Financial Functions Stabilization Act[1]

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Abstract

In 1990, the asset-pricing bubble in Japan peaked and began a steady decline. Over the next seven years, a series of bank failures induced the Japanese government to introduce the first of a series of capital injections in 1998, 1999, and 2004. The capital injection of 1998, authorized by the Financial Functions Stabilization Act, made ¥13 trillion ($103 billion) available to financial institutions that applied. By the end of the injection window, 21 banks and trusts applied for and received ¥1.8 trillion ($13.5 billion) in subordinated debt and loans and preferred shares. While there were no limits on compensation for management, the Act restricted dividend payments and required banks to submit restructuring plans. However, lack of oversight over bank balance sheets to pursue risk-based injection strategies, regulatory forbearance, and banks' application for capitalization below balance sheet needs prevented complete recapitalization of the banks and led to a second recapitalization scheme one year later.

Keywords: capital injection, Japanese Financial Crisis, Japan, *jusen*, Resolution and Collection Bank, Financial Crisis Resolution Committee, regulatory forbearance

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1 The Financial Function Stabilization Act is also referred to as the Act for Early Strengthening of Financial Functions, the Act on Emergency Measures for the Stabilization of Financial Functions (raw translation), the Financial Stabilization Law, or the Financial Function Early Strengthening Law, written as 金融機能安定化法 in Japanese.

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Financial Functions Stabilization Act

At a Glance

The bursting of the asset price bubble in Japan in 1990 lead to the steady decline of Japanese assets. Due to high levels of interconnectedness in the system formed through *keiretsu* relationships between banks and firms, many banks became deeply undercapitalized through both non-performing loans and devalued assets. After the failure of four banks in 1997, the Japanese Diet passed the Financial Functions Stabilization Act on February 16, 1998.

The act allocated ¥13 trillion ($103 billion) of capital for injection into any bank and some non-bank financial institutions that applied. The Financial Crisis Management Committee (FCMC) reviewed each application. The applications required that applicants submit management improvement plans in addition to information on capital requests. The capital injections were contingent on estimates of need. They took the form of subordinated debts and loans and preferred shares purchased by the Resolution and Collection Bank (RCB), a partial subsidiary of the Deposit Insurance Corporation of Japan (DICJ). The DICJ funded the RCB's purchasing through BoJ bond issuances and government guarantees. There was no explicitly defined repurchase schedule.

Summary of Key Terms	
Purpose: Maintaining credit order and the stability of the national economy while preventing the failure of financial institutions in Japan and overseas.	
Announcement Date	December 24, 1998
Operational Date	February 16, 1998
Injection Start Date	March 31, 1998
End of Application Window	March 31, 2003
Program Size	¥13 trillion ($103 billion)[3]
Peak Utilization	¥1.8 trillion ($13.5 billion)[4]
Eligibility	Any financial institution; some nonbank financial institutions
Participants	21 financial institutions
Administrator	Resolution and Collection Bank
Legal Authority	Passed through the Japanese Diet, executed by the Prime Minister's Office and DICJ

Between February 1998 and March 1998, 21 banks applied for capital injections with no rejections. Overall, of the ¥13 trillion allocated, ¥1.8 trillion ($13.5 billion) was used to purchase preferred shares and subordinated bonds. Applicant banks, trusts, and regional banks received varying capital-underwriting terms. By 2017, all banks had repurchased their shares, loans, and debts.

Summary Evaluation

[3] Converted based on March 31, 1998 dollar-yen exchange rate.

[4] Converted based on March 31, 1998 dollar-yen exchange rate.

Experts believe the injection of 1998 did not fully recapitalize the system; eight months after the first recapitalization scheme, the Diet passed a second recapitalization scheme.[5] The inability for the FCMC to = examine bank balance sheet information for those banks applying, in addition to the policy of regulatory forbearance, prevented a full recapitalization of the system. After the capital injection on March 31, 1998, two banks that had received injections under this scheme failed and were nationalized under new legislation passed in October 1998.

[5] For more information on the Prompt Recapitalization Act, please refer to the "Prompt Recapitalization Act" (2019) caservention.

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I. Overview

Background

Financial deregulation in Japan began in the early 1970s (Nakaso, 2001, page 3, Kanaya and Woo, 2000, pg 35). However, uneven deregulation of similar activities by different types of financial entity had created opportunities for regulatory arbitrage (Kanaya and Woo, 2000, pg 35).). Under the informal "convoy system," the Ministry of Finance and Bank of Japan relied on stronger banks to bail out weaker banks (Nakaso, 2001, pg 2, Kanaya and Woo, 2000, pg 21). The convoy system created an implicit assumption among market participants that the banking system was "fail-safe" as banks expected the Ministry of Finance to solutions to problems banks faced (Nakaso, 2001, pg 2). Banks supported the system because it facilitated mergers that allowed stronger banks to expand their branches, which had previously been a highly regulated activity (Nakaso 2001, 153).

In 1986, the Diet, the legislative body of Japan, revised the Deposit Insurance Act to create a formal safety net. The new law provided the Deposit Insurance Corporation of Japan (DICJ) two policy options to address a failed bank: 1) liquidating failed banks, with each depositor protected up to ¥10 million; 2) transferring the business of a failed bank to an assuming bank. At the time, officials believed the DICJ would draw upon the new fund only in the rare event of a small-bank failure. In its first year, the DICJ had an insurance fund of only ¥300 billion, which was far less than would be needed to rescue a failing large bank (Nakaso, 2001, 3). At the time, the size of deposits for the top 10 banks in the Japanese financial system was ¥264 trillion[6] (New York Times, 1987). This deposit insurance system's small size and inflexibility eventually made it inadequate for the coming financial crisis of the 1990s (Nakaso, 2001, 2).

When Japanese stock market and real estate prices collapsed in 1990-92, the initial systemic implications appeared limited. The few sporadic financial failures were of limited scope and systemic importance (Nakaso, 2001, 3). But over of the next decade, Japan would slip into a period of economic stagnation where real GDP growth fell below 1% for ten years, as seen in Figure 1 (Lipscy and Takinami, 2013, pg 328).

