Financial Reconstruction and Normalization Laws

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The Financial Reconstruction Law and the Early Normalization Law were enacted on October 23, 1998, creating a safety net composed of the early normalization scheme as a measure prior to failure to deal with the bad debt problem and the bankruptcy disposition scheme as the ex post facto measure. The effect of the efforts to avoid the financial crisis will be tested through injections of public funds. This report will review the implications of the two laws and discuss future objectives.

1. The Process to the Establishment of the Financial Reconstruction and the Early Normalization Laws

Let's look back over the processes leading to the enforcement of the Financial Reconstruction and the Early Normalization Laws.

Discussions about how to revitalize Japan's financial system started in June 1998 and developed into a concrete form with the introduction of the total financial reconstruction plan on July 2 which contained a bridge bank system. After a brief period of political vacuum up to the House of Councilors (upper house) election and the formation of the new Cabinet headed by Premier Keizo Obuchi, a financial reconstruction bill based on that plan was presented to the National Diet (Japan's parliament) on August 5. As a "preliminary skirmish" of deliberations at the plenary session of the House of Representatives (lower house), the budget committees of both lower and upper houses met to discuss the standard for designating a bank as insolvent and the applicability of the bridge bank system to major banks.

The impact of the reversal of political forces in the upper house switching the roles of the ruling party and the opposition parties combined with the criticism of the attempt to support the insolvent Long-Term Credit Bank of Japan (fears regarding this bank emerged from May) with public funds resulted in the mounting of a joint assault by the opposition parties on the ruling Liberal Democratic Party. After August 25, deliberations in the plenary session of the lower house continued to go adrift, forcing the ruling party to revise the bill three times.

On September 18, the heads of the ruling and opposition parties met to agree to amend the financial reconstruction bill, but the discussions there revealed the difference in their basic attitudes toward the handling of the Long-Term Credit Bank of Japan, pre-bankruptcy disposition and the issue of separation between the financial and fiscal authorities. At this juncture, the Russian crisis and the U.S.'s bailout of LTCM, a hedge fund, added to the rapidly growing international financial uncertainties. As there was not a moment to lose in preventing systemic risks, the ruling LDP managed to enact the bill only by swallowing the oppositions' proposal without any reservations. With the addition of two provisions, one for injections of funds into a bank taking over banks placed un-
nder special public administration (state control), and other for permitting banks eligible for the early normalization scheme to have their bad debts purchased (by the Resolution & Collection Corp.), on September 29 the ruling party agreed to accept the oppositions’ proposed financial reconstruction bill almost as it was.

On October 2, the financial reconstruction bill passed the lower house, and that evening, the LPD presented a draft for the early normalization scheme to the opposition parties. Some amendments were made to this scheme, and this step helped prepare the framework for pre-bankruptcy measures by paving the way for even healthy financial institutions with more than 8% capital adequacy ratio to receive injections of public money under certain conditions. The early normalization bill passed the lower house on October 13th.

Now the points at issue shifted to debate on organization aspects needed to form a framework. This included how to deal banks before falling into insolvency, how to deal with their bankruptcy, and how to organize a body to dispose of insolvent banks, how to set the disposition period for insolvent banks, and how to organize a body to administer and collect loans. The process of these discussions took on a greater aspect of political maneuvering between the ruling and opposition parties and even among the ruling party. In this process, the primary theme, concerning the administration's attitude toward the standard for judging bankruptcy and promotion of smooth disposition, was put on the back burner. It cannot be denied that this process of debate on the organizational framework gave the public the impression that the situation was not urgent, and the government failed to adequately convey to the people how serious the situation was and that it required immediate measures.

2. The Content of the Financial Reconstruction Law

In order to stabilize and revive Japan's financial functions, the "Law concerning urgent measures for the reconstruction of financial functions" (the Law) aims to establish systems and rules for dealing with the failure of financial institutions, maintain orderly credit and protect depositors. (Figure 1).

