



**FINANCIAL STABILITY AND FINANCIAL SECTOR SUPERVISION:  
LESSONS FROM THE PAST DECADE AND WAY FORWARD**

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**TOKYO, JAPAN**

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**JAPAN'S NON-PERFORMING LOAN PROBLEM AND  
FINANCIAL RECONSTRUCTION**

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# Japan's Non-Performing Loan Problem and Financial Reconstruction

The Third International Conference  
Financial Stability and Financial Sector Supervision  
Lessons From the Past Decade and Moving Forward

December, 2007

# The 3<sup>rd</sup> International Conference - resume

## 1. The onset of Japan's non-performing loan problem and bank bankruptcies

- (1) Bank operations during the bubble period
- (2) The onset of the non-performing loan problem following the bubble collapse
- (3) Bank bankruptcies and its causes
- (4) The government's response
  - Pay-offs frozen
  - Corrective measures rapidly introduced
  - Major banks intensively inspected
  - System to deal with bankruptcies introduced (Financial Reconstruction Act)
  - Injection of public funds (Financial Function Early Strengthening Act)

## 2. The increasingly serious non-performing loan problem

- (1) Growing deflationary pressure and management deterioration at large-scale debtors
- (2) Flaws in banks' risk management systems
- (3) Decline in banks' lending power (falling credit ratings, the Japan premium, credit-crunch)
- (4) The government's response
  - Creation of a financial inspection manual
  - Discovery and rapid disposal of non-performing loans (special inspections – the 2 to 3 year rule)
  - A financial reconstruction program
  - Progress report on disposal of non-performing loans



# Principal Events within Japan's Non-Performing Loan Problem (1)

The 1980's Onset of the bubble economy

Pressure caused by a declining trade surplus, the rapid rise in the value of the Yen, and low-level economic growth

⇒ Official discount rate reduced to achieve economic expansion

⇒ Low-level interest rate policy embedded long-term ⇒ spurred speculative investing in real-estate, shares etc.

⇒ Onset of the bubble economy (from the mid 80s)

The 1990s The onset and the increasing seriousness of the non-performing loan problem

Collapse of the bubble economy ⇒ long term economic recession, asset deflation, banks confronted with the non-performing loan problem



## Principal Events within Japan's Non-Performing Loan Problem (2)

The 1990s Onset and increasing seriousness of the non-performing loan problem

(Principal events)

1994 Bankruptcies of the Tokyo Kyowa Credit Union and Anzen Credit Union

1995 Bankruptcy of Hyogo Bank

1995 Injection of approximately ¥680 billion in public funds to deal with bankrupt home-loan financial institutions

1996 Decision taken to insure savings for the entire amount, and other assets (until March 2001) (pay-offs frozen)

1997 Bankruptcies of Hokkaido Takushoku Bank, Yamaichi Securities and others

1998 Financial Supervisory Agency established – collaboration with the Bank of Japan for intensive inspections at major banks

Financial Reconstruction Act implemented (a system for dealing with bankruptcies)

Financial Function Early Strengthening Act implemented (capital strengthening via public funds)

Nationalization of the Long Term Credit Bank of Japan

Falling credit ratings, the Japan premium, credit-crunch

1999 Financial inspections manual published

Capital strengthening for 15 major banks and 4 regional banks

5 bankruptcies among Second Association Regional Banks



## Principal Events within Japan's Non-Performing Loan Problem (3)

### The 2000's Normalization of the non-performing loan problem

- 2000 Financial Services Agency established
- 2001 Direct repayment of non-performing loans promoted (establishment of the 2 to 3 year rule etc.)
  - Special inspections implemented (major banks)
  - Extension of insurance for entire amount of savings and other assets (until March 2005)
- 2002 Establishment of a bridge-bank to continue operations of two bankrupt Second Association Regional Banks
  - Announcement of the Financial Reconstruction Program
- 2003 Capital strengthening for a major bank (Resona Bank)
  - Temporary nationalization of a major regional bank (Ashikaga Bank)
- 2004 Financial Reform Program announced
- 2005 Ban on pay-offs lifted
  - Target of reducing in-half non-performing loan ratios at major banks achieved (end of March 2002, 8.4% ⇒ end of March 2005, 2.9%)