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[6] Conversion based on December 31, 1987 dollar-yen exchange rate. Source: Board of Governors of the Federal Reserve System (US), Japan / U.S. Foreign Exchange Rate [DEXJPUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DEXJPUS, November 15, 2019.

Figure 1. Japan Real GDP Growth, 1956-2012.

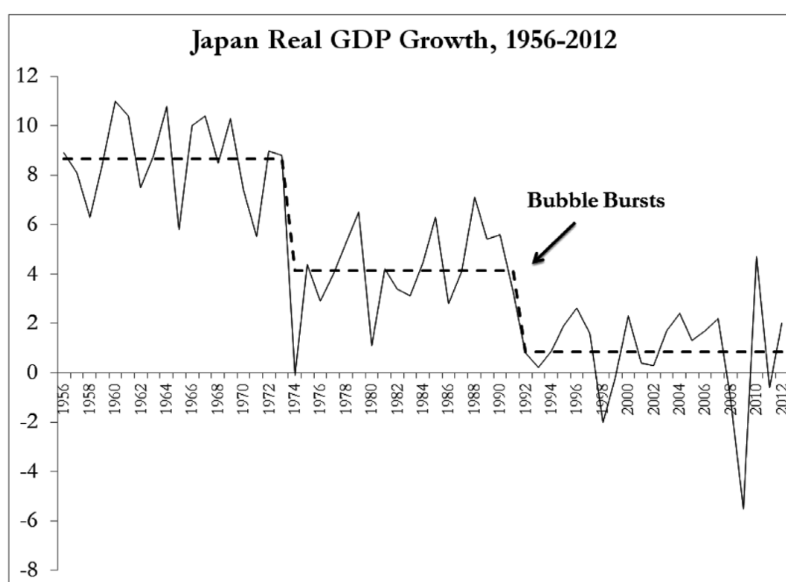


Figure 2. Japan Real GDP Growth, 1956–2012
Source: Japanese Cabinet Office SNA Statistics.

Officials were aware at this point that major banks like Nippon Credit Bank were transferring bad loans to paper companies to reduce their own balance sheet exposure, but allowed such behavior to continue as the existing infrastructure permitted funneling bad debt—a practice known as *tobashi* that was controversial amongst finance ministry officials (Amyx, 2004, pg 151, 325). By avoiding the liquidation of bad debt through this funneling behavior, banks never realized the bad debt at market price, leading to inflated asset values on bank balance sheets (Amyx, 2004, pg 151).

In October 1994, two months before the failures of Tokyo Kyowa and Anzen, two urban credit cooperatives, the Governor of the Bank of Japan, Yasushi Mieno, gave a speech remarking, "It is not the business of the central bank to save all financial institutions from failure. On the contrary, failure of an institution that has reasons to fail is even necessary from the viewpoint of nurturing a sound financial system" (Nakaso, 2001, pg 4). The Ministry of Finance also faced competing interests—given authority of both fiscal policy and financial regulation, the Ministry began to prioritize "budgets over banks," where the use of public funds contradicted the balanced budgetary principles in the short term (Amyx, 2004, 159-160).

At the time, capital requirements for domestic Japanese banks were weaker than international standards (Allen et al, 2009, pg 9). Japanese banks were encouraged to meet Basel I capital standards, but received no formal penalties for noncompliance, as these standards were seen more as a managerial guidance (Allen et al, 2009, pg 111).

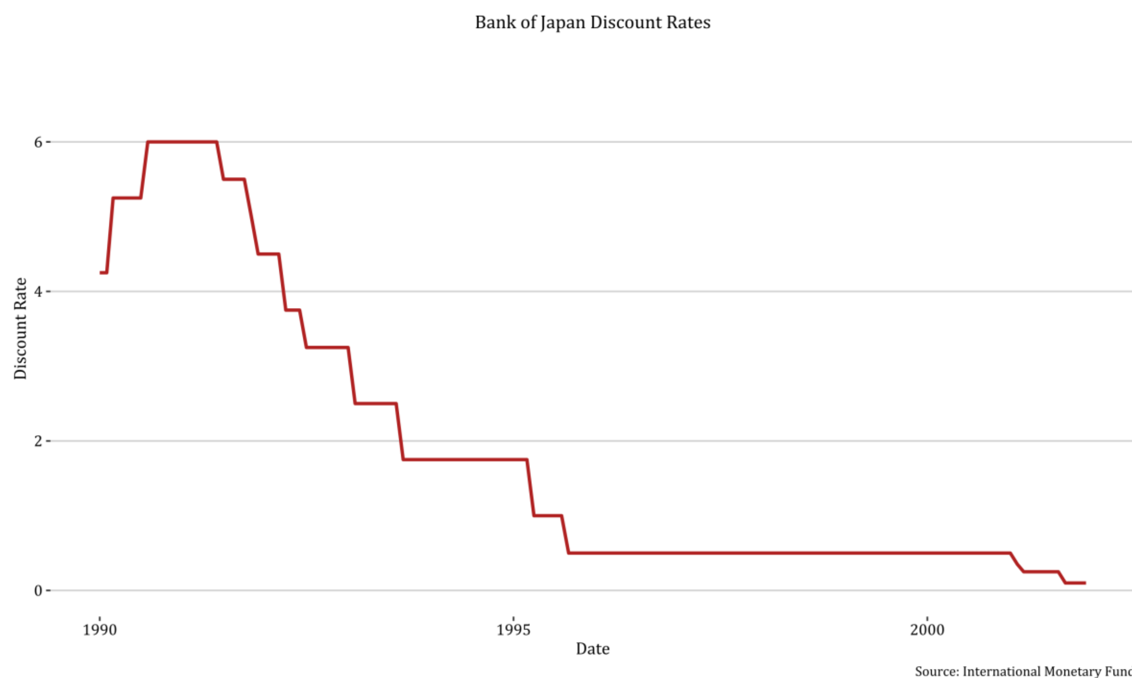
The failure of Tokyo Kyowa and Anzen in December 1994 tested the government's infrastructure for dealing with unsound financial institutions. No stronger financial institution was willing to take them over. Also, losses exceeded the amount that the DICJ was authorized to provide to protect insured depositors. On December 9, the BOJ

established a new bank to assume the businesses of the two institutions, wiping out existing shareholders, and removing the management of the two institutions. The new bank, Tokyo Kyoudou Bank (TKB), was capitalized with ¥40 billion, of which the BOJ subscribed ¥20 billion and private financial institutions subscribed ¥20 billion. Private financial institutions also extended low-interest loans to the new bank. Virtually all Japanese financial institutions participated, providing capital and loans. The DICJ provided funds to protect insured depositors. However, the Bank of Japan's role was controversial. Although the law allowed the central bank to provide risk capital to banks in its function as lender of last resort, it hadn't done so since the 1960s (Nakaso, 2001, pgs 4-5).