![Figure 1 The Agreed Framework for the Financial Reconstruction Law](source: Nomura Research Institute)
1) Principles of Bankruptcy Disposition

Article 3 of the Law stipulates that insolvent banks should be disposed of by March 31, 2001 in an intensive campaign. The principle of bankruptcy liquidation has six conditions: (1) The financial situation, including bad debts, and other operational factors of insolvent financial institutions should be disclosed; (2) Financial institutions unable to maintain operational soundness should not be allowed to survive; (3) Responsibilities of shareholders and executives should be made clear; (4) Depositors should be protected; (5) Financial institutions' intermediary functions in financing should be maintained; and (6) The cost of liquidation of insolvent institutions should be minimized.

2) Asset Appraisal and Report

The Law requires financial institutions to appraise their assets and report to the Financial Reconstruction Commission during the accounting term in question or within the period specified by the ordinance of the competent ministries (Article 6), and obligates them to disclose the total of the appraised assets (Article 7). It also stipulates that those who have included any false statement in the report should be imprisoned for up to five years or a fine of ¥5 million or under (Article 78).

3) Administration by Financial Public Administrator and Transfer to Public Bridge Bank

The opposition parties' draft called for administration of insolvent financial institutions by the financial disposition administrator, and special public administration designed for forced acquisition of shares by the state. The amended draft allowed increased options that permitted the financial institutions administered by financial administrator to shift to the category of public bridge banks (Clause 4, Article 27), in addition to administration by the financial administrator (Article 8). The "Heisei (the period that started with the enthronement of the present Emperor in 1989) Financial Reconstruction Corp." which was included in the original government plan was dropped in favor of capital investment by Deposit Insurance Corp. in the public bridge bank.

Although the financial administrator assigned by the Financial Reconstruction Commission makes efforts to find financial institutions willing to accept the transfer of the insolvent institutions' business,*1 the administrator may request, if he or she deems it necessary, the Financial Reconstruction Commission to establish a public bridge bank. The public bridge bank is required to implement disposition in such forms as merger, transfer of operations, or transfer of shares, within a year, or once a year up to two years (for a total of three years) after it takes over the operations (Article 31).

Initially, the plan by the government and the ruling party contained an idea of establishing a public bridge bank by purchasing the shares of the insolvent financial institutions. But this idea was later dropped.

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*1 In principle, the Financial Reconstruction Commission will finish its administration through such means as transfer of operations, within a year after it was assigned to the job of administration. In unavoidable circumstances, the period may be extended by no longer than a year (Article 25).
4) Special Public Administration

The Law requires special public administration to go into effect when banks are judged as incapable of fully repaying debts with their assets, or as having suspended repayment of deposits or there is a possibility of a suspension of repayment of deposits, (that is, when they go bankrupt due to excess of debt and financing difficulty) (Article 36), and when it is feared that they may have to suspend repayment of deposits and so cause a possible liquidity crisis) (Article 37).

On October 23, 1998, The Long-Term Credit Bank of Japan filed an application in accordance with Clause 2, Article 68 of the said law, "when a financial institution foresees a possible suspension of repayment of deposits in consideration of its operations and its financial position, it should report this fact and its reasons in writing to the Financial Reconstruction Commission". This was done in expectation of receiving special public administration treatment as stipulated in Article 37. However, Article 36 was applied instead, and the bank was acknowledged in essence as having gone bankrupt.

By March 31, 2001, the Financial Reconstruction Commission is required to terminate its job of special public administration (Article 52). This means it must make the banks under special public administration complete all dispositions by transferring their operations and shares.

5) Purchasing of Assets

The Deposit Insurance Corp. can purchase assets from financial institutions, public bridge banks and special public administration, and entrust the Resolution and Collection Corp. (a bank which has concluded a special resolution and collection agreement pursuant to Clause 1, Article 7 of the Supplementary Rule of the Deposit Insurance Law) with the administration and disposition of these assets (the special resolution and collection agreement is stipulated in Articles 53 and 54).*2

The standard for the purchase of assets should be disclosed in advance by the Financial Reconstruction Commission. (Article 56)

Funds needed by the RCC to purchase assets will be lent or guaranteed by the Deposit Insurance Corp. (Article 57)

On November 17, the preparation office for the establishment of the Financial Reconstruction Commission announced the "asset judgment criteria" to decide which loan credits should be held or taken over by the financial institutions which have been put under special public administration and shifted to the category of public bridge banks. (Figure 2)

Conditions for the judgment standard are prescribed for each debtor category used by those banks for self assessment. Credits for "doubtful borrowers" which fall under category II are classified according to their financial soundness. The conditions include relieve measures that even companies saddled with carried-over losses can receive continued loans if they can expect to dissolve losses by the end of the accounting term in two years time. However, it is open to question whether small and medium-sized companies beset with transferred losses can eliminate the losses in two years at a time when the credit crunch still prevails.