# Number of Failed Financial Institutions

Year (Japanese Heisei Calendar)	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	Total
	Western Calendar	90	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	
<b>Total</b>	0	1	1	2	4	6	5	17	30	44	14	56	0	1	0	0	0	<b>181</b>
<b>Banks</b>	0	1	0	0	0	2	1	3	5	5	0	2	0	1	0	0	0	<b>20</b>
<b><i>Shinkin</i> Banks</b>	0	0	1	1	0	0	0	0	0	10	2	13	0	0	0	0	0	<b>27</b>
<b>Credit Unions</b>	0	0	0	1	4	4	4	14	25	29	12	41	0	0	0	0	0	<b>134</b>

(Note) Shift in number of financial institutions dealing with savings: 1990, 1012 → 2006, 582

# Trends in Bankruptcies at Financial Institutions and Creating and Maintaining a Safety-Net

Year	No. of Bankruptcies	Principal Bankruptcy Cases (Month/Year) and Cost of Disposal (Amount of credit offered: \100 million)		Maintenance of a Safety Net (year/month)
71~90 Total	0			<ul style="list-style-type: none"> <li>● Deposit insurance system established (71/4) (Deposits insured to upper-limit: limit calculated according to insurance payments)</li> <li>● Capital-assistance method introduced (86/7)</li> </ul>
91	1	(91/7)	Toho Mutual Savings Bank (Lending 80)	
92	1	(92/4)	Toyo <i>Shinkin</i> Bank (200)	
93	2			
94	4	(94/12) (94/12)	Tokyo Kyowa Credit Union Anzen Credit Union (2 credit unions, totaling 400)	<ul style="list-style-type: none"> <li>● Tokyo Kyodo Bank established (95/1)</li> </ul>
95	6	(95/7) (95/8) (95/8) (96/3)	Cosmo Credit Union (1,250) Hyogo Bank (4,730) Kizu Credit Union (10,044) Taiheiyo Bank (1,170)	<ul style="list-style-type: none"> <li>● Resolution and Collection Bank established</li> </ul>
96	5	(96/11)	Hanwa Bank (812)	<ul style="list-style-type: none"> <li>● Special funds assistance systemized (deposits insured to entire amount)</li> <li>● Higher insurance premiums and special insurance premiums introduced (96/6)</li> </ul>
97	17	(97/10) (97/11) (97/11) (97/11)	Kyoto Kyoei Bank (436) Sanyo Securities applies to the Company Rehabilitation Act (97/11) Hokkaido Takushoku Bank (17,631) Yamaichi Securities announces its voluntary discontinuance of business (97/11) Tokuyo City Bank (1,192)	<ul style="list-style-type: none"> <li>● Diversification of disposal methods introduced, such as new merger companies (97/11)</li> <li>● System to inject public funds to insure deposits etc. to entire amount introduced</li> <li>● The Resolution and Collection Bank's sphere of operations expanded</li> <li>● System to inject capital into financial institutions established (98/12)</li> </ul>
98	30	(98/5) (98/5) (98/10) (98/12)	Midori Bank (7,719) Fukutoku Bank, Naniwa Bank *(---) Long Term Credit Bank of Japan ** (32,350) Japan Securities Credit Bank ** (31,414)	<ul style="list-style-type: none"> <li>● Special public management system introduced</li> <li>● Financial liquidation administration and bridge-bank system introduced</li> <li>● System for capital strengthening for financial institutions introduced (98/10)</li> </ul>
99	44	(99/4) (99/5) (99/6) (99/8) (99/10)	Kokumin Bank *** (1,749) Kofuku Bank *** (4,847) Tokyo Sowa Bank *** (6,845) Namiaya Bank *** (6,299) Niigata Chuo Bank *** (3,556)	<p>(1999 reports – 2000 Law revision)</p> <ul style="list-style-type: none"> <li>● Diversification of methods for disposing of bankruptcies continued and made permanent</li> <li>● Exceptional measures for crisis situations established</li> <li>● The principle that deposits are insured for the entire amount abolished (02/4)</li> </ul>
2000	14	(00/12)	Credit Union Kansai Industrial Bank (6,599)	
91~00 Total	124			

(Note 1) The number of bankruptcies is based on the official announcement of bankruptcy numbers in which deposit insurance was invoked.

(Note 2) Prior to 1998, the most common method of disposing of a bankruptcy was capital-assistance that presupposed the transfer of business and operations (another method was rescue mergers). However, from fiscal 1998, disposal methods were diversified. Within the table, \* refers to special mergers incorporating the sale of assets without the provision of credit, \*\* refers to special public management, while \*\*\* refers to the financial liquidation administration.

