

## Banks and the Safety Net

### 1. Introduction

In fiscal 2003, the net income for banks turned from a negative (net losses) in fiscal 2002 (year ending March 31, 2004) to a positive in fiscal 2003. This was due to such factors as an increase in profits from stocks sales and a decrease in provisions for bad loans thanks to the cyclical economic recovery. However, the lending margin, that reflects the interest margin fell due to such factors as a decline in loans. Given these observations, an analysis of the profits and financial statements of the banks are in order to see if the banks have actually regained their strength and enhanced their profitability.

In this report, we utilize recent data and analyze the banking sector. First, using data for fiscal year ending March 2004, we analyze the financial makeup of banks – their profitability, their bad loan conditions and their capital positions. Then we examine the Deposit Insurance Corporation that manages the deposit insurance system in Japan and look at the current conditions of the safety net ahead of the complete elimination of the blanket guarantees on deposits from April, 2005.

### 2. Profit Structure of the Banks

We first take a look at the profit structure of banks (Table 1). “Lending Margin” has declined in fiscal 2003 over fiscal 2002 by 400 billion yen. This is due in part to a decline in loans and a fall in yield on securities. “Other Revenue” refers to all net income outside of net interest income, less the gains and losses from sales of securities, and gains and losses from sales of real estate. Looking at some components of other net income, “Fees and Commissions” is the balance of various fee incomes from sources such as foreign exchange fees, and this has been growing since 1999 as banks are now selling investment trusts and annuities over the counter, as well as arranging syndicated loans, etc. This also illustrates that banks are diversifying their sources of income. Bond-related gains and losses in fiscal 2002 increased over the previous fiscal year, but in fiscal 2003 it declined due to an increase in the interest rate. However, extraordinary gains and losses improved by 600 billion yen over the previous year leading to an increase in other revenue of 500 billion yen. This was due to such factors as the windfall tax refund and interest resulting from the settlement of the lawsuit against the revenue-based enterprise tax imposed by the Tokyo Metropolitan Government, the return of the entrusted portion of employees pension fund, and the reversal of some reserves for possible loan losses.

In fiscal 2003, lending margin income declined, but other revenue increased enough to lead to a final slight increase in the item of about 13.3 trillion yen. “Operating Costs” have been on a declining trend since fiscal 1997 due to cost reductions, mainly in personnel expenses. In fiscal 2003, they were 6.7 trillion yen. Loan Loss increased rapidly from 2 trillion yen in fiscal 1992 to 6.2 trillion yen in fiscal 1994. In fiscal years 1995, 97, and 98, they rose from 13.4 trillion yen to a massive 14 trillion yen. In fiscal years 1999 and 2000, loan loss stabilized at a level between 6 and 7 trillion yen, but in fiscal 2001 when the Financial Services Agency (FSA) launched a special examination, provisions for bad loans rose to 9.4 trillion yen. This is because the FSA lowered the

assessment of the lending by the major banks to some companies whose managements were questionable. In fiscal 2003, loan loss charges fell to 6.1 trillion yen due to such factors as improved corporate profits as a result of the economic recovery and thus lower provisions for loan losses, and the Resolution and Collection Corporation's raising the purchase price of bonds leading to smaller losses on sales of bad loans. After Loan Loss Charges have been deducted from Gross Profit before Loan Loss, we are left with the profit from their core business, their Net Operating Profit. This figure has been negative from fiscal 1993, but in fiscal 2003, we finally saw a positive figure of 0.5 trillion yen. However, this is due in large part to some extraordinary profits, and so we can say that banks are still having difficulty writing off their bad loans with their core business profits.

Net profit in fiscal 2001 and 2002 marked large negative figures due to the large losses from asset disposal. Some factors playing a part here are, first, impairment losses of stock holdings were recorded, and second, losses on sales of stocks ballooned as stocks were sold despite the stagnant stock market. In fiscal 2003, the recovery in stock prices have led to realized capital gains of 0.6 trillion yen, and a net profit marking a positive figure for the first time in three years.

“Real Net Interest Income” is Lending Margin less Loan Loss, and so this is the lending margin of the banks after taking into account losses from non-performing loans. When the charges for bad loans grew in fiscal years 1995, 97 and 98, this Real Net Interest Income marked negative figures of 2 to 4 trillion yen. In fiscal 2003, the loan loss charges shrank, leading to a positive real net interest income of 2.9 trillion yen.

Table 1. Profit structure of Banks (all banks basis)

trillions of yen

Financial Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lending Margin (A)	7.1	8.9	9.8	9.2	9.7	10.8	10.8	10.0	9.7	9.7	9.4	9.8	9.4	9.0
Other Revenue (B)	2.6	2.2	2.5	2.8	2.1	3.5	3.6	3.6	2.7	2.4	2.9	3.1	3.8	4.3
Operating Costs (C)	7.1	7.5	7.7	7.7	7.8	7.8	8.0	7.9	7.6	7.3	7.1	7.0	7.0	6.7
Salaries and Wages	3.6	3.8	3.9	3.9	3.9	3.9	3.9	3.8	3.6	3.5	3.4	3.2	3.2	3.1
Gross Profit (D)=(A)+(B)-(C)	2.6	3.5	4.5	4.3	4.0	6.5	6.4	5.7	4.9	4.9	5.2	6.0	6.2	6.6
Loan Loss (E)	0.8	1.0	2.0	4.6	6.2	13.3	7.4	13.4	14.0	6.3	6.5	9.4	7.0	6.1
Net Operating Profit (F)=(D)-(E)	1.8	2.5	2.5	-0.4	-2.2	-6.8	-1.0	-7.8	-9.1	-1.4	-1.3	-3.4	-0.8	0.5
Realized Capital Gains (G)	2.0	0.7	0.0	2.0	3.2	4.4	1.1	3.6	1.4	3.8	1.4	-2.4	-4.1	0.6
Net Profit (F)+(G)	3.8	3.3	2.5	1.7	1.0	-2.4	0.1	-4.1	-7.7	2.4	0.1	-5.8	-4.9	1.0
Asset	927.6	914.0	859.5	849.8	845.0	847.1	858.4	845.0	762.5	741.9	806.0	772.1	739.0	750.0
Outstanding loans	521.7	537.1	542.4	539.1	538.5	553.6	563.3	536.4	492.4	475.9	474.1	464.5	435.0	422.5