*2 See 4. Below for the establishment of Resolution and Collection Corp.
**6) Exceptions to the Operations of the Deposit Insurance Corp.**

The Deposit Insurance Corp. aims to comply with the provisions of Article 34 of the Deposit Insurance Law and achieve the purpose of "establishing a system for emergency measures regarding special public administration of banks and purchases of financial institutions in order to stabilize and revive Japan's financial functions" (Article 1). For this purpose, the Deposit Insurance Corp. is authorized to subscribe to the capital of the public bridge bank (Article 60), lend funds to banks under special public administration (Article 61) and cover the loss generated by the public bridge bank in performing its operations (Article 62). Article 63 also authorizes the DIC to take over the operations of insolvent financial institutions, public bridge bank and banks under special public administration, and underwrite the shares issued by financial institutions that take over the shares of the above-mentioned institutions and banks.

In order to secure its financing, the DIC is authorized to borrow from the Bank of Japan, financial institutions and others and issue its own DIC bonds (Article 65). These borrowings are guaranteed by the government (Article 66).

Incidentally, a financial reconstruction account (Article 64) of ¥18 trillion was set up in the DIC (Article 13 of the enforcement ordinance for the Law ("Law concerning urgent measures for the reconstruction of financial functions")). *3

This step has made it possible to inject public funds into bridge banks for the purpose of capital increase by a bridge bank which takes over the operations of insolvent financial institutions. The Chuo Trust & Banking, which is to act as a bridge bank for the bankrupt Hokkaido Takushoku Bank, is expected to be the first to receive injections from this account.

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*3 The financial reconstruction account has been prepared to subscribe to the capital for the establishment of public bridge banks, and offer loans, guarantee debts, cover losses and purchase shares of public bridge banks (Article 60).
3. Contents of the Financial Reconstruction Commission Establishment Law

"The Financial Reconstruction Commission establishment law" and "the law concerning the preparation of related laws following the enforcement of the Financial Reconstruction Commission establishment law" stipulate the organization and jurisdiction of the Commission. The opposition parties proposed that a state minister be appointed to the commission's chairmanship to take charge of all financial administrative matters including liquidation of bankrupt financial institutions and their shift to state-ownership and that all the powers of the Financial Planning Bureau of the Ministry of Finance be transferred to the Commission. However, the scope of the jurisdiction has been modified in the amended bill.

1) The Establishment of the Commission pursuant to the State Administrative Organization Law

The Financial Reconstruction Commission is established as an extra-ministerial bureau of the Prime Minister's Office (Article 2) pursuant to the State Administrative Organization Law (Clause 2, Article 3). The matters and powers under the Commission's jurisdiction are confined to the matters under the Prime Minister's Office (Financial Supervisory Agency), surveys, planning and drafting regarding the financial bankruptcy liquidation system and the financial crisis control, administration and special public administration (state control) by the financial administrator, as well as the matters related to the disposition of other bankrupt financial organizations. The ruling and opposition parties agreed that planning and drafting regarding the financial bankruptcy disposition system and financial crisis control should be placed under joint control with the Ministry of Finance. However, this agreement is not specified in any provisions of the law.

2) Organization

The Commission is organized by a chairman and four Commission members (Article 5). The chairmanship is assigned to a state minister (Article 6), and the Commission members are appointed by the Prime Minister, with the sanction of the upper and lower houses, from among those with outstanding insight and experience in economic, financial and legal matters (Article 7). Their term of office is up to the day when the Financial Reconstruction Commission is disbanded (Article 8).

