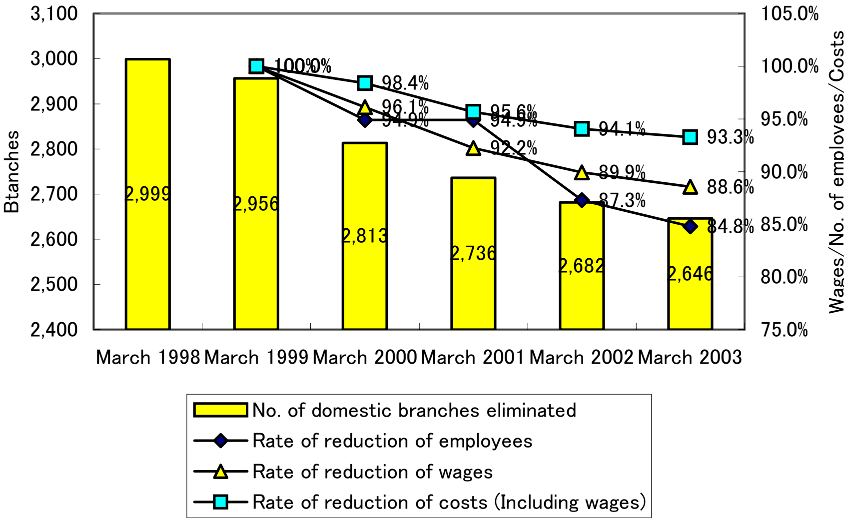
core customers in the wholesale market which has become unprofitable, attempts to increase the profit margin (interest rate spread) on the small and medium company market, an area where there is some risk, and opening up the retail market and looking for mass sales.

2) The Main Thrust Is on Restructuring Plans

In reality, the core contents of these plans to achieve sound operations hinge on restructuring over the next four years. This will include a cutback in executives through the introduction of an executive officer system, a reduction of employees, and reduction in remuneration and wages, a reduction in branches and a reduction in recreation facilities.

Figure 4 is based on the restructuring plans of the major banks. Over the next four years, the number of domestic branches will be reduced by 310 and the number of employees will be cut by 15% (about 20,000). However, overall costs including non-personal expenses are to be cut by only 7%. This is said to be due to the occurrence of spending on rationalization, higher levels of risk control, and equipment related spending including IT spending. Regarding the cut in the number of employees, it is planned to cut this by about 15% over the next four years. However, this is less than 4% per year, and it is heavily criticized as being within the limits of natural attrition. The rate of reduction of personnel is greater than the rate of the cut in wages. This is thought to be due to the planned introduction of a yearly contract system, that is a mechanism to breed competitiveness, under which the more talented people will get higher wages.

Figure 4 Cuts in the Number of Branches and Employees



Source: Compiled by Nomura Research Institute based on the plans of the major banks to achieve sound operations (operational normalization plans)

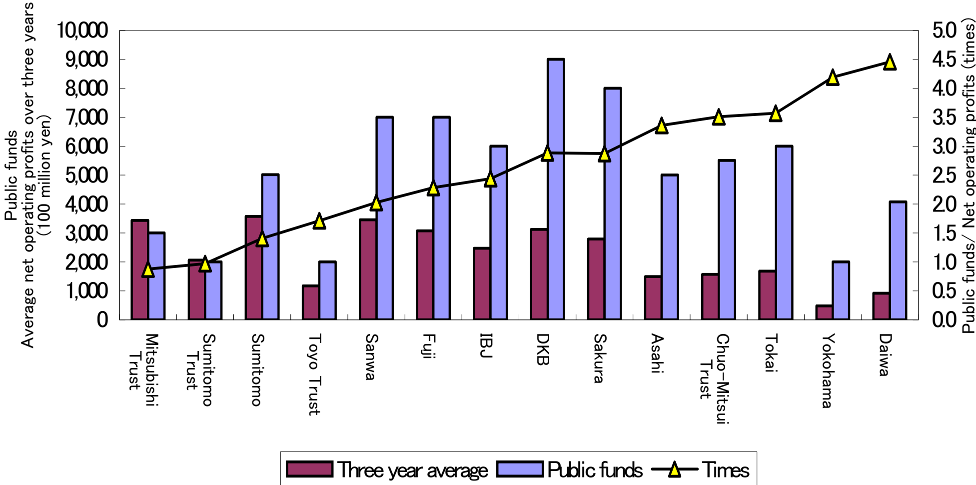
3) The Important Point Is to Switch to High Revenue Operations

Basically, the plan to achieve sound operations, required as a condition for receiving an injection of public funds, should be concrete measures to switch to high revenue operations. As shown in Figure 5, in the case of banks requiring relatively large injections of public funds

the ratio of these funds the to average net operational revenues over the past three years stands at up to 4.

