Banks Revolt against Takenaka's Financial Policies

By Tani Sadafumi

A severe shock has rippled across Japan's financial administration. While Prime Minister Koizumi Jun-ichiro was publicly promising President George W. Bush that he would accelerate the disposal of banks' non-performing loans (NPLs), the Bank of Japan (BOJ) announced that it would directly purchase banks' shareholdings. The prime minister reviewed the post of Yanagisawa Hakuo, then Minister for Financial Services, and appointed in his place Takenaka Heizo, advocate of a hard-landing approach to Japan's financial problems. Even though he has forced to back down in the face of opposition from the ruling parties and the financial establishment, around the end of October Takenaka announced the government's comprehensive package of anti-deflation measures. Let us take a look back over the circumstances surrounding these events.

While visiting the United States for a meeting of the United Nations General Assembly, Koizumi met with Bush in New York on Sept. 12 last year. In this meeting, Koizumi publicly promised to "step up the disposal of banks' NPLs," for which he won Bush's support. After his return to Japan, Koizumi, on Sept. 15, instructed the then Minister for Financial Services to speed up the disposal of banks' NPLs. In regard to his fellow cabinet member Takenaka, the Minister of State for Economic and Fiscal Policy, who advocated a bold solution to the problem of banks' NPLs, Yanagisawa had taken a negative stance on the injection of public funds into banks, based on the understanding that "currently there is no financial crisis."

Faced with these circumstances, the BOJ took bold action. After the conclusion of the Monetary Policy Meeting of the BOJ's Policy Board on Sept. 18, BOJ Governor Hayami Masaru reconvened the standing Policy Board and proposed that the BOJ directly purchase shares held by banks without going through the markets, and obtained unanimous consent for his proposal. The meetings were separated like this in an attempt to clearly present the share purchase not as a market operation but as a policy of "prudence" (financial stabilization).

The aim of the BOJ was to support the dissolution of the cross-shareholdings between banks and corporations, and to improve the management condition of banks, which was on a roller coaster due to fluctuating share prices. The details were studied, and the specific method announced by the BOJ on Oct. 11 was as follows: (1) The total value of the purchase is to be ¥2 trillion. (2) The period of the purchase is up to Sept. 30, 2003 (or if the goal was not met, up to Sept. 30, 2004). (3) The buy-up will target the shares of companies with a BBB$^-$ rating or higher, and additionally, the portion of those shares among the bank's equity capital that exceeds the bank's core capital (Tier 1).

After October, 2004, banks are to be prohibited from holding any shares over Tier 1 capital. As of the end of March, 2002, the value of shares over Tier 1 held by banks was ¥8 trillion. The BOJ would absorb one quarter of this from the market. About 10 banks are targeted.

This decision caused considerable surprise, given that until that time, the BOJ had rejected calls for a purchase of the banks' shares, saying that it could damage the BOJ's financial soundness, and even weaken the value of the yen. Nakahara Nobuyuki, a former appointed member of the BOJ's Policy Board, said the measure "ran counter to existing policies," and Yamamoto Kozo, a Diet member, criticized the plan by asserting that "if it can be done, it should have been done right from the start." In fact, Hayami himself admitted that the measure, yet to be tried by any central bank in the United States or Europe, was certainly a move normally "off limits to banks and not a conventional measure."

Nevertheless, the BOJ resorted to this "non-traditional measure" because of its skepticism about the government's stance on the NPL problem. Article 43 of the Bank of Japan Law says that the central bank can take any measures needed to preserve the financial system. But Yanagisawa had given no thought to invoking Article 102 of the Deposit Insurance Law, which would indicate that a financial crisis had been declared. In considering the application of the law, there is clearly a gap between the government and the BOJ. For the BOJ's part, its dramatic decision was a call to action for a government that was not taking the crisis seriously enough. A top official for the Financial Services Agency (FSA) bluntly commented: "They went ahead and jumped from the top of the cliff. To say 'now it's the government's turn' is a little strange."

Unexpectedly, the BOJ's approach proved right. At a cabinet reshuffle on Sept. 30, last year, Koizumi moved Yanagisawa aside and made Takenaka both Minister of State for Economic and Fiscal Policy and Minster for Financial Services concurrently. Until directly before this, attention was indeed focused on Yanagisawa's prospects, but nobody had predicted that victory would be awarded to just one of the two big hitters, whose paths were so different. In Japan's political culture, when both parties are involved in a quarrel, it is rare for just one side to emerge the clear winner. Takenaka, who received the prime minister's nod, pursued the experiment in bold financial reform.