3) Establishment of the Financial Supervisory Agency and the Stock Price Evaluation Committee within the Financial Reconstruction Commission

It has been decided to establish the Financial Supervisory Agency within the Financial Reconstruction Commission under the Financial Supervisory Agency Establishment Law (1997 Law No. 101), following the enactment of the Financial Reconstruction Commission Establishment Law. Accordingly the Financial Supervisory Agency Establishment Law (Article 3 of Supplementary Rules) was repealed. Incidentally, the Securities and Exchange Surveillance Commission is established within the Financial Supervisory Agency. The Stock Price Evaluation Committee is to be formed within the Financial Reconstruction Commission to take charge of "matters concerning administration, special public administration and disposition of other insolvent financial institutions..."
by the financial administrator", which comprises a part of the matters under the FRC's control (Clause 2, Article 4). The five members are all non-regulars.

4. Establishment of the Resolution and Collection Corp. (Japanese version of RTC)

The law for partial amendment of the Deposit Insurance Law, which was proposed by the opposition, aims to establish the Resolution and Collection Corp. (Japanese version of RTC). This organization will be formed through merger and acquisition of the Resolution and Collection Bank by the Housing Loan Administration Corporation (Article 8-2 of Supplementary Rules of the Deposit Insurance Law). An additional merger of the Cooperative Credit Purchasing Co. will be studied in the future. The Resolution and Collection Corp., which was not a profit-making organization under the oppositions' plan, has been defined as a joint-stock company under the amended bill ("the law concerning emergency measures for the reconstruction of financial functions" (Article 59)).

5. Contents of the Early Normalization Law

"The law concerning emergency measures for early normalization of financial functions" (the Law) is designed as a scheme to facilitate pre-bankruptcy measures, aiming at early normalization of financial functions by forming an emergency measure system for capital reinforcement of financial institutions. Financial institutions will be grouped into four categories by the level of capital adequacy ratio, "sound", "low capital", "very low capital", and "conspicuously low capital". The scheme can give orders to financial institutions to rationalize their operations according to this categorization. The scheme is characterized by the fact that it ensures injections of funds even into healthy institutions with a capital adequacy ratio of over 8%.

1) General Rules for Measures taken by the Financial Reconstruction Commission

General rules for early normalization of financial functions (Article 3) stipulate the following six points: (1) prevention of financially unhealthy state, (2) instructions to financial institutions to rationalize their operations and clarify their management responsibilities and responsibilities to shareholders, (3) enhancement of system efficiency by promoting reorganization of financial institutions, (4) minimization of social cost, (5) effective coordination with prompt corrective measures, and (6) adequate disclosure.

Clause 2 of Article 3 stipulates three prerequisites for the measures taken by the Financial Reconstruction Commission; (1) proper assessment of assets, (2) preparation of proper levels of reserves, and (3) adequate assessment of securities and other assets.

Clause 3 stipulates that financial institutions which fall under the category of "conspicuously low capital" should be ordered to implement either equity capital increase, drastic curtailment of operations and mergers, or termination of banking business.

Based on Clause 2, on November 10, 1998 the Financial Reconstruction Commission Establishment Preparation Office released "the guidelines for assessment of assets", indicating the qualification standard for capital injections (Table 2) and urging financial institutions to apply for capital injections. It also announced a new standard for assets appraisal and reserves requirements. Figure
3 shows a comparison of the new standard with the standard set by the Federation of Bankers Association of Japan.

Starting in the term ending in March 1999, financial institutions are now required to disclose "the information on loans under risk administration" and "the value of assets" appraised under the Financial Reconstruction Law. This stipulation allows three kinds of information on bad loans to exist within a financial institution, the two stated above and classified credit, thus posing a problem of how to distinguish these standards.

2) Applications for Capital Increase and Presentation of Operational Normalization Plans

Financial institutions, which plan to apply for capital increase to the Deposit Insurance Corp. by March 31, 2001 in order to issue shares or receive subordinated loans for the purpose of early normalization, are required to present the plans for operational normalization, such as measures to rationalize their operations and establish a responsible management system, to the Financial Reconstruction Commission through the Deposit Insurance Corp. (Article 5).