5 times. The extent to which this burden can be lightened depends on how much improvement in revenue earning capacity can be achieved.

Figure 5 Correlation between Public Funds and Net Operating Profits Over the Past Three Years



Source: Compiled by Nomura Research Institute based on the plans of the major banks to achieve sound operations

As can be seen in Figure 3, Fuji Bank and Sakura Bank have formulated positive plans for a just over 140% jump in net operating profit from the term to March 1999 to the term to March 2003. They intend to concentrate on the following operations as a measure to expand revenues.

- Application of an appropriate profit margin (interest rate spread) matched to the credit risk in transactions with companies.
- Increase in non-asset revenues through investment bank operations.
- Securing revenues through private banking operations, and an increase in outstanding loans to individuals and housing loans.

However, even the banks that have submitted very progressive plans are not considered to be engaging in a thoroughgoing review of operations and a review of profitability. All the banks have aimed their sights at the same objectives, "Selection and concentration", and the Financial Reconstruction Commission has also required this. However, in the final analysis, there is nothing to distinguish any of them. We cannot perceive any clear direction such as focusing only on being a global company working the individual market or existing on securities and investment bank operations rather than living on extending loans.

Japan's banks depend on interest on loans extending for about 60% of their operational funds and revenues. The banks are all saying that they will fix appropriate and fair interest rates matched to the credit risk. This means that, using the internal ranking of customer firms, the banks will apply appropriate interest rates and in this way expand the spread. However, currently an adverse environment prevails in the form of the protracted economic

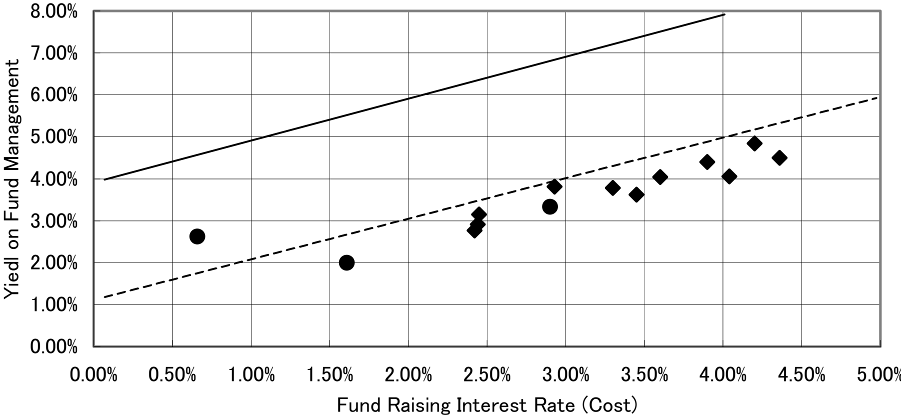
recession, the tendency for big companies to avoid using banks, the BIS rule problem and the insufficiency of capital on the part of the banks. Thus, in this climate, it is very difficult to be more selective when accepting customers and effect a real-term hike in the interest on loans extended, centering on the medium-standing firms, the small and medium size firms and the individual market.

Figure 6 shows a plot of the total average interest rate spread distribution of the 14 major banks. The dotted line shows a total average interest rate spread of 1% and the solid line shows the total average interest rate spread of the top ten US banks which averages 4%. According the plans of the 14 major Japanese banks to achieve sound operations, over the next four years several of these banks are planning to expand their spread by 30 to 50bp. However, even so, the total average interest rate spread is not able to rise above the 1% line.

Figure 7 is a comparison of an estimate of the current profit ROA and ROE of the Japanese banks that received an injection of public funds (▲ mark) in the term to March 2003 with the current profit ROA and ROE of all US banks nationwide (■ mark) over the past 10 years. Almost all the Japanese banks are located in the ROE 4 to 8% and ROA 0.2 to 0.4% areas. However, the US banks are at a level close to ROA of 1% and ROE approaching 15%. The gap between current profit ROA is very clear. In order to boost current profit ROA, it is necessary to reduce the leverage ratio by reducing total assets and increasing equity capital, or to boost current profit ROE by increasing current profit. Thus, the balance of assets, capital and current profits is very important.