Notes:

- 1) 131 banks were included in this data: 7 city banks, 2 long-term credit banks, 8 trust banks, 64 regional banks and 50 second regional banks. Foreign banks were excluded from this analysis. Also, figures were for banks on non-consolidated bases.
- 2) We classified the items from the Income Statements as follows:
  - Lending Margin = Interest Income - Interest Expenses
  - Other Revenue = Fees and Commission Income + Trading Income + Trust Fees + Other Business Income + Gains on Investment of Money Held in Trust + Other Operating Income - Fees and Commission Expenses - Trading Expenses - Other Business Expenses - Losses on Investment of

- Money Held in Trust + Extraordinary Gains (Excluding Gains on disposal of Premises and Equipment)
- Extraordinary Losses (Excluding Losses on disposal of Premises and Equipment)
- Operating Costs = General and Administrative Expenses (including deposit insurance premiums)
- Loan Loss = Provision of Allowance for Bad Debts + Loan Write-offs + Other Operating Expenses
- Net Operating Profit = Gross Profit – Loan Loss
- Realized Capital Gains = Gains on Sales of Securities + Gains on Disposal of Premises and Equipment – Losses on Sales of Securities – Losses from Sales of Premises and Equipment
- Net Profit = Net Operating Profit + Realized Capital Gains = Income Before Taxes

3) In order to remove the effects of changes in accounting standards from these figures, we removed deferred tax assets from total assets, and we also removed loan loss provisions from fiscal 2000 that are now listed in assets.

Source: “Corporate Finance Data Base” NEEDS-Financial QUEST

### 3. Profitability of Banks

The main reason for the low profitability of banks is that they are not securing the lending margins that they should be. If lending rates were determined by the credit risk of the borrower, then the risk of default should be adequately provided for in the lending margin, and as a result, profits from their lending activities should not be negative.

Table 2 shows the credit ratings of companies and the average borrowing rates that they are procuring.

Table 2. Credit ratings and borrowing rates

Credit rating	AAA	AA	A	BBB	BB	B	CCC
Borrowing Rate	n/a	1.58%	1.52%	1.43%	1.53%	1.85%	2.13%
No.of companies	0	13	34	66	39	10	3

Notes:

1) Borrowing Rates = Interest Paid \* Discount Rate (of which interest on corporate bonds, Commercial Papers, losses on bills sold, and discounts on sales are excluded)/Average Outstanding Balance of Long-Term and Short-Term Borrowing

Where Average Outstanding Balance of Long-Term and Short-Term Borrowing = (Long-Term Borrowing, Short-term Borrowing at Beginning of Term + Long-Term Borrowing, Short-term Borrowing at End of Term) /2

2) This excludes companies whose borrowing is zero, companies whose financial data is incomplete, and electric power companies whose borrowing from government financial institutions are high. 165 companies were surveyed.

3) Ratings are taken from S&P's publicized ratings list of business companies (September 1 2004). Ratings with plus and minus signs were categorized together with the flat ratings. Example: BB+ and BB- were categorized together with BB.

Sources: Standard & Poor's Company Ratings List, “Corporate Finance Data Base” NEEDS-Financial QUEST

Normally, as the rating of a company deteriorates, the credit risk increases, and so the lending rate should also rise. From the above table, companies rated at low rates of B and CCC are being charged higher lending rates than companies with higher ratings. However, the difference in rates

with AA companies is only 0.3 to 0.6% and quite marginal.

We take the probabilities of default of each rating, and multiply this by a 70% loss given default ratio (i.e., we assume 30% of the loan to be recoverable), and define this to be the additional premium on the interest rate to cover itself against losses in case of default. If this is the case, then for AAA and AA-rated creditworthiness, the additional premium might be low, but for companies rated at only BB or B, then their lending rates should be 1-4% higher than the rates that the banks are currently charging. Banks need to strengthen their profitability by setting their lending rates according to the credit risk of the borrower.

