

Tighter Auditing Leads to Public Funds Injection for Resona

By Tani Sadafumi

On July 1, the government injected nearly ¥2 trillion of public funds into Resona, one of Japan's leading financial groups, virtually nationalizing the Group. As a result of the bail-out, Resona's capital adequacy ratio, which had fallen below the level required for sound management, recovered into the double digit range. This avoided the kind of negative economic impact that resulted from the jitters that rippled through Japan's financial system when the Hokkaido Takushoku Bank and Yamaichi Securities went bankrupt in 1997, and when the Long-Term Credit Bank of Japan and the Nippon Credit Bank failed in 1998. However, there remains little likelihood of rebuilding Resona. The government's handling of Resona on this occasion has raised many issues relating to the administration of banks by the Financial Services Agency (FSA).

Resona, which is Japan's fifth largest financial group after Mizuho, Sumitomo Mitsui, Mitsubishi Tokyo, and UFJ, was formed through a merger this year between Daiwa Bank and Asahi Bank (itself the result of a merger between Kyowa Bank and Saitama Bank). Under the umbrella of the holding company Resona Holdings, Inc., the Resona Group consists of the Resona Bank, the core of the Group, the Resona Trust & Banking Co., and three banks with regional operating bases – Saitama Resona Bank, the Kinki Osaka Bank and the Nara Bank. While Resona styles itself as a "super regional bank" and follows a management policy that distinguishes it from the megabanks mentioned above, the fragility of its finances has been recognized for some time.

The trigger for the public capital injection into Resona was the bank's auditors. According to sources in Diet deliberations and press conferences, Asahi & Co., one of the two auditing companies that checked Resona's accounts for the year to March 31,

2003, resigned as auditor in mid-April because of "a major difference in thinking on tax-deferred assets wherein it was not possible to reach accommodation with the Bank" (President, Iwamoto Shigeru). The remaining auditor, Shin Nihon & Co., gave its final approval to Resona's accounts, on the condition that the bank reduced tax-deferred assets. As a result, Resona became undercapitalized and governmental support was needed.

Tax-deferred assets are assets for accounting purposes and are able to be treated as capital; when banks dispose of their non-performing loans (NPLs), the taxable paid amounts are expected to be refunded. However, a precondition of this is that profits will be made to put the banks in the black. The auditors concluded that the outlook for the bank's results was not as rosy as top management seemed to think.

In concrete terms, while Resona claimed it had five years' reserves of tax-deferred assets, the auditor Shin Nihon & Co. notified the bank that this had to be reduced to three years. The impact of this tighter assessment of the bank's capital was to bring its capital adequacy ratio down by about 2.6 percentage points. And as a result of other negative factors such as the fall in Japanese share prices, Resona's capital adequacy ratio, which should have been above 6%, plunged to 2.07%. Resona Holdings capital adequacy ratio was in the 3-4% band, below the benchmark for sound management of 4% (the level for domestic banks).

In response to this situation, on the evening of May 17, Prime Minister Koizumi Jun-ichiro invoked Article 102 of the Deposit Insurance Law for the first time to call a meeting of the Financial System Management Council, which he chaired himself, at the prime minister's official residence. The urgency of the meeting is clear from the fact that it took place despite the absence of its main member, Shiokawa

Masajuro, the Finance Minister, who was attending a Group of Seven (G7) finance ministers' summit in Normandy, France. The financial crisis response council, which includes Koizumi, Chief Cabinet Secretary Fukuda Yasuo, FSA Minister Takenaka Heizo and Bank of Japan Governor Fukui Toshihiko, immediately drew up a policy to inject public funds into Resona.

The next steps were an application by Resona for public funds (May 30), an official decision by the government to grant the funds (June 10) and a vote by a Resona general meeting of shareholders (June 27). As a result, on July 1, the government injected ¥1.96 trillion into the Bank, gaining management rights as its largest shareholder, with holdings of more than 70%. The public funds boosted Resona Bank's capital adequacy ratio to 12.2%, and that of Resona Holdings to 11.9%, the level of a sound regional bank.

Many of the bank's top executives resigned, including Katsuta Yasuhisa, the President of Resona Holdings and leaders affiliated with him. In their place, a new management system was inaugurated, staffed as follows: Hosoya Eiji, Chairman of Resona Holdings (former JR East Japan vice-president); Kawada Kenji, President of Resona Holdings (formerly, Resona Holdings Managing Director and Corporate Executive Officer [connections to Saitama Bank]); and Nomura Masaaki, head of Resona Bank (former Executive Director of Resona Holding [connections to Daiwa Bank]). At the same time, the new Resona Bank became Japan's first major bank to switch to a U.S.-style corporate governance model where outside directors monitor management.