(Note 3) Regarding the treatment of the Long Term Credit Bank of Japan, in addition to financial credit of \3,141.4 billion yen, \95.1 billion was paid as from the Financial Reconstruction Account as a compensation loss.

(Note 4) The actual amount of financial credit provided may differ due to later reductions.





## Measure to Stabilize the Financial System – Injection of Public Funds

(as of August, 9<sup>th</sup>, 2007)

- Former Financial Stabilization Act (Feb. 98)
  - Injection of ¥1.8 trillion into 21 banks
  - Of which, ¥1.6 trillion recovered
- Financial Function Early Strengthening Act (October 1998)
  - Injection of ¥8.6 trillion into 32 banks
  - Of which, ¥7.2 trillion recovered
- Revised Deposit Insurance Act (April 2001) in response to financial crisis
  - Injection of ¥2.0 trillion into Resona Bank (June 2003)
  - Of which, ¥2.7 billion recovered
- Special Measures Act Concerning the Promotion of the Organizational Restructuring of Financial and Related Institutions (January 2003)
  - Injection of ¥6.0 billion into the Kanto Tsukuba Bank
- Financial Functions Strengthening Act (August 2004)
  - Injection of ¥40.5 billion into two regional banks

# Trends in Ratings For Major Banks (Moody's)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997				
Aaa	Dai-ichi Kangyo Bank Fuji Bank The Mitsubishi Bank Sumitomo Bank Industrial bank	Dai-ichi Kangyo Bank Fuji Bank The Mitsubishi Bank Sumitomo Bank Industrial bank	Industrial bank								Aaa			
Aa 1	Sanwa Bank Mitsubishi Trust and Banking Sumitomo Trust & Banking	Sanwa Bank Mitsubishi Trust and Banking Sumitomo Trust & Banking	Dai-ichi Kangyo Bank Fuji Bank The Mitsubishi Bank Sanwa Bank Sumitomo Bank	Dai-ichi Kangyo Bank Fuji Bank The Mitsubishi Bank Sanwa Bank							Aa 1			
Aa 2	Tokai Bank The Bank of Tokyo The Long-term Credit Bank of Japan Mitsui Trust and Banking	Tokai Bank The Bank of Tokyo The Long-term Credit Bank of Japan Mitsui Trust and Banking	The Bank of Tokyo Mitsubishi Trust and Banking Sumitomo Trust & Banking	The Bank of Tokyo Industrial bank					Bank of Tokyo-Mitsubishi	Bank of Tokyo-Mitsubishi	Aa 2			
Aa 3	Yasuda Trust and Banking Toyo Trust and Banking	Daiwa Bank Yasuda Trust and Banking Toyo Trust and Banking	Sakura Bank Daiwa Bank Tokai Bank Mitsui Trust and Banking Toyo Trust and Banking	Fuji Bank Asahi Bank Sumitomo Bank Daiwa Bank Tokai Bank	Dai-ichi Kangyo Bank Fuji Bank The Mitsubishi Bank Sanwa Bank Sumitomo Bank Daiwa Bank The Bank of Tokyo Industrial bank	The Mitsubishi Bank Sanwa Bank The Bank of Tokyo Industrial bank	The Mitsubishi Bank Sanwa Bank The Bank of Tokyo	The Mitsubishi Bank Sanwa Bank The Bank of Tokyo	Sanwa Bank Nippon Trust Bank	Sanwa Bank Nippon Trust Bank	Aa 3			