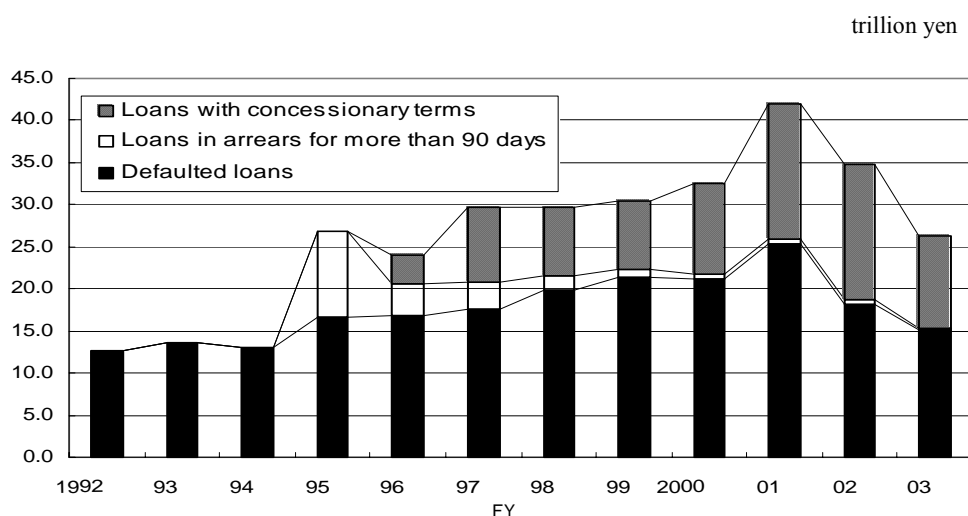
#### 4. Non-Performing Loans

We define " Non-performing loans (NPLs)" here as, of the receivables such as loans held by banks etc., those with which interest or principal are past due, or those loans that are feared to become past due. In Japan, there are three definitions of bad loans: 1) Self Assessment Loans, 2) Risk Management Loans and 3) Loans based on the Financial Reconstruction Law. Self Assessment Loans represent the most important standard because banks estimate their loan-loss reserves and the amount of write-offs based on this classification. Risk Management Loans and Loans based on the Financial Reconstruction Law are disclosed. They are required by the Banking Law or the Financial Reconstruction Law. However Self Assessment Loans are not disclosed on an individual basis.

##### • Risk Management Loans

At the end of March 2004, these risk management loans of all banks amounted to 26.2 trillion yen in total, and shrank by 8.6 trillion yen over the previous year. This is due to such factors as the progress made by banks to take their NPLs off their balance sheets, and also the fact that loans that were previously categorized as “non-performing” were upgraded to normal assets thanks to the recovery of the economy, the accompanying improvement in the business conditions of the borrower, and the progress made in reconstruction of the companies.

Figure1. Risk Management Loans



Source: Financial Services Agency

• Assets Classified by Self-Assessment

In fiscal 2003, Estimated classified loans amount to 50.9 trillion yen (Table3) and Risk Management Loans were 26.2 trillion yen. Since the classified loans are more broadly defined than disclosed NPLS, the amount of classified loans is about twice as much as the disclose loan figure.

For example, borrowers which are deficit or have problems in financial condition although scheduled payment is carried out, have possibilities to be categorized classified loans. But they are not Risk Management Loans.

However, there is a problem about laxness of standard “superior guarantee”. For example if the guarantee is from a non-dividend paying company which is listed on a stock market or an over-the counter traded company, the asset guaranteed by this company may be considered non-classified according to the Bank Examination Manual of the FSA.

Table3. Asset Classified by Self-assessment

Financial year		trillion yen					
		Mar-99	Mar-00	Mar-01	Mar-02	Mar-03	Mar-04
All credit exposure		551.8	535.8	536.3	511.6	474.2	455.7
	Non classified loans(category )	487.5	472.4	470.7	440.5	409.6	404.8
	Classified loans	64.3	63.3	65.7	71.1	64.6	50.9
	Substandard(category )	61.0	60.5	63.1	67.8	62.7	49.5
	Doubtful(category )	3.2	2.8	2.6	3.3	1.9	1.4
	Estimated Loss(category )	0.1	0.0	0.0	0.0	0.0	0.0

Source: Financial Services Agency

By type of Bank, we see that the so called “city banks” have improved their books tremendously. With the Financial Revival Program of October 2002, the major banks were required to reduce their share of NPLs in fiscal 2004 to half of their levels of fiscal 2002. To meet this goal, banks actively disposed of their bad loans, and also took care so that no new bad loans would occur, leading to a much-improved outstanding amount of NPLs. However, the strengths of the banks differ greatly by bank. There are city banks that continue to have high NPL ratios. As for regional banks, although they are moving to reduce their NPL ratios, some banks continue to have high NPL ratios. Bad loan disposal has been centered on the major banks, while the regional banks lag behind.

## 5. Real Capital Levels of Banks

To find the real capital bases, we focus on the liquidation value of the banks. We take the shareholder’s equity portion of the balance sheet and adjust the figure for 1) the shortage in allowance for loan losses -- the difference between stringently assessed bad loans that need to be disposed of -- and the actual allowance for loan losses that were reserved, 2) deferred tax assets that need to be removed and 3) other items that require adjustment.

We then also subtract the preferred shares issued for public funds from the real capital base for

further reference. The reason that we remove the preferred shares for public funds is that if these are converted to common stock and cannot be sold in the market, then they must be bought back. Thus this lacks in the “permanence” that is required in the definition of capital. As the real capital indicates the liquidation value of banks, if this figure is negative, then the bank is in a real excess debt position.

The real capital ratio we find here will be much lower than the BIS capital ratio because there are no supplementary items in the numerator, and because the denominator – the assets – have not been risk-weighted. We also note that in finding the real capital ratio, the available data on the individual banks' self-assessment classification is not complete and so in order to find the amount of NPLs that require writing off, we use Mr. Fukao's (Japan Center for Economic Research, 2003) matrix and translate the loans disclosed under the Financial Revitalization Law into the categories of loans under self-assessment.