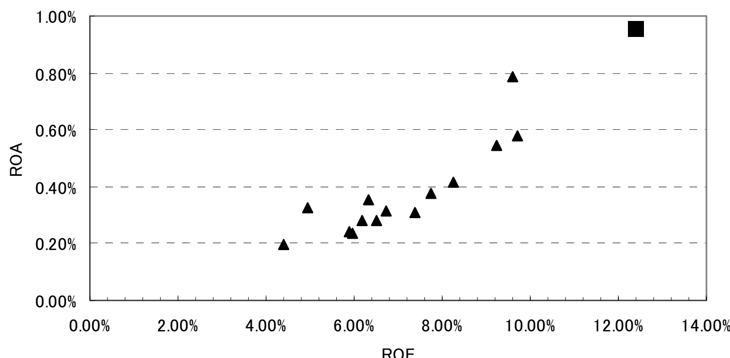
The limitations of profitability of the Japanese banks clearly show that it is difficult for these banks to continue to exist as unaffiliated global financial institutions. It will be impossible to avoid a realignment leading to a boosting of revenues earning capacity.

Figure 6 Total Average Interest Rate Spread Distribution of the 14 Major Banks



Source: Compiled by Nomura Research Institute based on the plans of the major banks to achieve sound operations

Figure 7 Current Profit ROA & ROE in the Term to March 2003



Source: Compiled by Nomura Research Institute based on the plans of the major banks to achieve sound operations (operational normalization plans)

4. Future Objectives

As of the end of March 1999, public funds were injected into Japanese banks, but this left a number of doubts unanswered. These included doubts as to whether even the 15 major banks were suffering from a state of capital insufficiency due to the need to dispose of bad debts. On April 11, 1999, the Financial Reconstruction Commission and the Financial Supervisory Agency came to the conclusion that Kokumin Bank a second tier (Second Association of Regional Banks) local bank in Tokyo had fallen into a state of liabilities in excess of assets as of the end of September 1998. Under the Financial Reconstruction Law, they dispatched financial administrators to the bank, and if a bank willing to take Kokumin Bank over is not found, they decided that a public bridge bank system would be applied, the first such case. On the same day, the authorities decided to implement measures to promote prompt corrective action vis-a-vis the Kofuku Bank, a second tier local bank in Osaka (Second Association of Regional Banks) (on March 26, 1999 the same measures were implemented for the Hokkaido Bank). Thus, the realignment led by the authorities has moved from the major banks to the local financial institutions.

Japan's financial system is moving towards an age of the principle of responsible management and stress being placed on market disciple, generally referred to as the deregulation of the financial sector and Japan's financial Big Bang. However, it is ironic to note that in reality the government is intensifying its intervention in the operations of private sector banks, and through this progressively restoring stability. Moreover, the market is merely placing a positive evaluation on the performance of the Financial Reconstruction Commission and the Financial Supervisory Agency, agencies which act along lines approved by the market, rather than evaluating the performance of each individual bank in achieving sound operational status. In this sense, it is unavoidable that the government should intervene for some time to come. However, unless the individual banks all achieve a recovery in confidence placed in them, there is a strong possibility that the market will once again make a severe judgment against the banks. Thus, the objective for the time being is to see just how much progress the banks can achieve in reforming themselves.

In addition, as the wave of realignment advances centering on mergers and disposition of bankruptcies, the possibility cannot be overlooked that the outflow of deposits will pose a new turmoil factor in the financial system at the time when government will no longer provide unlimited deposit guarantees. Seen from this viewpoint, the financial system council (?) is scheduled to debate an expansion of the functions of the deposit insurance corporation to secure a further stabilization of the financial system. Funding support including the special fund support system amounted to 54 cases by March 1999, and monetary donations of 5.7 trillion yen (32 cases in fiscal 1998 alone worth about 3.7 trillion yen) and purchase of assets worth about 3 trillion yen were implemented. The fiscal state of the Deposit Insurance Corporation has deteriorated due to the continued disposition of bankruptcies, and it appears that a review of the introduction of a variable insurance premium system is unavoidable. Many outstanding problems still remain such as an expansion of the range of products needing protection such as bank debentures, an area which conventionally has not been covered by protection, and the establishment of a new depositor protection system proposed by Masaharu Hayami, the Governor of the Bank of Japan.

However, as advances are made in the creation of such safety nets, concern is felt over the moral hazards besetting the bank management teams and depositors. Thus, a considerable amount of time will be required before it is possible for a system of responsible management and market disciple to take root in Japan.