Private financial institutions were also increasingly reluctant to contribute to the convoy system, worrying about the impact on their own profitability and reputations (Nakaso, 2001, pg 5). Deregulation had also made it easier for banks to expand without facilitated mergers under the convoy system (Amyx, 2004, 153). In 1994, banks, for the first time, outright refused to participate in these rescues (Amyx, 2004, 153). In 1995, following another failure by a major bank, Moody's changed its ratings criteria so that it would not take into consideration the possibility of a government-organized rescue; in this new system, Japanese banks received an average rating of "D" (Amyx, 2004, 157).

At this point, there was little room for the BOJ to ease monetary policy due to already low discount rates. As the state of the economy deteriorated, the BOJ began reducing interest rates rapidly, dropping the overnight lending rate from 6% in 1990 to 1% by 1995, shown in Figure 2 below (Lipscy and Takinami, 2013, pgs 331-332). These low rates meant that from 1995 onwards, interest income for Japanese savers dropped by approximately ¥1 trillion yen per year (Amyx, 2004, 152). The central bank also was reluctant to lower rates further in fear of increasing inflation, even in the midst of a deflationary environment (Lipscy and Takinami, 2013, pg 332).

Figure 2. Interest Rates for Bank of Japan.



In this environment with little room for monetary policy stimulus, as well as limitations on deposit insurance, *jusen* trouble emerged, beginning in 1993 and reaching full scale by 1995 (Nakaso, 2001, 6). *Jusen* companies—non-bank lenders founded by banks and other financial institutions to make housing and real estate development loans—experienced massive losses of ¥6.4 trillion. After an intense debate in the Japanese Diet, the legislative body of Japan, the Diet passed the first publicly funded package to address the banking problem, allocating losses to founder banks, lender banks, agricultural financial institution, and public funding (Nakaso, 2001, 6). The usage of taxpayer funding to cover the losses of unviable, non-depository financial institutions met public outcry; an Asahi poll found 87% of the public opposed the *jusen* bailout (Nakaso, 2001, 6; Lipscy and Takinami, 2013, pg 337). As a result, the Minister of Finance promised the Diet that no further public-funded injections would occur except for the *jusen* injections (Lipscy and Takinami, 2013, pg 337).

Banks were also reluctant to take government funding through public injection. Not only would injections of public funding increase scrutiny of bank balance sheets, it would also call to question management practices and corporate salaries, and allow political intrusion into bank management decisions. In addition, issuance of new shares to the government would dilute the value of existing shares primarily held by other financial institutions and corporations (Amyx, 2004, 158).

By 1997, as the situation grew worse, with the collapse of four banks in succession, the BOJ acted as lender of last resort on an unprecedented scale (Nakaso, 2001, pg 8). In December 1997, the ruling Liberal Democratic Party (LDP) announced Japan's first recapitalization for banks in the post-war era (Japan Times, December 25, 1997).

Program Description

The Diet paired the intended recapitalization under the Financial Functions Stabilization Act with an amendment to the Deposit Insurance Act increasing depositor protection. The act allocated ¥17 trillion for depositor protection and ¥13 trillion for recapitalization for undercapitalized banks (Japan Times, February 17, 1998). The FFSA was a temporary measure intended to utilize public funding for capital injections to increase stability in the Japanese financial system (Nakaso, 2001, pg 11).

The day after the government announced the recapitalization program, the Nikkei average jumped 2.5% in a show of investor relief (Japan Times, December 26, 1997). However, some ratings agencies continued to downgrade major Japanese banks, with Standard and Poor's downgrades occurring on December 25, one day after the announcement by the LDP (Japan Times, December 26, 1997). Moody's kept ratings low, even after banks began applications for recapitalization in March 1998 (Japan Times, March 6, 1998).

After finalizing the banking bills, Prime Minister Ryutaro Hashimoto's Cabinet submitted the finalized version of two bills—one for increased depositor protection and one for recapitalization—to the Diet on January 19th, 1998 (Japan Times, January 20th, 1998). To encourage the passage of the bills, Prime Minister Hashimoto unconventionally visited the Diet to give a series of speeches on the necessity of the financial system stability measures (Japan Times, January 8th, 1998; Japan Times, January 13th, 1998; Japan Times, January 17th, 1998; Japan Times, January 21st, 1998). After passing the Lower House on February 7th, the bills passed the Upper House on February 16th and were formally enacted into law (Japan Times, February 8th, 1998; Japan Times, February 17th, 1998).

Before the recapitalization bill passed, the Japanese government worked to encourage banks to participate in the program, hoping that the vocal participation of stronger banks would encourage weaker rivals to participate as well (Japan Times, January 15, 1998). Several banks applied for the funding simultaneously on March 5, 1998 (Japan Times, March 6, 1998).

The Financial Crisis Management Committee (FCMC) oversaw the recapitalization. It consisted of seven members, including three from the private sector, the Minister of Finance, the Commissioner of the Financial Supervisory Agency (FSA), the President of the Bank of Japan, and the President of the DICJ (Law Text, Article 14). The Cabinet appointed members of the committee with consent from both houses of the Diet (Text of the Law, translated: Article 15). Dr. Yoko Sazanami, an academic at Keio University in Japan, chaired the committee (Madden and Dimand, 2018). The FCMC, part of the DICJ, was responsible for identifying banks in needs of capital injections and determining the amount and terms of such an injection (Madden and Dimand, 2018; Nakaso, 2001, pg 11-12). The Cabinet was responsible for terminating the operation of the FCMC (Text of the Law, translated: Article 26).