Looking back on these events, everything seems to have gone Takenaka's way. Takenaka, who was appointed FSA Minister in addition to his post as Minister of State for Economic and

Fiscal Policy in a cabinet reshuffle in last autumn, was in favor of injecting public funds into major banks driven into a state of capital insufficiency through strict assessments of their tax-deferred assets and strengthening of the reserve requirements for NPLs. However, this strong line met with powerful resistance from the major banks and Takenaka was forced to retreat. From the sequence of events, it looks as if Takenaka's rollback succeeded, but in actual fact, the bail-out of Resona was accidental rather than planned.

According to Katsuta, it was May 6 when the Shin Nihon auditors notified Resona that it should reduce its tax-deferred assets to a three-year amount. The next day, a dismayed Resona reported these audit findings to the FSA. At the same time, the due date for the release of Resona's accounts settlement data was no more than 20 days away (May 26). Katsuta said in a press conference held on May 17: "Notification in May by the auditors that our settlement of accounts had been disaffirmed was tantamount to a breach of faith." His rancor was based on the fact that it was too late at that point for the bank to do anything independently to raise its capital adequacy ratio.

The handling of Resona by the auditors was like a thunderbolt from the blue, not only for Resona but also for the FSA and Takenaka. The invoking of Article 102 of the Deposit Insurance Law, the basis for convening a meeting of the Financial System Management Council, was equivalent to the government declaring a financial crisis. However, at a meeting of the House of Representatives Budget Committee on May 28, Takenaka replied in a luke-warm fashion to an assertion by a member of the opposition party that the fiscal system was on the verge of a crisis. Takenaka stated that in the case of a person who is ill, "crisis" is used to mean a "critical condition," and he did not recognize a crisis in that sense. And in a press conference at the conclusion of a meeting of the Financial System Management Council, he said: "This injection of public funds does not mean bankruptcy proceedings for the

bank but support for it," emphasizing that this was a preventive measure to maintain the financial system. It could be said that with little time left before the accounts of the bank were due to be released, the only effective step for the government was to nationalize Resona.

In addition to Takenaka, many financial commentators have commented on major banks' over-use of tax-deferred assets in their finances. In this sense, the refusal of the auditors to pass Resona's financial statements was applauded by many economists. However, the top management of one auditing company said that the notion of passing responsibility for the management of banks and, by extension, for the financial system, on to audit companies could cause problems. Yanai Noboru, outside director of Resona Holdings and president of Arrow Consulting (formerly a director of the Long-Term Credit Bank of Japan) severely criticized the FSA's response to Resona by accusing the FSA of a dereliction of duty in claiming the problem was the responsibility of the bank and its audit company.

The problem here is the propriety of the auditors. The Resona problem made it clear that the discretion of an auditor can have a huge impact on the financial affairs of a major bank. Of course, the auditors base their judgments on certain rules. However, in the House of Representatives' Committee on Financial Affairs convened on June 11, Takeyama Kenji, president of Shin Nihon & Co., which finally approved Resona's financial statements, said, referring to the treatment of tax-deferred assets, that Resona's claim that it had five year's reserves was unrealistic, but if a three year period was used instead, he thought the bank had a possibility of recovery. But Iwamoto of Asahi & Co., which resigned from the audit, took a different view, saying: "Without its tax assets, the bank would be undercapitalized."

The source of the difference between the two opinions is unclear, because the details of the audits were not made public, but there is some suspicion that Resona was overburdened with debt. Assuming that this was the case, the government should surely have been

obliged to institute bankruptcy proceedings rather than bail Resona out. Of course, instituting bankruptcy proceedings would require a huge amount of funds. It could also trigger instability in the financial system, and the Japanese economy, finally showing signs of life, could stall.

This was the reason that the representatives from various countries attending the G7 finance ministers' summit showed strong appreciation for the government's response, as explained by Shiokawa. However, if Resona was over-indebted and could not be reformed, resuscitating it when it should be permitted to go under could set a bad precedent for the future. Japan's financial sector is over-banked as it is.

Another point is the suspicion that arises out of the Resona case. While some banks would be less prone than others, doubts could arise about the financial condition of other banks. Katsuta suggested by his tone in press conferences and other venues that if the audit had employed the same standards as usual, a substantial drop in Resona's capital adequacy ratio could have been avoided. With the Enron accounting scandal in the United States, auditors have begun investigating more thoroughly than before. However, will strict auditing extend to all banks? Many in the industry say that collusive auditing is rife in regional banks.

Okuyama Akio, chairman of the Japanese Institute of Certified Public Accountants, predicted that auditing of accounts for the settlement period that ends next March will be very strict and banks may be obliged to assess their tax-deferred assets as zero. He also said that accountants will not hesitate to perform strict audits. It is highly probable that the audit shock that hit Resona will reach other banks as well. **JTI**

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