Takenaka moved to resolve the NPL problem by confronting the banks with three basic policies: (1) Stricter assess-

ments of bank assets, (2) Strengthening of equity capital, and (3) Stronger good governance (management discipline). In addition, Takenaka established a Project Team for an Emergency Strategy for the Financial Sector and appointed a former staff member of the BOJ and financial consultant, Kimura Takeshi, to the team. Kimura is a bold reformer who drew up a list of 30 major heavily-debt-ridden companies which should withdraw from the market in 2001. His role was to put flesh on the hard-landing approach of Takenaka.

Many Diet members, who felt slighted by Takenaka's administrative approach of giving important posts to members of the private sector, harbored bitter feelings. Takenaka did not flinch despite all this, surely because of his confidence in being appointed by the prime minister and because he enjoyed the backing of the U.S. government. Minister of Finance Shiokawa Masajuro has praised Takenaka's approach out of a desire to help keep the Koizumi government in power.

Let us look at the main points of the financial regeneration plan drawn up by Takenaka, based on a draft by Kimura: (a) Reduce the proportion of the NPLs of the major banks to half their current level (8%) by the end of fiscal 2004 (March 31, 2005). (b) The FSA will carry out another special inspection of the banks. (c) The discount cash flow (DCF) method, used in the United States, will be applied to assessments of banks' assets. (d) From the accounting period ending March 31, 2004, the upper limit for deferred tax assets will be limited to 10% of Tier 1 capital as in the United States (currently the limit is approximately 40%). (e) Actively inject public funds. (f) Reshuffle, in principle, all the presidents of the banks that have accepted infusions of public funds and converted preferred shares already held by the government to common shares, and instruct those banks not to pay out retirement benefits. (g) Do not demand managerial liability for bank executives who retire by Dec. 31, 2002.

The cardinal points of this plan are rigorous: (1) Strictly assess banks' assets through special inspections and the introduction of the DCF method while encouraging the building up of allowances for loans. (2) Limit the inclusion of deferred tax assets. (3) To restore the capital adequacy ratios, which will drop as a result, inject public funds and effectively nationalize several major banks. (4) While cleaning up the management of those banks, sort debt-ridden companies into those that can be resuscitated and those that cannot. Naturally, this plan incurred fierce opposition from the Liberal Democratic Party, which is concerned about the survival of small and medium-sized enterprises, and from major banks afraid of being placed under the government's administration.

Takenaka held three rounds of talks with the top management of the major banks to try to persuade them to accept the plan, but failed. It was when the second round was held on Oct. 25 that seven chief executives of the banks took the unprecedented step of holding a joint press conference. At the meeting with the press, which began at 10 o'clock in the evening, the bankers were uniformly critical. Teranishi Masashi, head of the UFJ Bank and Chairman of the Japanese Bankers' Association said: "We were not able to have constructive talks with Takenaka." The President & CEO of the Bank of Tokyo-Mitsubishi, Miki Shigemitsu, asserted: "If deferred tax assets are to be treated the same way as in the United States, we should be refunded for past taxable depreciation and any new disposition should be tax free." Takahashi Atsushi, the President & CEO of the Sumitomo Trust & Banking Co., commented: "This brings into question whether Japan is really a constitutional state or not."

What financial circles saw as the biggest problem with Takenaka's proposals was the limitation on the inclusion of deferred tax assets. Teranishi commented: "We cannot tolerate the government suddenly changing the rules while the game is in progress. We thought we were playing soccer, but now the rules are for American football." According to estimates by Merrill Lynch Japan Securities Co., if Takenaka's proposals were implemented as they stand, among the major banks, only Sumitomo Trust & Banking and the Mitsubishi Tokyo Financial Group could maintain their capital adequacy ratios at the level required for international business, 8% or over. The others would not be able to meet the standard, for instance, the UFJ Group (7.01%) and the Resona Group (3.88%).

In the end, the comprehensive package of anti-deflation measures announced on Oct. 30, last year was a watered-down version of Takenaka's original proposals. In regard to deferred tax assets, the expression was "these will be immediately examined," while in regard to the infusion of public funds, the ambiguous wording was "this will be done when necessary."

Takenaka was not able to overcome the banks' objections to the effect that "if strict standards on tax enforcement are to be imposed on the banks as in the United States, then U.S.-style policies favorable to banks should also be adopted." And, because he tried to carry out his policies without drawing on the help of the bureaucrats, who are experts in laying groundwork behind the scenes, Takenaka was unable to enlist the cooperation of the ruling parties in dealing with legislative procedural problems. However, by promoting hard policy debate, he has succeeded in opening the eyes of large numbers of people to the country's financial problems. In addition, even though the government backed off from Takenaka's initial proposals, the banks have been forced to strengthen allowances for NPLs. As we move toward the goal of halving NPLs by the end of fiscal 2004, the second act in the whole financial policy debate is surely due to begin shortly. JJTI

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