The DICJ was responsible for the asset management operations of the capital injections specified by the FCMC (Text of the Law, translated: Article 3-(I-IV)). The DICJ purchased preferred shares or subordinated bonds from the financial institutions that applied for capital under the recapitalization scheme (DICJ Website; Text of the Law, translated: Article 3-(2:III)). The Crisis Management Account, an account set up for purchases under the FFSA, held the DICJ purchases (DICJ Website).

No banks were ineligible under the FFSA; while there was some debate about making the injections compulsory for certain banks, the idea was ultimately abandoned (Law Text: Article 2; Nakaso, 2001, pg 12 (footnoted)). Three non-bank financial institutions, all cooperatives, were also eligible, referred to by name in the law: Norinchukin Bank; the Agricultural Cooperative Association; and the Federation of Fisheries Cooperative Associations (Law Text, Article 2 (I-IV)).

Banks requesting funding applied through the Chairman of the Financial Supervisory Agency (FSA), Japan's bank regulator, who then applied on their behalf. The FCMC itself did not have supervisory power and could not look at any detailed balance sheet or supervisory information on the applicant banks (Law Text, Article 20; Nakaso, 2001, pg 12). These banks would be required to submit management improvement plans through the FSA. In the plans, the banks would describe how they would improve management and operations, and secure assets[7] (Law Text, Article 24). After the FCMC approved an application, it would go to the Prime Minister's Cabinet for approval, by either the Prime Minister or the Minister of Finance (Law Text, Article 5-2). Once approved, the DICJ would purchase preferred shares, subordinated debt, or subordinated loans (Law Text, Article 4-4).

Outcomes

In March 1998, 21 institutions applied for capital injections. Figure 3 below shows a table of the applications for capital made public.

[7] Author translation.

Figure 3. Applications for capital under the FFSA.

Applications for Capital

	Amount (¥ billion)	Form of Capital	Estimated Capital Ratio Increase (%)	Projected FY1997 Year-End Adequacy Ratio (without injection)
Bank of Tokyo-Mistubishi	100	SB	0.1	8.6
Sumitomo Bank	100	SB	0.2	8.9
Sanwa Bank	100	SB	0.2	8.5
Dai-Ichi Kangyo Bank	99	PS	0.3	8.3
Fuji Bank	100	SB	—	8.6
Sakura Bank	100	SB	0.1	8.4
Tokai Bank	100	SL	0.4	8.9
Asahi Bank	100	SL	0.4	8.4
Daiwa Bank	100	SL	0.8	8.2
Industrial Bank of Japan	100	SB	0.3	9
Long-Term Credit Bank of Japan	200	PS SL	1.3	8.8
Nippon Credit Bank	290	SL PS	1	7
Mitsubishi Trust and Banking Corp	—	—	—	
Sumitomo Trust and Banking Co.	100	SB	0.8	9-plus
Mitsui Trust and Banking Co.	100	SB	1	9.5
Yasuda Trust and Banking Co.	150	SB	1.2	10.8
Toyo Trust and Banking Co.	50	SB	0.7	10
Chuo Trust and Banking Co.	60	PS SL	2	9.4
Bank of Yokohama	20	SL		
Hokuriku Bank	—	SL	—	
Ashikaga Bank	—	—	—	8.1

Note: the capital adequacy ratio projections are projected from Sept 1997. SB is short for subordinated bonds, SL for subordinated loans, and PS for preferred shares. The mark '—' means that the banks did not disclose data.
Source: Japan Times, March 6, 1998. "21 banks apply to receive public funds."

The total application size amounted to close to ¥2 trillion. Within a week, the FCMC approved all 21 banks for the capital injections. However, two banks that had applied for subordinated debt and loans received less than requested, as the FCMC believed the use of such lower-quality capital would not sufficiently boost their capital adequacy ratios (Japan Times, March 13, 1998). In March 1998, ¥1.8 trillion was injected into 21 banks, averaging 1.9% of risk-weighted assets (DICJ Website; Giannetti and Simonov, 2013, pg 139). Every bank eventually repurchased the shares and subordinated debts sold to the DICJ under this program, as shown in Figures 4 and 5 below.

Figure 4. Timeline of subordinated debt and loan repurchasing.

Bank	Final Repurchase Date
Fuji Bank	March 2004
Industrial Bank of Japan	March 2004
Yasuda Trust & Banking	September 2004
Sakura Bank	March 2003
Sumitomo Bank	March 2003
Bank of Tokyo-Mitsubishi	February 2000
Mitsubishi Trust & Banking	December 2000
Sanwa Bank	March 2003
Tokai Bank	March 2003
Toyo Trust & Banking	March 2003
Asahi Bank	October 2005
Daiwa Bank	September 2005
Sumitomo Trust & Banking	March 2003
Mitsui Trust & Banking	March 2005
Chuo Trust & Banking	March 2003
Bank of Yokohama	May 2003
Hokuriku Bank	March 2006
Ashikaga Bank	March 2004
Long-Term Credit Bank of Japan	March 2003

Source: DICJ Website.

Figure 5. Timeline of preferred share repurchasing.

Bank	Final Repurchase Date
Dai-Ichi Kangyo Bank	August 2004
Chuo Trust and Banking	July 2006
Long-Term Credit Bank of Japan	November 2017
Nippon Credit Bank	June 2015

Source: DICJ Website.

The Japanese Diet passed a second, much larger recapitalization scheme, the Prompt Recapitalization Act, within a year of the FFSA injections. The new scheme made available an additional ¥25 trillion for capital injections into sound banks with liquidity needs. Under this scheme, the Japanese government ultimately allocated ¥8.6 trillion total (Unnava, 2018).