Figures for all banks in Japan, major banks, regional banks, second regional banks, were found by tallying up the figures for each individual bank. The amount we estimated as NPLs in the self-assessment asset categorization was a much greater amount than the FSA knows of. Then we calculated the NPLs that need to be written off, and the estimated shortage in provisions for bad loans much more stringently, and found the real capital rate (both including and excluding public funds). If we calculate the real capital adequacy ratios using the self-assessment loans that the FSA is aware of, the estimated shortage of provisions for NPLs are 4.3 trillion yen for all banks. Without including public funds, the real capital adequacy ratio becomes 1.02%, and including public funds, the ratio is 2.18%. Moreover, the shortage of NPL provisions for major banks becomes 2.3 trillion yen, and the real capital adequacy ratio is 0.17% not including public funds and 1.83% when public funds are included.

The real capital adequacy ratios of the banks are as shown in Table 4 . The real capital ratio not including public funds fell to 0.03% as at end March 2003, but this recovered to 0.83% as at March 31, 2004. However, the gap between the real capital adequacy ratios using capital figures that do and do not include public funds has widened, and the difference between the two has widened from 0.96% at end-March 2003 to 1.17% 2004. This is due to the fact that public funds are not being repaid actively, and in the meantime there have been further public fund injections. If we include the public fund injections into our calculations, then the real capital adequacy ratios would be 2.70% for end of March 1999 when massive funds went in to save the banks. At end-March 2000, it was 3.21% when the stock market recovered. However at end-March 2003 it fell to 0.99% due to appraisal losses resulting from the plunging stock market fell and loan loss charges, as well as the continuing fiscal year-end net losses. It then recovered to 2.00% at end March 2004 when the stock prices recovered.

Table 4. Real Capital Base (All Japanese Banks)

Trillions of yen									
	Total Shareholder's Equity	Estimated Shortage in Loan Loss Provisions	Deferred Tax Assets	Other	Public Funds	Real Capital Base	Corrected Total Assets	Real Capital Ratio	Real Capital Ratio (including public funds)
March 31, 1999	33.7	4.0	8.9	0.4	6.3	14.8	782.2	1.89%	2.70%
March 31, 2000	35.6	5.8	8.2	4.1	6.9	18.9	799.9	2.36%	3.21%
March 31, 2001	37.6	7.5	7.3	-3.5	7.1	12.2	850.0	1.43%	2.27%
March 31, 2002	30.2	6.8	10.7	-2.0	7.2	3.6	792.5	0.45%	1.36%
March 31, 2003	24.8	5.4	10.6	-1.3	7.3	0.2	762.4	0.03%	0.99%
March 31, 2004	29.0	5.7	7.3	-0.8	8.9	6.4	763.5	0.83%	2.00%

Notes: 1) Banks included in this exercise are the same as for Table 1.

2) Real Capital Base = Total Shareholder's Equity – Estimated Shortages in Loan Loss Provisions – Deferred Tax Assets + Others – Public Funds

Estimated Shortage in Loan Loss Provisions = Amount required for loan loss charges – provisions for loan losses

Amount required for Loan loss charges = 1% × Type I loans + 20% × Type II loans + 70% × Type III loans + 100% × Type IV loans

Other = (Profit and loss from securities revaluation– Equivalent of Deferred Tax Liabilities + Profit and loss from derivatives revaluation) – Revaluation Reserve for Land

3) Corrected Total Assets = Total assets + portion of trust with contract for replacement of losses – deferred tax assets + provisions for loan losses + Profit and loss from securities revaluation

Source: “The Status of Risk Management Loans Held by all Banks in Japan”, “Status of Non-performing Loans”, “Status of Self-Assessment”, Financial Services Agency  
 “Corporate Finance Database” NEEDS-Financial QUEST  
 “Annual Report” Deposit Insurance Corporation of Japan,  
 Disclosure material and Financial Statements of individual banks  
 “Financial Statements of all Banks”, Japanese Bankers Association

The same results for only the major banks are shown in Table 5. The real capital adequacy ratio has followed the same pattern as for all banks in Japan. From end-March 2002, the real capital adequacy ratio has been negative. For this group of banks, we can conclude that they continue to have very weak capital bases, particularly since there was a 2 trillion yen recapitalization in fiscal 2002, and in June 2003 public funds for common and preferred shares totaling 2 trillion yen were injected into Resona Holdings (Resona Bank)

Table 5. Real Capital Base (Major Banks)

Trillions of yen									
	Total Shareholder's Equity	Estimated Shortage in Loan Loss Provisions	Deferred Tax Assets	Other	Public Funds	Real Capital Base	Corrected Total Assets	Real Capital Ratio	Real Capital Ratio (including public funds)
March 31, 1999	22.8	3.0	6.6	-0.2	6.2	6.8	516.4	1.33%	2.52%
March 31, 2000	23.9	3.8	5.7	2.8	6.5	10.6	535.2	1.99%	3.21%
March 31, 2001	24.2	5.3	5.3	-2.5	6.6	4.5	580.3	0.77%	1.91%
March 31, 2002	18.0	4.7	8.0	-1.2	6.6	-2.4	522.8	-0.47%	0.80%
March 31, 2003	13.1	2.9	7.9	-0.5	6.6	-4.8	495.2	-0.98%	0.36%
March 31, 2004	16.9	3.3	5.5	0.0	8.2	-0.1	494.3	-0.03%	1.63%