3) Establishment of the Early Normalization Account for Financial Functions

While the financial function stabilization law was repealed, Article 15 of the Law stipulates the establishment of "the financial functions early normalization account" with a budget of ¥25 trillion (Article 5 of the Enforcement Ordinance of the Law).

Table 2  Outline of the Conditions and Standards for Share Underwriting

<table>
<thead>
<tr>
<th>Capital Adequacy Ratio</th>
<th>Standard by the Early Normalization Law for Financial Functions</th>
<th>Legal Conditions by Category</th>
<th>Standards set by Considering Categories and Other Factors</th>
<th>Legal Conditions by Category</th>
<th>Standards set by Considering Categories and Other Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category</td>
<td>Unified International Standard</td>
<td>Domestic Standard</td>
<td>Voting Shares</td>
<td>Shares other than Voting Shares</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Off Category</td>
<td>8% - 4%</td>
<td>4% - 2%</td>
<td>Low capital</td>
<td>1. Operational rationalization (reduction of executives and staff as well as spending)</td>
<td>5. Reduction of dividends and executive bonuses</td>
</tr>
<tr>
<td>Category I</td>
<td>Over 8%</td>
<td>Over 4%</td>
<td>Sound</td>
<td>Merger with financial institutions with deteriorated business performance</td>
<td>Indispensable to avoid credit crunch</td>
</tr>
</tbody>
</table>


### Capital Adequacy Ratio

<table>
<thead>
<tr>
<th>Category</th>
<th>Domestic Standard</th>
<th>Legal Conditions by Category</th>
<th>Loans, securities, foreign exchanges, interest receivable, (authorized public accountant)</th>
<th>Disclosure Standard for Loans under Risk Administration (Federation of Bankers Associations of Japan)</th>
<th>Loans, securities, foreign exchanges, interest receivable, (Prime Minister's Office)</th>
<th>Methods such as Reserves (Article 2 of Draft Notification)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category I: Normal Credit</td>
<td>4%-2%</td>
<td>2%-0%</td>
<td>Very low capital</td>
<td>Loans requiring careful collection</td>
<td>Loans requiring careful collection</td>
<td>Loans requiring careful collection</td>
</tr>
<tr>
<td>Category II: Uncollectible loans:</td>
<td>2%-0%</td>
<td>1%-0%</td>
<td>Conspicuously low capital</td>
<td>Loans of seriously doubtful collection</td>
<td>Loans of seriously doubtful collection</td>
<td>Loans of seriously doubtful collection</td>
</tr>
<tr>
<td>Category III:</td>
<td></td>
<td></td>
<td></td>
<td>Consistently low capital</td>
<td></td>
<td></td>
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<tr>
<td>Category IV:</td>
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</tbody>
</table>

### Legal Conditions by Category

1. Basic reform of management (Resignation of representative executives, reexamination of the salary system, including a reduction of the salary level, and reexamination of organization and business (reduction of executives and branches and closing of overseas offices) should all be implemented in principle.)
2. Measures to enhance market appraisal by improving ROE through disposition or expansion of divisions
3. Sale of less necessary facilities
4. Suspension of dividends and executive bonuses
5. Establishment of a system to clarify management responsibilities
6. Keeping share value appropriate by capital decrease, etc. (When net assets decline below capital)
7. Certain implementation of prompt corrective measures
8. Implementation of measures to prevent a decrease in credit extension (Outstanding loans to small and medium-sized companies should be increased in principle).

### Note

In judging if the applicants satisfy these conditions and standards, the conditions for the category in which the issuing financial institutions fall may be moved to conditions for an upper level of category, depending on the progress in write-off of bad debt, reserves, credit extension, and operational rationalization up to the time of application.