A1			The Long-term Credit Bank of Japan Yasuda Trust and Banking	Sakura Bank Mitsubishi Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Sakura Bank Asahi Bank Tokai Bank	Dai-ichi Kangyo Bank Fuji Bank Sumitomo Bank	Dai-ichi Kangyo Bank Fuji Bank Sumitomo Bank Industrial bank	Dai-ichi Kangyo Bank Fuji Bank Sumitomo Bank Industrial bank	Dai-ichi Kangyo Bank Fuji Bank Sumitomo Bank Industrial bank	Dai-ichi Kangyo Bank Fuji Bank Sumitomo Bank	A1			
A2			The Long-term Credit Bank of Japan Mitsui Trust and Banking Yasuda Trust and Banking	The Long-term Credit Bank of Japan Mitsubishi Trust and Banking Sumitomo Trust & Banking	Sakura Bank Asahi Bank Tokai Bank	Sakura Bank Asahi Bank Tokai Bank	Sakura Bank Asahi Bank Tokai Bank Nippon Trust Bank	Sakura Bank Asahi Bank Tokai Bank Nippon Trust Bank	Asahi Bank Tokai Bank	Asahi Bank Tokai Bank Industrial bank	A2			
A3	<p>&lt;Reading the symbols&gt;            Deposit ratings (long term) for the end of each fiscal year            Aaa: offers exceptional financial security.            Aa: offers excellent financial security.            A: offers good financial security – can be considered in the upper-level of mid-range rating            Baa: offers adequate financial security.            Ba: offers questionable financial security – indicates speculative elements.            BB: offers poor financial security – indicates a lack of appropriate investment conditions            Caa: offers poor financial security.            Ca: offers extremely poor financial security, considered a speculative investment            C: is the lowest rated class, offers extremely poor prospects of ever offering financial security.</p>				Mitsui Trust and Banking Yasuda Trust and Banking Toyo Trust and Banking	Daiwa Bank The Long-term Credit Bank of Japan	Daiwa Bank The Long-term Credit Bank of Japan	Daiwa Bank The Long-term Credit Bank of Japan	Sakura Bank	Sakura Bank	A3			
Baa1								Mitsubishi Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Mitsubishi Trust and Banking Sumitomo Trust & Banking	Mitsubishi Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Daiwa Bank The Long-term Credit Bank of Japan Mitsubishi Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Daiwa Bank The Long-term Credit Bank of Japan Mitsubishi Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Baa1	
Baa2									The Hokkaido Takushoku Bank The Nippon Credit Bank, Ltd. Mitsui Trust and Banking Yasuda Trust and Banking The Chuo Credit Union Nippon Trust Bank	The Hokkaido Takushoku Bank The Nippon Credit Bank, Ltd. Mitsui Trust and Banking Yasuda Trust and Banking The Chuo Credit Union Nippon Trust Bank	Mitsui Trust and Banking Yasuda Trust and Banking	Mitsui Trust and Banking Yasuda Trust and Banking	Mitsui Trust and Banking Yasuda Trust and Banking	Baa2
Baa3											The Hokkaido Takushoku Bank The Nippon Credit Bank, Ltd. The Chuo Credit Union	The Hokkaido Takushoku Bank The Nippon Credit Bank, Ltd. The Chuo Credit Union	The Hokkaido Takushoku Bank The Nippon Credit Bank, Ltd. The Chuo Credit Union	Baa3