Key Design Decisions

1. **The Diet passed the Financial Functions Stabilization Act as part of a suite of financial stabilization bills that also included an amendment to the Deposit Insurance Act.**

In December 1997, the ruling Liberal Democratic Party announced the first Japanese recapitalization for banks in the post-war era (Japan Times, December 25, 1997). In a separate bill, the Diet amend the Deposit Insurance Act (Japan Times, February 8th, 1998; Japan Times, February 17th, 1998). Through the new bills, a total of ¥30 trillion of public funds was made available: ¥17 trillion for the DICJ to cover the losses of failed financial institutions (up from an original ¥300 billion); ¥13 trillion for capital injections into banks (Nakaso, 2001, pgs 3, 11).

Prime Minister Hashimoto also announced a ¥2 trillion income tax reduction, aimed at jump-starting the economy, on December 17th, 1997 (Japan Times, December 18th 1997). The tax cut was funded through government-issued bonds and was submitted to the Diet as a supplement to the fiscal year 1997 budget (Japan Times, January 8th, 1998). On February 4th, 1998, the Diet passed a supplementary budget that provided financing for the ¥2 trillion personal income tax cut (Japan Times, February 5th, 1998).

The legislation was the first in a series of capital injections from 1998-2008, with a second capital injection in March 1998 and a third injection legislation in June 2004 (Hoshi and Kashyap, 2010, 409).[8]

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[8] For more information on the Prompt Recapitalization Act, please refer to the "Prompt Recapitalization Act" (2019) caservention. For more information on the Act of Strengthening Financial Functions, please refer to

2. **The Japanese Diet thoroughly debated the Financial Functions Stabilization Act, which provided a legal basis for the capital injection, and announced it publicly; Prime Minister Hashimoto made a series of rare floor speeches during this time.**

In December 1997, the ruling Liberal Democratic Party announced the first Japanese recapitalization for banks in the post-war era (Japan Times, December 25, 1997). The day after the announcement of the recapitalization, the Nikkei average jumped 2.5% in a show of investor relief (Japan Times, December 26, 1997). However, some ratings agencies continued downgrading major Japanese banks, with Standard and Poor's downgrades occurring on December 25th, one day after the announcement by the LDP (Japan Times, December 26th, 1997). Moody's kept ratings low, even after banks began applications for recapitalization in March 1998 (Japan Times, March 6th, 1998).

The Financial Functions Stabilization Act established the intended recapitalization. The FFSA was a temporary measure intended to utilize public funding for capital injections to increase stability in the Japanese financial system (Nakaso, 2001, pg 11). The act allocated ¥13 trillion ($103 billion) for the recapitalization of undercapitalized banks (Japan Times, February 17th, 1998).

After finalizing the banking bills, Prime Minister Ryutaro Hashimoto's Cabinet submitted the finalized version of two bills—one for increased depositor protection and one for recapitalization—to the Diet on January 19th, 1998 (Japan Times, January 20th, 1998). To encourage the passage of the bills, Prime Minister Hashimoto unconventionally visited the Diet to give a series of speeches on the necessity of the financial system stability measures (Japan Times, January 8th, 1998; Japan Times, January 13th, 1998; Japan Times, January 17th, 1998; Japan Times, January 21st, 1998).

Additionally, prior to the passage of the bill, the Japanese government worked to encourage banks to participate in the program, praising banks choosing to participate in the program in the hope that the vocal participation of stronger banks would encourage weaker rivals to participate as well (Japan Times, January 15th, 1998).

After passing the Lower House on February 7th, the bills passed the Upper House on February 16th and were formally enacted into law (Japan Times, February 8th, 1998; Japan Times, February 17th, 1998).

3. **The Deposit Insurance Corporation of Japan (DICJ) funded the capital injections and the Financial Crisis Management Committee, a committee of the DICJ, oversaw them.**

To apply for funding, banks would submit plans to the Financial Supervisory Agency (FSA), who would then apply to the FCMC on their behalf (Law Text: Article 20).

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the "Act on Strengthening Financial Functions" (2019) and "Amendment of the Act on Strengthening Financial Functions" (2019) caserventions.

The FCMC served as an in-house committee of the DICJ (Japan Times, February 24, 1998). As the Prime Minister's office hoped to have injections done before April 1, 1998, the beginning of the new fiscal year, the FCMC was on a strict timeline (Japan Times, February 7, 1998). The FCMC consisted of seven members, with three members from the private sector, the Minister of Finance, the Commissioner of the Financial Supervisory Agency, the President of the Bank of Japan, and the President of the DICJ (Law Text, Article 14). Yoko Sazanami, an academic at Keio University, chaired the Committee, though domestic finance was outside of Sazanami's research focus as an international economist (Madden and Dimand, 2018). The Cabinet appointed members of the committee were appointed with consent from both houses of the Diet (Text of the Law, translated: Article 15). The Cabinet was responsible for terminating the operation of the FCMC (Text of the Law, translated: Article 26).

The FCMC met six times between February 16th and March 31st (Takatoshi et all, 2001, pg 61). The committee decided votes through simple majority, with the Chairperson acting as the tie-breaking vote (Law Text: Article 19-2). After the decision passed through the committee, it was sent to Cabinet for full approval (Law Text: Article 5-3). In the case of credit cooperatives, also eligible for capital injection under the Financial Functions Stabilization Act, the law required the prefectural governor also be consulted (Law Text, 5-4). In the case of the Federation of Agricultural and Fisheries Cooperative Associations, the Minister of Agriculture, Forestry, and Fisheries was consulted (Law Text, 5-5).

The Resolution and Collection Bank (RCB), the asset management corporation tasked with holding the preferred shares and subordinated loans and debts of the banks applying for capital injection, was formed from the reorganization of the Tokyo Kyoudou Bank in June 1996 (Nakaso, 2001, pg 7). At its formation, the RCB had a broader role as an assuming bank for failed credit cooperatives, when there were no assuming bank in the private sector. In addition, the RCB could purchase non-performing loans from failed financial institutions, increasing the incentives for solvent institutions to assume the failed institution (Nakaso, 2001, pg 7). After restructuring, the RCB became a 75% subsidiary of the DICJ, receiving ¥120 billion in capital from the DICJ, ¥20 billion from the Tokyo Kyoudou Bank, and ¥20 billion from the Bank of Japan (DICJ 2001 Annual Report, pg iii; Nakaso 2001, pg 4).