### Source

Financial and Fiscal Situation (Kinyu Zaikai Jijo) (The Financial Reconstruction Commission Establishment Preparation Office of the Prime Minister's Secretariat)

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**Figure 3**  Interrelations between Standard for Assets Assessment Classification and Standard for Disclosure of Bad Debts

<table>
<thead>
<tr>
<th>Classification Standard for Assets Assessment (Financial Supervisory Agency)</th>
<th>Debtor Category for Self Appraisal</th>
<th>Disclosure Standard for Loans under Risk Administration (Federation of Bankers Associations of Japan)</th>
<th>Disclosure Standard for Financial Functions Reconstruction Law (Prime Minister's Office)</th>
<th>Methods such as Reserves (Article 2 of Draft Notification)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans, securities, foreign exchanges, interest receivable, (authorized public accountant)</td>
<td>Borrower</td>
<td>Loans</td>
<td>Loans to insolvent borrowers and delinquent loans</td>
<td>Loans to bankrupt and reorganizing borrowers and similar credit</td>
</tr>
<tr>
<td>Loans with eased lending conditions</td>
<td>Loans of over 3 months in arrears</td>
<td>Loans of over 3 months in arrears</td>
<td>Loans of over 3 months in arrears</td>
<td></td>
</tr>
<tr>
<td>Normal credit</td>
<td>Normal borrowers</td>
<td>Normal credit</td>
<td>Normal credit</td>
<td></td>
</tr>
</tbody>
</table>

Source: Compiled by Nomura Research Institute from Financial and Fiscal Situation (Kinyu Zaikai Jijo) and Nikkin.

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Financial Reconstruction and Normalization Laws 9
6. Future Objectives

The recently established safety net will not operate effectively without the following factors. First is the securing of leadership of the Financial Reconstruction Commission. Present problems include how to prepare standards for appraising assets which are being disclosed, and accurately and promptly prepare to meet the conditions for capital injection. It is necessary to secure staff versed in practical affairs and prevent the government's financial administration from being divided until the establishment of the Financial Reconstruction Commission.

Second is to secure the effectiveness of the insolvency liquidation functions. The combined use of the special public administration method and the bridge bank method has been realized, but further attention should be focused on the difficulty in applying the bridge bank method to major banks, and on how to ensure the adequacy of the stock price evaluation standard by the special public administration formula.

The problem requiring the greatest attention at present is how to secure the effectiveness of the early normalization scheme. The standard for capital injection has been arranged in such a way that it is easy to apply by not questioning the applicant's management responsibility, for instance, but banks remain reluctant. The 18 major banks have applied for a total of only ¥5-6 trillion, in almost equal individual amounts, irritating the government which has been encouraging them to apply for a few trillion yen per bank. If the government's stance generates an impression that capital injection is the sole purpose of its policy, the market's confidence will be lost again. As there is a theoretical contradiction between the aim of solving the credit crunch in the government's emergency economic measures and the government's explanation of the normalization scheme designed for capital increase, confusion often arises, and some people are voicing the opinion that capital injection should be increased if the credit crunch cannot be resolved.

If the question of whether Japan's financial system can be stabilized is responded to by merely saying that this will happen when the credit crunch is resolved, the answer may miss the point. The phenomenon of the credit crunch has actually been caused by the relationship between the level of damage sustained to banks' equity capital and their subsequent measures to improve their capital adequacy ratio.

Thus, the need is to stabilize the financial system and this should not be done by measuring the success in resolving the credit crunch in terms of figures but by ascertaining to what extent the banks' equity capital has been improved.

It would be difficult to directly ascertain the extent to which the credit crunch is being resolved unless the degree of leeway to secure funds leading to equity capital increase and new credit extension is confirmed. The question of whether equity capital can be increased with the amount requested by banks or within the ¥25 trillion quota can be answered only by ascertaining the degree of banks' truthfulness in their future disclosures. This is because unless it is ascertained that the degree of disclosure of information on the amount of bad loans and reserves is sufficient to gain the market's confidence, the adequacy of the necessary amount of public funds is unverifiable. Financial stabilization, by its nature, cannot be ensured by indicating the solving of the credit crunch phenomenon in terms of net increase in loans. Instead it should be measured only by improving the degree of disclosure of information on asset devaluation, etc.

The market will pay greater attention to the degree of disclosure in the future. It is time to realize that only improved disclosure can be a key element of differentiation strategies and indicate an
attitude able to meet social responsibilities.