# Trends in Ratings For Major Banks (Moody's)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	
Aaa											Aaa
Aa 1											Aa 1
Aa 2										Mizuho Bank Bank of Tokyo-Mitsubishi UFJ Mitsubishi UFJ Trust Bank Sumitomo Mitsui Banking Corporation Mizuho Corporate Bank Mizuho Trust & Banking Co., Ltd.	Aa 2
Aa 3										Sumitomo Trust & Banking	Aa 3
A1	Bank of Tokyo-Mitsubishi Sanwa Bank						Mizuho Bank Bank of Tokyo-Mitsubishi UFJ Bank Sumitomo Mitsui Banking Corporation Mizuho Corporate Bank Mitsubishi Trust and Banking Mizuho Trust & Banking Co., Ltd. UFJ Trust Bank	Mizuho Bank Bank of Tokyo-Mitsubishi UFJ Mitsubishi UFJ Trust Bank Sumitomo Mitsui Banking Corporation Mizuho Corporate Bank Mizuho Trust & Banking Co., Ltd.	Mizuho Bank Bank of Tokyo-Mitsubishi UFJ Mitsubishi UFJ Trust Bank Sumitomo Mitsui Banking Corporation Mizuho Corporate Bank Mizuho Trust & Banking Co., Ltd.	Resona Trust & Banking Co., Ltd. Resona Bank Saitama Resona Bank Central Mitsui Trust and Banking	A1
A2	Sumitomo Bank Nippon Trust Bank	Bank of Tokyo-Mitsubishi	Bank of Tokyo-Mitsubishi	Bank of Tokyo-Mitsubishi	Bank of Tokyo-Mitsubishi	Bank of Tokyo-Mitsubishi	Sumitomo Trust & Banking	Sumitomo Trust & Banking	Sumitomo Trust & Banking	Aozora Bank Shinsei Bank	A2
A3	Dai-ichi Kangyo Bank Industrial bank	Sanwa Bank Sumitomo Bank Nippon Trust Bank	Dai-ichi Kangyo Bank Fuji Bank Industrial bank Sakura Bank Sanwa Bank Sumitomo Bank Tokai Bank Nippon Trust Bank Mitsubishi Trust and Banking	Dai-ichi Kangyo Bank Fuji Bank Industrial bank Sanwa Bank Sumitomo Mitsui Banking Corporation Tokai Bank Mitsubishi Trust and Banking	Mizuho Bank UFJ Bank Mizuho Corporate Bank Sumitomo Mitsui Banking Corporation Mitsubishi Trust and Banking Resona Trust & Banking Co., Ltd.	Mizuho Bank UFJ Bank Mizuho Corporate Bank Sumitomo Mitsui Banking Corporation Mitsubishi Trust and Banking Resona Trust & Banking Co., Ltd.	Resona Trust & Banking Co., Ltd.	Resona Trust & Banking Co., Ltd. Resona Bank Saitama Resona Bank	Resona Trust & Banking Co., Ltd. Resona Bank Saitama Resona Bank Shinsei Bank Central Mitsui Trust and Banking		A3
Baa1	Sakura Bank Fuji Bank Asahi Bank Tokai Bank Mitsubishi Trust and Banking Toyo Trust and Banking	Dai-ichi Kangyo Bank Sakura Bank Fuji Bank Asahi Bank Tokai Bank Industrial bank Mitsubishi Trust and Banking	Asahi Bank Toyo Trust and Banking Yasuda Trust and Banking	Asahi Bank Toyo Trust and Banking Yasuda Trust and Banking	Mizuho Asset bank UFJ Trust Bank	Mizuho Trust & Banking Co., Ltd. UFJ Trust Bank Sumitomo Trust & Banking Shinsei Bank Aozora Bank	Shinsei Bank Aozora Bank Central Mitsui Trust and Banking	Shinsei Bank Aozora Bank Central Mitsui Trust and Banking	Aozora Bank		Baa1
Baa2	Mitsui Trust and Banking Yasuda Trust and Banking	The Long-term Credit Bank of Japan The Nippon Credit Bank, Ltd. Yasuda Trust and Banking Toyo Trust and Banking Sumitomo Trust & Banking	Shinsei Bank The Nippon Credit Bank, Ltd. Sumitomo Trust & Banking	Shinsei Bank Aozora Bank Sumitomo Trust & Banking	Shinsei Bank Aozora Bank Sumitomo Trust & Banking		Resona Bank Saitama Resona Bank				Baa2
Baa3	Daiwa Bank The Long-term Credit Bank of Japan The Nippon Credit Bank, Ltd. Yasuda Trust and Banking The Chuo Credit Union	Daiwa Bank Mitsui Trust and Banking The Chuo Credit Union	Daiwa Bank Central Mitsui Trust and Banking	Daiwa Bank Central Mitsui Trust and Banking	Daiwa Bank Asahi Bank Central Mitsui Trust and Banking	Resona Bank Saitama Resona Bank Central Mitsui Trust and Banking					Baa3