The DICJ acts independently of the Bank of Japan or the Treasury, though in close cooperation (FSB 2016, pgs 13, 24). The issuance of government-backed DICJ bonds, as well as annual budgetary appropriations, funds the DICJ's financial assistance (FSB, 2016, pg 8-9). In rare instances, the DICJ may borrow money directly from the Bank of Japan (FSB 2016, pg 24). Funding for the FFSA came from ¥3 trillion of special government bonds that the DICJ could cash on request, and ¥10 trillion in government-guaranteed credit lines (Nakaso 2001, pg 11).

Through the RCB, the DICJ purchased the preferred shares and subordinated debts of banks out of the crisis management account (Hoshi and Kashyap, 2010, pg 406; DICJ Website).

4. Participation was voluntary and open to any domestic or foreign bank, as well as specified nonbank financial institutions.

Any domestic or foreign bank was eligible for a capital injection, though no foreign banks participated in the injection (Law Text, Article 2; DICJ Website). Credit cooperatives as well as Shinkin banks, a type of cooperative regional credit union, were also eligible (DICJ Annual Report, 1997). In addition to the financial institutions eligible for capital injection, a set of non-bank financial institutions, all cooperatives, were also eligible: Norinchukin Bank, Agricultural Cooperative Association, and the Federation of Fisheries Cooperative Associations (Law Text, Article 2). The law did not require the participation of any banks, though there was some debate regarding forced injections during the summer of 1998 during discussions to amend the capital injection framework. However, this idea was ultimately abandoned (Nakaso, 2001, pg 12 [footnote]).

There were some standards for screening for banks determining whether the banks needed capitalization: banks could not be losing money for three years prior to application, the banks applying were important to the financial and credit system, and banks were unlikely to fail. Details are shown in Figure 6 below.

Figure 6. Screening standards for applicant banks.

Screening Standards			
(In the case of a receiving financial institution such as a merger)			
Standard 1	The applicant financial institution is in a situation where its capital adequacy has deteriorated due to merger, etc. Specifically, it is assumed that the capital adequacy ratio is recognized to have declined before and after the merger.		
Standard 2	If the capital adequacy situation is not improved, there is a risk that maintenance of the credit order and stability of the regional economy may be seriously affected.		
Standard 3	Must not exceed the scope necessary for the smooth implementation of resolution. The larger of the following shall be the limit for underwriting of preferred stock, etc.		
	(1)	Amount required to recover to the level of capital adequacy before the merger	
	(2)	Amount necessary to secure 8% (4% in the case of domestic standards) of risk assets of bankrupt financial institutions that have been added up due to mergers, etc.	
(For general financial institutions)			
Standard 1	The management status of the applying financial institution has not deteriorated significantly. Not applicable to any of the following.		

	(1) For the last three consecutive years, recurring profit or net profit has been in the red or no dividends.
	(2) Be the third category as the trigger for early corrective action. Or, the capital adequacy ratio, which is the second category and does not assume underwriting of preferred stock, etc., is expected to remain in that category even after one year.
Standard 2	If the capital adequacy situation is not improved, it may cause one of the following situations.
	(1) There is a risk that the financial function in Japan may be significantly impaired.
	(2) There may be a significant obstacle to economic activities such as corporate activities and employment situation in the region and field.
	Note In making this decision, it is important to address promptly without overlooking the slightest signs of financial system anxiety.
Standard 3	The purpose is not to rebuild the management of the applying financial institution, but to maintain the credit order.
Standard 4	The applicant's financial institution is not considered to have a high probability of failing even after it has subscribed for preferred shares.
Standard 5	Disposal of preferred stock, etc. is not recognized as being extremely difficult after a considerable period of time.
	In making this decision, take into account the financial status and profit level of the applicant financial institution, the prospect of improvement in the asset content and capital ratio, the merchandise of the preferred shares to be underwritten, the current market situation, and other factors.

Source: Archived DICJ Report, 1997:
https://web.archive.org/web/20010628232956/http:/www.dic.go.jp/annual/h09/4-12.html.
Author's translation.

In addition to providing information in an application to determine whether banks met the screening criteria, banks also were required to submit management soundness plans, where they described plans to improve management structure, secure assets owned, and improve operations. These plans would be made public unless they could create uncertainty in the public about the bank's performance (DICJ Annual Report, 1997). Under this, three banks that received public funds—the Long Term Credit Bank, Chuo Trust, and Nippon Credit Bank—publicly announced their intention to trim staff, promising to cut 2,900 employees over the following three years (Japan Times, March 14, 1998).

5. The underwriting terms of capital injections were dependent on capitalization status as reported by banks.

The FCMC was responsible for determining underwriting terms for preferred shares and subordinated debt issued through the recapitalization scheme (Nakaso, 2001, pg 12; Law

Text, Article 23). The FCMC determined the terms of the capital injections on a case-by-case basis. Banks received differing yield rates on subordinated bonds ranging from LIBOR + 0.55 percent to as high as LIBOR + 2.95 percent. After 5 years, the rates on subordinated bonds were raised by 1.50 percent. Banks selling preferred shares had differing conversion dates(DICJ Website). The preferred shares purchased were converted to common shares after a grace period; Kanaya notes when examining a similar policy utilized in the March 1999 capital injection that the conversion of common shares gave the government the opportunity to act as an activist shareholder, forcing restructuring if dissatisfied with the bank's progress (DICJ Website; Kanaya and Woo, 2000, pg 32). While banks had the ability to acquire shares with approval by the DICJ, in practice, the small windows before conversion (at most seven months after the injection) lead to all preferred shares in the injection converted to common shares (Law Text, Article 4-(5), DICJ Website).