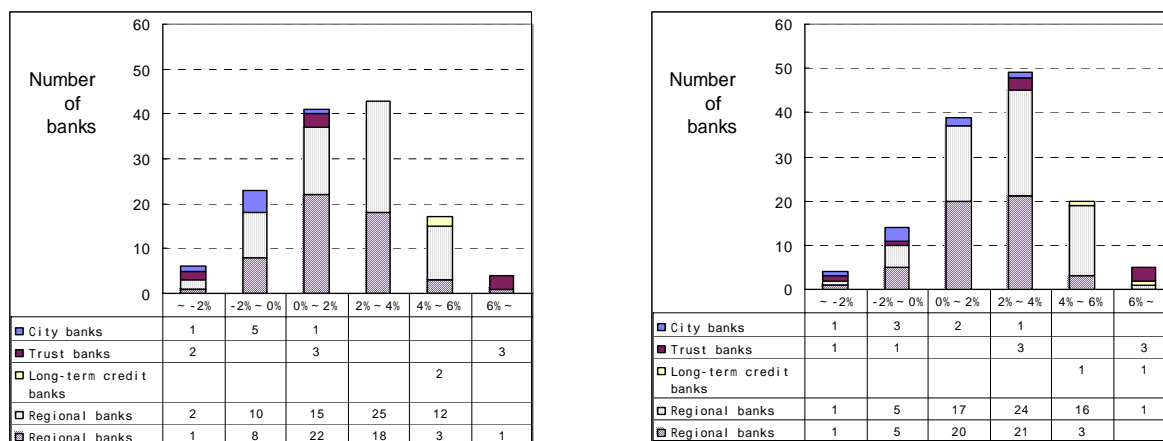
Notes: 1) Major banks are the 17 City Banks, Long-term Credit Banks and Trust Banks. 2) 3), same as Table 4

Sources: Same as Table 4

Only 24 of the 131 banks have received public funds through the issuance of preferred shares as at March 31, 2004, and 90% of the funds went to the major banks.

We then look at the distribution of capital ratios across the banks in Figure2. Although there were 29 banks (8 major banks, 12 regional banks and 9 Second Regional Banks) as at March 31, 2003 whose capital adequacy ratio excluding public funds were less than 0%, by the end of March 2004, this number had shrunk to 18 (6 major banks, 6 regional banks, and 6 Second Regional Banks). If we include public funding into our calculations, then as at end-March 2003 there were 16 banks with capital adequacy ratios of below 0% (4 large, 8 regional, 4 Second Regional). This had also declined by end-March 2004 to 7 banks (1 large, 3 regional, 3 second regional).

Figure2. Distribution of Capital Ratios Across the Banks (excluding public funds)  
 (end March 2003) (end March 2004)



Sources: Same as Table 4

## 6. The Deposit Insurance System as Safety Net

### 6.1 Overview of the Deposit Insurance System in Japan

#### 6.1.1 Deposits etc. Eligible for Deposit Insurance.

The deposit insurance system is the system whereby if a financial institution does not repay deposits for some reason, depositors are protected and settlement of funds ensured. The deposit

insurance system is the core of the safety net of the financial system. That is, when a bank becomes insolvent, the system prevents this from causing a chain reaction into the entire financial system. Japan's deposit insurance system dates back to the 1971 Deposit Insurance Law, when the Deposit Insurance Corporation of Japan (DICJ) was established as the body to manage the system. The Deposit Insurance Law has gone through several revisions in its history. Deposit Protection now looks like as is outlined in Table 6.

Table6. Outline of Deposit Protection

		April 2002- end of March 2005	April 2005 onwards
Insured Deposits	Current deposits	Full amount protected	Full amount protected for deposits for payment and settlement purposes (Note 1)
	Ordinary deposits		
Insured Deposits	Specified deposits	Total up to a maximum principal of 10 million yen (Note 2) plus accrued interest thereon (Note 3)  Portion in excess of 10 million yen payable depending on the asset situation of the failed institution (subject to deductions)	
	Time deposits		
	Installment savings		
	Money trusts under the guarantee of principal (including such loan trusts as "Big")		
Uninsured deposits	Bank debentures (limited to custody-only products such as "Wide")	Not protected Payable depending on the assets situation of the failed institution (subject to deductions)	
	Foreign currency deposits		
	Negotiable certificates of deposit		
	Money trusts under no guarantee of principal (such as "Hit")		

- Notes: 1. These deposits must meet the following three conditions: they must not accrue interest, must be payable on demand and must be used for payment and settlement services.
2. When financial institutions merge or receive the transfer of all operations after April 2003, effective for one year after the merger date, the protected amount will be “10 million yen × the number of institutions involved in the merger” (i.e., 20 million yen if two institutions merge)
3. The distribution of earnings on installment savings provisions and money trusts will be protected in the same way as interest.

Source: An Outline of the Deposit Insurance System, Deposit Insurance Corporation

When a depositor makes a deposit at a financial institution eligible under the deposit insurance system, the depositor, the financial institution and the DICJ automatically enter into an insurance relationship. The deposit insurance system is financed by the premiums paid by the eligible financial institutions. They pay these premiums to the system every year, the amount depending on

the amount of deposits of the financial institution. The premium rate, that will determine the premiums to be paid, is a fixed rate. The rate from fiscal 2003 is 0.09% for deposits that are protected in full, and 0.08% for deposits that are protected up to specific amount.

#### 6.1.2 Resolving Bank Failures

There are three methods the DICJ may employ to resolve bank failures. The “financial assistance” method, and the “pay-out” method and, as an exceptional measure, a failure can be handled according to Article 102 of the Deposit Insurance Law where measures against “financial crises” are laid out. Generally, the “financial assistance” method should be applied.