# Special Inspections

(period ending March 2002)

Special inspections:

- Based on the 2001 Front-Loaded Reform Program, debtors with significantly fluctuating market evaluations were inspected for the purpose of establishing timely and appropriate allocation of debtor status reflecting their company performance and other market signals, and also that provided for depreciation and reserve funds

⇒ Inspection and verification of ¥12.9 trillion in credit for 149 debtors

【Summary or results】

Units (¥ trillion)

Period ending September 2001			Period ending March 2002		
Debtor Status	Number of Debtors	Total Amount	Debtor Status	Number of Debtors	Total Amount
Normal	50	3.2	Normal	35	2.4
			Requiring Attention	35	2.6
Requiring Attention	56	6.4	Requiring Management	45	4.2
			Significant Bankruptcy Risk and Below	34	3.7
Requiring Management	43	3.2			

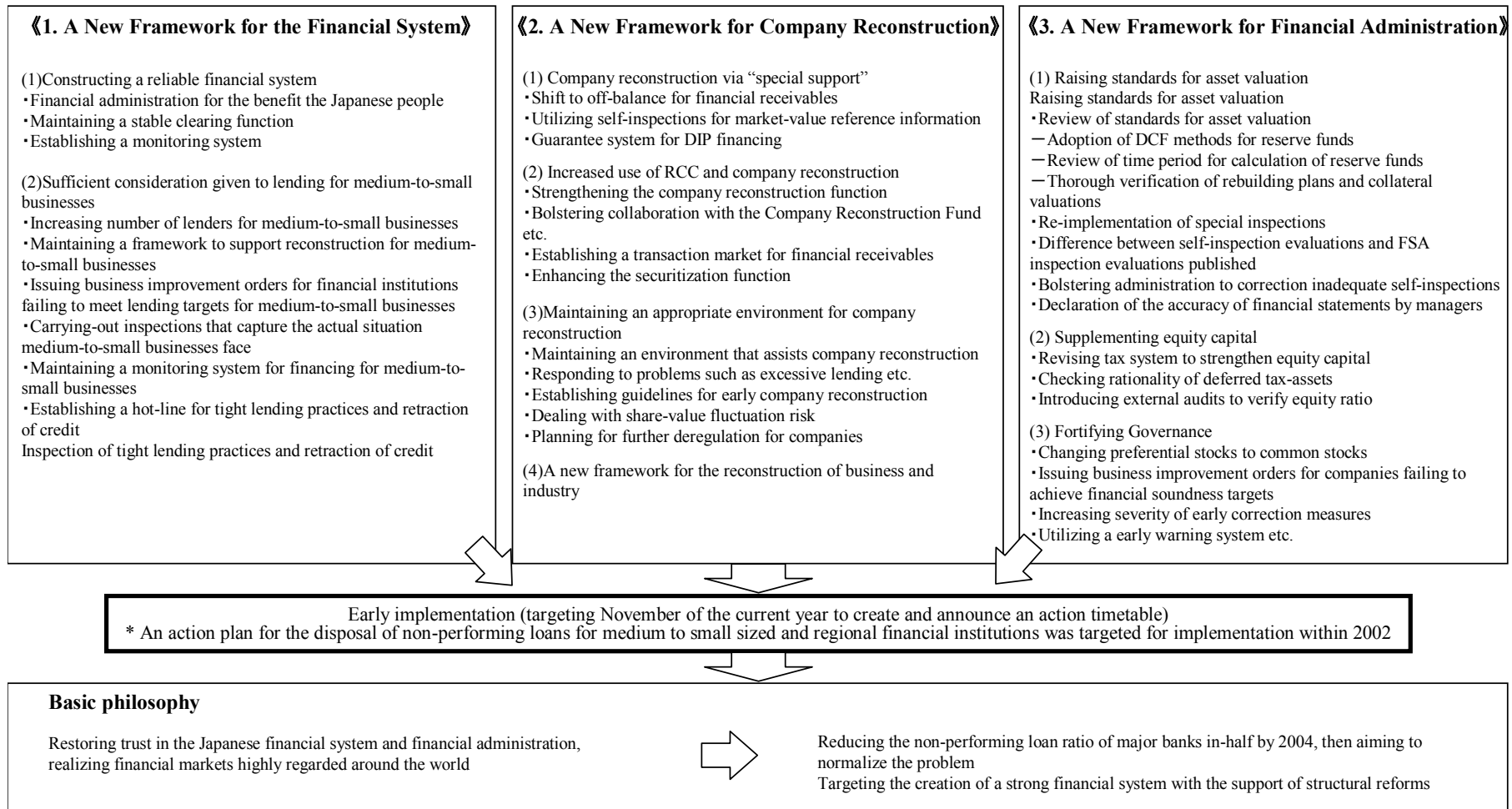
- 71 debtor companies – or approximately half and equivalent to ¥7.5 trillion – had their debtor status downgraded, among which 34 companies equivalent to ¥3.7 trillion were downgraded to “significant bankruptcy risk and below”
- as a result of the special inspections, loss on disposal of non-performing loans increased ¥1.9 trillion

# Financial Reconstruction Program

## Financial Reconstruction Program

—Economic Reconstruction Through Solving the Major Banks' Non-Performing Loan Problem—