Unlike the later recapitalization legislation, the Prompt Recapitalization Act, the law did not give the FCMC supervisory power as it was housed in the DICJ, a non-supervisory institution (Nakaso, 2001, pg 12). The FFSA instead required banks to self-report balance sheet information checked by independent auditors to the Financial Supervisory Agency (FSA, 2000: 1-(1)). Banks applying for capital injections under the FFSA also were required to submit self-assessments on the quality of assets on their balance sheets to the Financial Supervisory Agency (FSA, 2000, 2-(1)). Certified public accountants audited these self-assessments as well (FSA, 2000, 2-(1)).

These assets were partitioned into four categories:

- Category I assets were assets not considered needing risk management in any form and were collectable;
- Category II assets were credit exposures for which banks judged that adequate risk management on an exposure-by-exposure basis would be needed;
- Category III assets were those about which banks had serious concerns in terms of their collection and were likely to incur losses, but banks were unable to determine the timing or size of the losses;
- Finally, category IV losses were exposures that banks were unable to collect or valueless (FSA, 2000, 2-(2)).

Under this assessment structure, banks estimated the size of their categories II, III, and IV assets to be ¥65.3 trillion, ¥8.7 trillion, and ¥2.7 trillion respectively as of January 1998 (FSA, 2000, 2-(2)). The self-assessment results under the FFSA are shown in Figure 7 below.

Figure 7. Results of self-assessment of asset quality for Japanese Banks applying for recapitalization under the Financial Function Stabilization Act.

Self-Assessment Result of Asset Quality				
	Total Credit Exposure			
		Category I	Category II	Category III

Total of All Banks	648,506	576,548	65,763	6,073
Major Banks	452,374	402,018	45,418	4,816
Regional Banks	196,132	174,530	20,345	1,257
Cooperative Type Financial Institutions	146,617	130,923	14,846	845
Shinkin Banks	74,563	64,411	9,753	397
Credit Cooperatives	15,342	12,801	2,223	318
Agricultural Cooperatives	29,961	28,626	1,304	31
Total	795,123	707,471	80,609	6,918

Note: Due to write-off and provisions, banks whose closing account month is March do not have Category IV assets. However, as for banks that have trust accounts, the closing time of trust account is different from that of the banking account, therefore there is non-disposal of Category IV assets (118 billion yen), and total credit exposure includes the amount of Category IV.

Source: Financial Supervisory Agency, 2000. In billions of yen.

Institutions submitted these audits to the Financial Supervisory Agency, which was responsible for submitting the application to the FCMC (FSA, 2000; Law Text, Article 20).

6. There were no limits on shareholder compensation or management compensation.

Unlike its successor, the Prompt Recapitalization Act, the FFSA did not place any moratorium on management compensation or dividends under the law. However, there was a requirement to pay some portion of the dividends to the DICJ, based on cabinet ordinance.

Average pay for executives of these banks varied by each bank. Some banks, such as the Tokai Bank, did not show a reduction in average pay but posited that the costs would decrease as the makeup of executive boards changed. Other banks such as the Bank of Tokyo-Mitsubishi showed cost cutting through maintaining average pay and decreasing the number of executives. Most of the 21 banks planned to pay their executives ¥20 million or more a year, and stated so as part of their public restructuring plans (Japan Times, March 18, 1998).

7. There was no explicit exit strategy outlined or mandated for banks participating in the capital injection.

All banks receiving a capital injection in the form of subordinated loans or debt had step-up clauses on the debt or loans injected. The step-up clauses, increasing the yield of the bonds and debts, would come into effect six years after the injection. Each yield rate and change in rates varied by bank. In addition, a majority of the subordinated loans and debts purchased were perpetual, never expiring (DICJ Website).

Banks receiving preferred shares faced mandatory conversion dates on the issued preferred shares. These mandatory conversion dates were set to take place within eight months of the capital injection (DICJ Website).

All banks receiving capital injections repurchased their shares, loans, and debt, within ten years, with the exception of Nippon Credit Bank and the Long-Term Credit Bank of Japan, which repurchased their debts in June 2015 and November 2017, respectively (DICJ Website). In the summer of 1998, the Long-Term Credit Bank of Japan failed, leading to the Financial Reconstruction Law, under which the Japanese government nationalized the bank (Nakaso, 2001, pg 12-13). The Nippon Credit Bank followed in December 1998, and was nationalized under the same legislation (Nakaso, 2001, pgs 13-14).

Evaluation

Many experts write that the capital injection of March 1998 was too small for the size of non-performing loans in the financial system. Within twelve months of this capital injection, two banks receiving capital, the Long-Term Credit Bank of Japan and the Nippon Credit Bank, failed and were subsequently nationalized (Allen et al, 2009, pg 10). Months after, , the Diet passed a much larger capital injection scheme, the Prompt Recapitalization Act, allocating more funding and injecting more than quadruple the amount injected under the Financial Functions Stabilization Act (Unnava, 2019). Montgomery and Shimizutani find that this second injection was more effective than the first round, as the first round primarily helped Japanese banks clear the 8% BIS capitalization ratio, but did not increasing lending, encourage restructuring, or increase write-offs of non-performing loans (Montgomery and Shimizutani, 2009, pg 19).

This was compounded by the capital requirements for domestic Japanese banks, which were weaker than international standards, at 4% necessary capitalization rather than the Basel Committee's 8% capitalization ratio as part of Basel I standards (Allen et al, 2009, pg 9). In addition to weaker capital standards, the authorities also weakened accounting standards to allow banks to avoid marking down the depressed value of real estate and stocks. The allowed up to 45% of unrealized gains on securities to be counted as Tier II capital for banks with international operations (Kanaya and Woo, 2000, pg 30). They also changed regulations to allow banks the option of not applying the lower of cost or market accounting for equities held for investment purposes (Kanaya and Woo, 2000, pg 30). These accounting measures were not treated as formal requirements until after the FFSA capital injections had already been performed, and the authorities did not require mark-to-market accounting even after the recapitalization scheme was enacted (Allen et al, 2009, pg 11).

