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## *Delicate Maneuvering Needed in Recovering Public Funds from Banks*

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The share prices of Japanese banks have been on decline in the aftermath the sub-prime loan debacle in the U.S. The decline has eroded the unrealized gains on the shares held by the Japanese government, which it had earlier acquired as a means to infuse capital into troubled banks. As of the end of September 2007, such gains totaled 1,003.9 billion yen, or 53% less than those six months before. Many bank preferred shares are now underwater, threatening the timely repayment of capital to the government. At the same time, loss mitigation efforts may lead to further reorganization of Japanese regional banks.

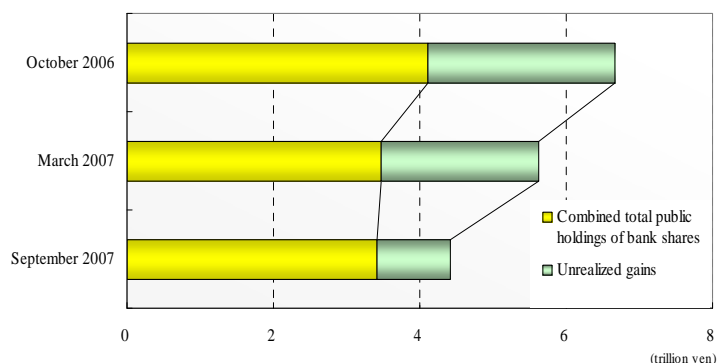
### *Unplanned acquisition of common shares*

On August 1, The Resolution and Collection Corporation (“RCC”) topped the shareholder list of Shinsei Bank with a 12.68% ownership, by far the largest stake by a shareholder. This was a result of mandatory exchange of all Series 3 Class-B Preferred Shares (“Preferred Shares”) into the bank’s common shares. The Preferred Shares were issued to bring in public funds into the bank and had been owned entirely by RCC. The transaction, however, caused the losses of 32.6 billion yen to surface.

Typically, the price at which bank preferred shares are exchangeable into common is reset yearly based on the current stock price levels, and thus unrealized losses, once incurred, may often be cleared. The exchange price, however, has a predetermined floor and, if the share price goes below it, the losses will remain.

In the case of Shinsei Bank’s Preferred Shares, the actual exchange price was set equal to the floor price of 600 yen per common and, by dividing the price into the

**Figure: Combined Total Public Holdings of Bank Shares and Unrealized Gains**



Note: The holdings figures reflect the combined total holdings of preferred and common shares by the government. Unrealized gains on preferred shares which are not yet exchangeable into common are set to be zero.

Source: Deposit Insurance Corporation of Japan and financial reports filed by relevant banks. The figures are compiled by the author.

outstanding amount of the Preferred Shares of 120 billion yen, 200 million shares of common stock were issued to RCC. Valued at the price of 429 yen per share on August 1, those common shares were worth only 85.8 billion yen, leaving the gap between the market value and the principal as unrealized losses.

In 2006, Shinsei Bank acquired part of the Preferred Shares in question from RCC immediately before raising the exchange price, bringing 30.6 billion yen of capital gains to the government. Much of the losses from the recent exchange may seem to be offset by these earlier gains but the unrealized losses have widened since the exchange as the common stock price fell further to 362 yen by the end of September.

As a condition for the injection of public funds, The Financial Services Agency (FSA) required recipient banks to submit a 'Management Improvement Plan' ('MIP') and, in the event the actual results shall substantially fall short of the plan, FSA has authority to impose administrative sanctions. In fact, the agency issued a 'Business Improvement Order' to Shinsei Bank in June 2007. It could well be the intention of the authorities to leverage on their strong supervisory power over management to turn around the business and have bank shares stage rally, which should lead to the successful recovery of public funds before preferred shares face mandatory exchange. If that was the case, it may be said that the government is now unexpectedly stuck with common shares with unrealized losses.

Shinsei Bank has already announced its intention to acquire Series 2 Class-A Preferred Shares originally issued by the Long-Term Credit Bank of Japan prior to their mandatory exchange into common in April 2008. The floor for these preferred is fairly low at 360 yen and there seem to be no obstacles to the planned repurchase.

The issue that remains relates to common shares. Given the lower dividend yield of common stock at 0.55% in comparison with that of the Preferred at 1.24%, it is hardly justifiable to continue to hold the common shares. In case losses are realized, however, the government may be criticized because of its failure to dispose of the investment at profit. This is especially true given that there has been no precedence of impairment of public funds infused into banks, except in the case of bankruptcy.

In the case of Aozora Bank, its two preferred issues sustained slight combined unrealized losses at the end of September. Specifically, the floor price for Series 5 preferred stock was high at 450 yen, leading to 24.5 billion yen of unrealized losses, while Series 4 preferred stock issued by Nippon Credit Bank, its predecessor, still enjoyed 21.5 billion yen of profits. The bank is expected to acquire the two series from the government with attentions to the common stock price so that the profits and losses may offset each other.

Five series of preferred shares of Risona Holdings recorded unrealized losses when valued based on their respective exchange prices as at September-end 2007. Out of the five series, however, only two had the price of common stock finishing below their floor price. Moreover, the government enjoys sizable gains on its holdings of the Risona's common stock which it acquired in 2003 for the purpose of infusing capital in the bank and the losses may easily be covered by those gains. The public holdings in shares of Mitsui Trust Holdings (name changed to Chuo Mitsui Trust Holdings) recorded total unrealized gains of approximately 360 billion yen.

### *Loss mitigation as a potential catalyst for regional bank reorganization*

Six regional banks have total of seven outstanding preferred issues exchangeable into common and all of them recorded unrealized losses at the end of September. Three issues of as many banks had the common stock price closing below their floor. There are possibilities that unrealized losses will not be cleared even if the exchange prices of these preferred issues are lowered to their respective floor prices. In such event, additional measures might become necessary.

Historically, many regional bank reorganizations have been triggered by public fund repayment and related events. In 2006, the government sold its preferred stake in Yachiyo Bank to Sumitomo Trust and Banking and the two entities entered into business and capital alliance. Momiji Holdings merged with Yamaguchi Bank after receiving administrative sanctions due to its likely failure to achieve targets required by MIP.

In August 2007, Kyushu-Shinwa Holdings sold its banking arm, Shinwa Bank, to Fukuoka Financial Group for 76 billion yen and decided to liquidate itself. Kyushu-Shinwa will repay 30 billion yen and 23 billion yen in preferred capital to the government and other private preferred shareholders, respectively, before distribution amounts to the common shareholders are determined.

Kyushu-Shinwa's preferred shares owned by the government became exchangeable into common in March but the common stock price have since stayed much lower than the floor price of 278.70 yen. By liquidating the company, public funds escaped the losses. Prior to this move, Fukuoka Financial Group had also integrated management with Kumamoto Family Bank through the acquisition of preferred shares owned by the government.

In times of financial depression, the government amassed 10,432.6 billion yen of realized losses in financial assistance to now defunct financial institutions and other forms. It has, on the other hand, recorded 1,613.4 billion yen in realized gains as at the end of September from public fund repayment by major banks and other institutions. It remains to be seen how much of public financial burden can be reduced and efforts by the authorities to mitigate losses may complicate the process. If public common share ownership is no longer exception, it may be necessary for the government to formulate a rule on the exercise of shareholders' rights through voting.

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