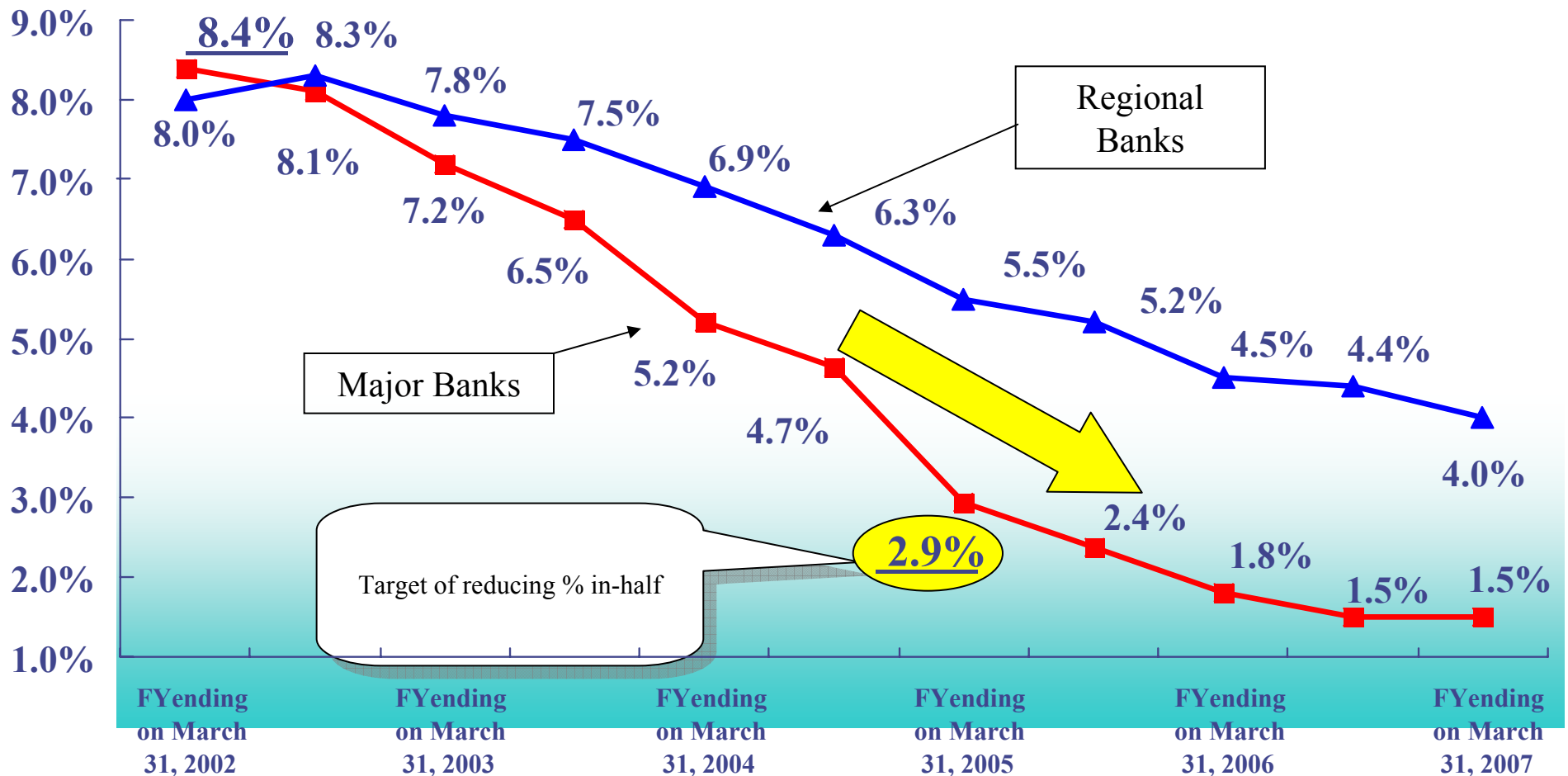
Economic reconstruction by solving the major banks' non-performing loan problem  
 – key elements are solving the major bank non-performing loan problem and progressing structural reforms  
 Forcibly reinvigorating the economy while attempting to minimizing hardship  
 – implementing an integrated policy combining measures for employment and also for medium-to-small businesses



# Progress Report on the Disposal of Non-Performing Loans

## ○ Financial Reconstruction Program (October 30, 2002)

By 2004, the ratio of nonperforming loans at major banks was reduced by half (period ending March 2002, 8.4%), and efforts to normalize the problem were continued



(Note) Numbers are based on those published in disclosure for the Financial Reconstruction Act