Under the “pay-out” method, the DICJ pays insurance directly to the depositors of the failed institution. Bankruptcy proceedings are taken, and all financial functions of the institution are terminated, and liquidated. Under the “financial assistance” method, if a financial institution fails, the DICJ provides financial assistance to the acquiring financial institution that may either acquire the business of the failed financial institution, or acquire the failed financial institution itself so the acquisition is conducted smoothly. The methods of financial assistance can take many forms: grants, loans to the acquiring bank or deposits of funds, purchase of assets, guarantees of debts, subscription of debts, subscription of preferred shares etc., or loss sharing. There has been 25 trillion yen paid in financial assistance to date.

Also, if the financial institution’s finances deteriorate, then the Minister for Financial Services can direct the financial administrator to manage the business and its assets. If no financial institution is immediately forthcoming to acquire the failed financial institution or its businesses, then a “bridge bank” can be temporarily established to assume the role of an acquiring bank until one can be found. For the insurance payout method, there are two types of insurable contingencies that can instigate a payout. The first, the Category 1 insurable contingency is the suspension of repayments of deposits by a financial institution. In this case the DICJ determines within one month of the incident (this can be extended for up to one more month), if insurance payments will be made to the depositors, this decision being subject to a resolution by the Policy Board. The category 2 insurable contingency is triggered when the financial institution’s operating license is revoked, when bankruptcy is declared, or when there is a resolution to dissolve the financial institution. Insurance payments will be made without the need for decision by the DCIJ. For the payout method, this entails the failed financial institution undergoing liquidation proceedings, and so there has yet to be a case where a failed financial institution was dealt within this way.

The measures in response to a financial crisis were established when the Deposit Insurance Law was revised in May 2000. When the Prime Minister determines that a bank failure may cause serious damage to the credibility of Japan or of a region, and following deliberation with the Financial System Management Council, some exceptional measures can be dictated such as capital injection by the DICJ subscribing the shares of the financial institution, or special crisis management in the form of DIJC acquiring the shares. Depending on the type of financial institution, there are three measures as outline in Table 2-6. Some real life examples of these measures being invoked are: In June of 2003, the Item 1 measure was invoked when the DICJ subscribed preferred and common shares of Resona Bank resulting in a capital injection of 2 trillion yen. In November of

the same year, after deliberation with the Financial System Management Council, the shares of Ashikaga Bank were acquired by the DICJ, resulting in a de facto nationalization of the Bank.

Table 7. Measures against Financial Crises

Article 102, paragraph 1	Eligible Financial Institutions	Details of Measure	Remarks
Item 1 Measures	All financial institutions (except those that fall under Item 2 measures)	Capital injection (subscription of shares, etc., by Deposit Insurance Corp. to recover the capital adequacy ratio of financial institutions).	<ul style="list-style-type: none"> <li>Financial institution that has been authorized for Item 1 measures submits application to Deposit Insurance Corp. for them to subscribe shares, etc.</li> <li>The financial institution, when submitting the application, must also submit a business improvement plan.</li> </ul>
Item 2 Measures	Failed or insolvent financial institutions	Financial assistance of an amount exceeding the pay-out cost.	<ul style="list-style-type: none"> <li>Financial institutions that have been authorized for Item 2 measures are immediately put under the control of the financial administrator</li> </ul>
Item 3 Measures	Failed financial institutions that are insolvent	Acquisition of shares by Deposit Insurance Corp. (Special crisis management)	<ul style="list-style-type: none"> <li>Item 3 measures are to be implemented only when implementation of Item 2 measures are deemed to be inadequate to avoid damage to the credibility of Japan or other regions where financial institution are conducting business.</li> </ul>

Note) Failed financial institutions are defined as financial institutions that have suspended or are anticipated to suspend repaying deposits.

Source: A Guide to the Deposit Insurance System, Deposit Insurance Corporation of Japan

## 6.2 Issues with the Deposit Insurance System

### 6.2.1 Financial Conditions of the Deposit Insurance Corporation

Looking at the General Account, that is used for financial assistance that fall within the payout costs, the insurance premium income was 522.1 billion yen in fiscal 2003. Since there were no new instances of financial assistance paid out, the account had a profit of 512.7 billion yen, marking a profit for the first time in six years. However, there continues to be a 3.5 trillion yen deficit carried over from costs associated with past failures of financial institutions, and so their government guaranteed borrowing and bond issuance totaled 5.3 trillion yen. Moreover, of all the seven accounts of the DICJ, the outstanding amount of government guaranteed borrowing and bonds is a massive 19.9 trillion yen. By simple addition, the excess debt of the organization is 4.5 trillion yen and desperately needs to be addressed.