The policy of regulatory forbearance also affected the speed and size of the Japanese response to the non-performing loan problem. Japan was facing the "first instance of a 'return to depression economics' by an advanced developed economy in the post-World War II period" (Lipscy and Takinami, 2013, pg 329, 336). The Liberal Democratic Party was increasingly vulnerable electorally during this time, providing opponents opportunity to criticize regulatory breakdown if the LDP acknowledged issues in the financial system

through publicly funded capital injections (Amyx, 2004, 159). Japanese policymakers faced a skeptical public, reducing the ease with which correctional legislation could be passed; in particular, the lack of convincing precedent for recapitalizations made it difficult for Japanese political leaders to convince the public of its efficacy (Lipscy and Takinami, 2013, pg 347; Lipscy and Takinami, 2013, pg 323-324). Effective legislation also required trial and error (Lipscy and Takinami, 2013, pg 347).

The difficulty in experimentation, combined with the belief that the situation would eventually right itself, contributed to regulatory forbearance, such as relaxed accounting standards, to conceal issues on balance sheets rather than address them (Lipscy and Takinami, 2013, pg 341). This experimentation and reluctance to immediately address the situation lead to the extended timeline for the financial crisis response in comparison to the United States during the Great Recession (Lipscy and Takinami, 2013, pg 334-336).

Japanese policymakers also encouraged or assisted the behavior of overstating stability in the Japanese market. Under the belief that the market would eventually right itself, the Ministry of Finance reported overly optimistic growth projections (Amyx, 2004, 152). From 1991-1998, the EPA over-projected growth rates (Amyx, 2004, 152).

The limited supervisory capacity of the FCMC also affected the efficacy of injections under the recapitalization scheme. Allen et al show the capital injection of 1999 succeeded in comparison to the injections of 1998 due to the risk-based liability evaluations for capital injections in the Prompt Recapitalization Act, where regulators had access to bank balance sheets, in comparison to the Financial Function Stabilization Act, where the commission overseeing injections were unable to look at bank balance sheets (Allen, Chakraborty, and Watanabe, 2009, pg. 29, Nakaso, 2001, pg 12). Without information allowing regulators to discern between individual bank's risk exposures, regulators could not determine whether certain bank applications required more capital than requested.

This allowed banks to apply for similar capital injection amounts, regardless of their balance sheet needs. Banks' fear of being singled out as a weak bank lead to several banks applying for far less capital than they needed, with most banks matching the amount applied for by the healthiest bank (Hoshi and Kashyap, 2010, pg 406-409). In applying for capital, banks banded together and applied independently and simultaneously, setting their capital application amount to the same amount as the healthiest bank in the system in an attempt to hide which bank was truly the weakest bank (Hoshi and Kashyap, 2010, pg 406-409). This, paired with the self-assessment and reporting on non-performing loans on balance sheets and inability for the FCMC to examine bank balance sheets through supervisory capacities, prevented the capitalization of banks at the amount needed by the Japanese financial system.

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Summary of Program

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- "金融機能の安定化のための緊急措置に関する法律." – *Original text of legislation passed.*
- "平成9年度預金保険機構年報" – *A set of screening standards for Japanese banks applying for capital injection.*

Press Releases/Announcements

Media Stories

- Surprise tax cut unveiled: ¥2 trillion reduction in income, resident levies (December 18, 1997)
- LDP calls for further DIC guarantees (December 25, 1997)
- Nikkei rises above 15,000 (December 26, 1997)
- Worst of financial crisis is over, Mitsuzuka says (December 27, 1997)
- Parties unite over policy: New alliance calls for tax cuts worth ¥6 trillion (January 8, 1998)
- Bill earmarks ¥10 trillion: funds would be used to purchase ailing banks' shares (January 9, 1998)
- Hashimoto vows efforts to protect financial system (January 13, 1998)
- Banks praised for accepting public funds (January 15, 1998)
- LDP approves capital injection for Norinchukin, farm banks (January 16, 1998)
- Hashimoto restates need for stability (January 17, 1998)
- Cabinet sends banking bills to Diet (January 20, 1998)
- 'Convoy system' ruled out: Hashimoto pushes plan to aid banks (January 21, 1998)
- Diet approves ¥1.14 trillion extra budget (February 5, 1998)
- Lower House passes two key bank bills (February 7, 1998)
- Bank crisis bills to pass Diet Monday (February 13, 1998)
- Moody's unmoved by bailout plan: Ratings agency predicts debilitated banking system for next century (February 14, 1998)
- Diet OKs bills allowing public aid for banks (February 17, 1998)
- DIC members prioritize financial system stability (February 24, 1998)
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- "The Japanese Banking Crisis of the 1990's: Sources and Lessons" (Kanaya, and Woo, 2000) – *An overview of the regulatory policies of the Japanese government during the early parts of the financial crisis.*
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- "Japan's Financial Crisis: Institutional Rigidity and Reluctant Change" (Amyx, 2006) – *A book on the differing political incentives and structures contributing to the regulatory forbearance policies of Japan in the 1990s*.
- "The Effectiveness of Bank Recapitalization Policies in Japan." (Montgomery and Shimizutani, 2009) – *A summary of the differing goals of recapitalization and the efficacy of the 1997 and 1998 recapitalizations under these goals*.
- "The Politics of Financial Crisis Response in Japan and the United States." (Lipscy and Takinami 2013) – *An assessment of first-mover disadvantage as a factor in regulatory forbearance policy in Japan.*
- "Will the U.S. Bank Recapitalization Succeed? Eight Lessons from Japan." (Hoshi and Kayshap, 2010) – *A summary of the series of capital injections in Japan and the efficacy of each, as well as lessons learned*.

Interview Guide

Prospective Interviewee: Dr. Yoko Sazanami, Hiroshi Nakaso

1. Given your limited supervisory powers, how did the FCMC determine the underwriting terms for injection on a case-by-case basis?
2. Why did you ultimately decide, in the summer of 1998, to not mandate participation in the capital injection scheme?
3. Under the Act, the Cabinet Ordinance determined the portion of dividends taken from banks after purchasing shares. How was the portion of dividends calculated and decided? Was this process made public?
4. Was there ongoing disagreement over the size of the injections—did anyone at the time believe they were too small? What were the arguments for and against increasing size, if there were any?