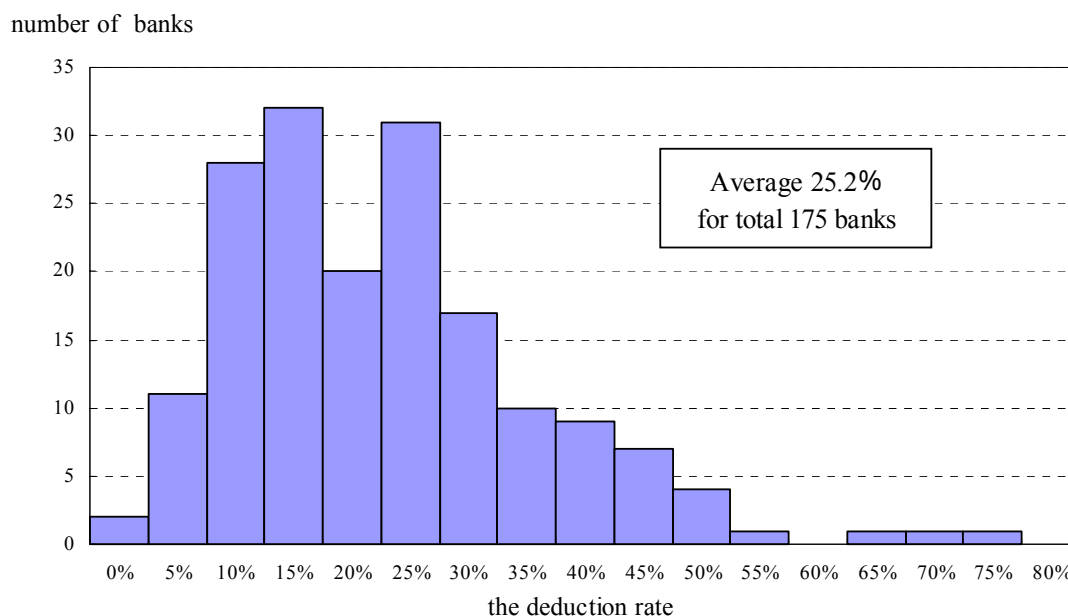
However, if insurance premiums are raised to improve the financial situation of the DICJ, then the banks must finance the increase through one of the following ways: if banks reduce their expenses, such as through reducing human resource expenses, the financial institution itself bears the burden, if banks lower their interest rates paid on deposits, then the depositor pays, or if they raise their lending rates, then borrowers will pay. Thus in the end it is likely that the banks' pay for the higher premiums by lowering their profits, that is, the shareholder will pay. However, if in the end the DICJ is unable to repay its obligations, then the government guarantee would be claimed, and the taxpayers will pay.

### 6.2.2 The deposit deduction (“cut”) rate of failed institutions upon pay-out

We have calculated the deduction rate to all failed financial institutions in cases where the DICJ has provided financial assistance (grants) to the acquiring institution in the past. This deduction rate is defined as the rate by which the deposits in excess of 10 million yen per person would be “deducted” i.e., would not be paid back to the depositor in the case a payout occurs. We define the excess debt amount as the amount granted to the acquiring bank from the DICJ to cover the losses in the acquisition (Figure 3), and we find the liability amounts using the most recent balance sheets before the failure.

Of the 175 failed banks, the average deduction rate is 25.2%. Although there are 109 banks (62.2% of total number of banks) whose rates fell between 10% and 30%, there were also 50 banks (28.6% of total) whose deduction rates were greater than 30%. We examine these rates of banks that failed before and after the introduction of the Early Corrective Measures around April of 1998 and find that the average deduction rate has indeed fallen from 27.6% to 24.6%, but the difference is minimal, and there were 40 failed banks whose deduction rates were over 30% from April, 1998. We see that even after the implementation of the Prompt Corrective Action, the deduction rates remain at high levels. It would be difficult to conclude that these Prompt Corrective Action, then are functioning effectively. Looking at current financial statements, we cannot say that all banks are healthy. Thus, it is imperative that these Prompt Corrective Action are appropriately implemented. Moreover, we are looking for improvements such as strengthening the standards for terminating the business of financial institutions. If the businesses functions of the bank can be brought to a halt before they institution enters into an excess debt situation, then a deposit deduction can be avoided, and it should be easier to find an acquiring financial institution.

Figure3. Degree of Insolvency Failed Deposit Taking Financial Institutions  
 from April 1992 to June 2004



### 6.2.3 Issues Related to Dealing with Failures

After the lifting of the blanket guarantee, the system will attempt to handle these cases of bank failures over the weekend (Friday to Monday proceedings). Under the method whereby the failed bank is acquired or its businesses transferred to an acquiring institution, if a failure is announced one week, the failure proceedings would be handled over the weekend, and a new acquiring bank would take over on Monday. However, practically speaking, in the case of a bank with large assets and a large number of accounts, it is questionable if this can be done so expeditiously. In this scenario of a Friday to Monday resolution, it becomes imperative that the bank is able to group their accounts by name of account holder. This refers to the banks being able to find multiple accounts held by a single account holder and to group the accounts so that the total deposits of the individual can be confirmed.

If this cannot be done in a speedy manner, then the insurable deposit amount cannot be determined and the deposits to be transferred to the acquiring bank cannot be confirmed. Then the DICJ is not able to determine the amount of financial assistance needed. This “data cleansing” exercise is an extremely time consuming one, since accounts in financial accounts can be dormant (no activity for a specified length of time), can be opened in the name of a family and can be even fictitious.

By the new rules set in June 2004, the financial institution cannot find the account after making reasonable efforts to locate it, or if the account holder is refusing to respond, then the account can be handled separately from normal accounts as “data non-confirmable” and can be handled outside of the name grouping exercise. However, in the case of some credit associations, credit unions and other such small and medium sized financial institutions, their databases and systems may be lacking. There is difficulty in being able to organize and group the different types of deposits to the same depositor, and this appears to be taking much time. It can be anticipated that paying deposits back to the depositors would take a long time with the lack of the infrastructure to compile this data quickly.

### 6.2.4 Issues related to Payments and Settlement Accounts

With the lifting of the blanket guarantee on deposits in April of 2005, new accounts used for payments and settlements would have their deposits fully guaranteed. Under the current zero interest rate environment, providing a full guarantee for deposits in these types of accounts is actually tantamount to providing an unlimited guarantee on all deposits. Even if there is a balance in ordinary accounts, since the interest rates are negligible, most of the deposits are expected to be moved to these payments and settlements accounts. Moreover, even if the depositor has more than 10 million yen in deposits, if he deposits only 10 million in accounts at different banks, then this is equivalent to having his full deposit principal and interest guaranteed.

The people who will benefit the most from using these payment and settlement accounts will be those large depositors such as the corporations and government bodies that have over 10 million yen of balances in these accounts for settlement. If they did not have payment and settlement accounts, then corporations and local bodies with large balances would have more of an incentive to select banks based on the account holder's need to make payments and protect their deposits. However, with this guarantee on balances in these accounts, there is no incentive for the account holder to

select the safer bank, and instead a moral hazard will come into play. Depositors should be responsible for selecting a safe bank, and banks should ensure that they are managed in such a way that they are considered safe enough to be chosen by their depositors. For this reason, even for accounts used for payments and settlements, the full deposit amount should not be guaranteed. A better system would be if for deposits of 10 million yen and less, deposits would be deducted by 5% of their principal.

#### 6.2.5 Issues Related to the Equality of Deposit Insurance Premiums

Under Japan's Deposit Insurance system, eligible financial institutions pay a determined share of their deposits to the DICJ as the insurance premium. Healthy banks with high capital adequacy ratios and banks that are technically in excess debt, all pay the same premium rates. Under this system, the risks of failure of the individual financial institutions are not at all taken into account. The healthier the bank is, the less fair this system is. Lately, more and more countries are implementing variable premium rates depending on the credit risk of the bank. Introducing variable deposit insurance rates would be effective and have the following benefits. There will be incentive for the financial institution to make sure it is healthy, and will lead to a strengthening of their finances. The stability of the financial system will be enhanced, and will lead to lower losses for the Deposit Insurance Corporation. This will ensure that the premiums paid for deposit insurance are more fair among the financial institutions.

However, a variable premium rate is not something that can be introduced immediately. There are many opinions on how premium rates should be determined, and this is something that needs some further deliberation to find the optimal way of determining the rates. In countries where this variable rate system was introduced, banks were given some preparation time to improve their finances before the new rates took effect, and in many cases, some interim measures were implemented to give the banks some time to deal with the increase in their premiums. Moreover, as a prerequisite to implementing this measure, the following is required: a monitoring system for financial institutions be established, a method of evaluating and analyzing the risk profile of the individual financial institutions be established, and the management of financial institutions overall be stable prior to the implementation. In Japan's case, the infrastructure is not yet there, and so implementing this measure will not take place in the immediate future.

## 7. Conclusion

In this report, we analyzed the banks' profitability, their non-performing loans, their capital adequacy, and the deposit insurance system using mainly fiscal 2003 (ending March 2004) data. The issues with banks and the deposit insurance system that were highlighted with this analysis are as follows:

First is the problem of the continued low profitability of the banks. In fiscal 2003, on an All-Banks basis, the net business profits were finally in the black after being in the red from fiscal 1993. This was due to lower expenses and a smaller write-off amount for bad loans. However, there was an additional boost from extraordinary profits such as the tax refunds resulting from the settlement of the lawsuit with the Tokyo Metropolitan Government, and these figures may not

necessarily be a reflection of a recovery in profitability. To improve profitability, banks need to secure correct lending margins. Compared to the US, the margins earned on lending are very low, and for commercial loans, banks are not setting their interest rates commensurate with the risks of the borrowers. Banks must gain the capability to set appropriate interest rates based on the risk of the borrower, to secure a stable interest margin.

Second is the problem of non-performing loans. With the Financial Revitalization Program introduced in October 2002, the major banks were required to reduce their rate of NPLs by fiscal 2004 to half the levels of fiscal 2002. In fiscal 2003, the NPLs have been reduced significantly. Factors supporting this have been for example, with the recovery in the economy, the financial conditions of the borrowers have improved, and so their loan categories are being upgraded. Also, banks are progressing in taking their NPLs off their balance sheets. Banks had been unable to cover their loan write-offs with their core business profits since 1993. However, with improved profits in fiscal 2003, banks are now able to write off their NPLs with their net business profits. From the perspective of NPL disposal, improved profitability continues to be a very important issue.

Third is the issue of the continued weak capital bases of the banks. Although banks are depending less on deferred tax assets to boost their capital adequacy, this has not yet progressed to a satisfactory level. There are many banks that are in a situation of real excess debt when we calculated their real capital levels based on their recent financials. In the cases of Resona Bank and Ashikaga Bank the trigger for Article 102 of the Deposit Insurance Law being exercised was the unwillingness of the public accountants to recognize the amounts of deferred tax assets that the banks had recorded. It is imperative that the bank is healthy enough that the core capital is not made up of a large share of deferred tax assets.

Fourth are the issues associated with the safety net of the banking system, the deposit insurance system. The average deduction rate (the share of deposits that were not paid back to the depositor) for failed banks that received financial assistance from the Deposit Insurance Corp of Japan calculated as excess debt amount, was 24.6%. This suggests that the Prompt Corrective Action are not functioning as intended. If we examine the capital adequacy ratios of the banks that failed, they were above standard immediately before they failed. However, once they have failed, they are shown to be in excess debt. The supervisory authority needs to establish a stringent inspection framework so that weaker financial institutions can be recognized as risky before their excess debt expands beyond repair. In order to make the Deposit Insurance system a more robust system, depositors must take it upon themselves to select creditworthy banks they make their deposits with, and banks must be healthy enough to be chosen by depositors, to avoid a moral hazard situation. Moreover, to give banks more incentive to become healthy, a variable premium rate for deposit insurance should be introduced, so that the deposit insurance system is a fair one for all banks involved.