Shinsei Bank and Japan's Foreign-Capital Allergy

By Tani Sadafumi

SHINSEI Bank, corporate successor to the bankrupt Long-Term Credit Bank of Japan (LTCB), listed its shares on the first section of the Tokyo Stock Exchange in mid-February. Investors were impressed with the bank's low level of non-performing loans (NPLs) and high capital adequacy ratio, allowing the issue to post a strong opening price of ¥872. Shinsei Bank ranks sixth in aggregated market value among Japanese banks after Resona Holdings, with over ¥1 trillion. *Shinsei* means "newly born" in Japanese, and in the five years and four months since the collapse of the LTCB, the name has come to signify a large, healthy bank.

Despite this good news, the listing of Shinsei Bank's shares has been the subject of a great deal of less-than-enthusiastic commentary in Japan. The main reasons are: (1) much public money was injected to deal with the collapse of the LTCB; (2) Shinsei Bank's purpose-driven business stance has caused friction with other financial institutions and corporate borrowers; and (3) foreign capital was able to obtain high investment returns as a result. An executive from a large Japanese bank said, "Emotionally, it is frustrating to see foreign capital rake in huge profits after all the public funds that have been injected to restore the bank's health."

The LTCB, once an outstanding number one in a survey of bank employees entitled "The Bank Where I Want My Son to Work," defaulted in October 1998. The cause was negative equity from NPLs left over from the recklessly rapid expansion of loans on the books during Japan's bubble economy. The asset sheet included conspicuously large loans to resort developer EIE International Corp., which subsequently defaulted, triggering the bank's collapse. Simultaneous with the LTCB's default, the government announced that it would be placed under special public administration, and temporarily nationalized the bank.

In the summer of 1998, when it became apparent that LTCB's operations were at risk, the Sumitomo Trust and Banking Co., considered acquiring the institution, but the negotiations ended without an agreement. The institutions that offered themselves as post-default successors were mostly foreign, and ultimately a purchase agreement was concluded in February 2000 between New LTCB Partners CV, an investment fund led by Ripplewood Holdings, L.L.C., of the United States; Deposit Insurance Corp. of Japan (the Japanese government); and the LTCB. In March of the same year, the LTCB started over as a private sector bank, and changed its name to Shinsei Bank three months later.

The acquisition price consisted of ¥1 billion in "goodwill." Additionally, the New LTCB Partners subscribed to newly issued shares, for which they paid ¥120 billion. The amount invested to purchase the LTCB was therefore ¥121 billion.

The purchase agreement included a loan buyback provision, which was later to emerge as a problem. The provisions of this contract were similar, for instance, to a housing construction company's covenant promising repair work free of charge in the event of rainwater leakage from a building's roof during a contractually determined time period. The intent is to protect the purchaser from slipshod construction work. In the case of LTCB, these provisions required the government to buy at face value any loan assets (loans) originated by the LTCB in the three years to February 2003 that showed 20% or more deterioration in asset value relative to face value and were subject to material concern that principal and interest might become irrecoverable or that payments might fall into arrears.

In dealing with the bankruptcy of the LTCB, the government spent ¥3.6 trillion in public funds to replenish the bank's negative equity. The government bought claims on loans to 321 companies with a face value of ¥1,123.5 billion for a consideration of around ¥800 billion in accordance with the loan buyback provision. Including other items, the public funds injected so far amount to slightly under ¥8 trillion. Out of this, the estimates of losses due to the initial replenishment of negative equity are ¥4-5 trillion, which is ultimately to be absorbed by the public.

In contrast, foreign owners raised ¥220 billion in cash from a public offering of 32% of their stake in the bank. This translates into a gain of around ¥100 billion generated from an investment of ¥121 billion in March 2000. Additionally, since the investment fund still holds around 70% of Shinsei's share capital (with a total market value of ¥700 billion), depending on future business performance, gains can be expected from share offerings and distribution of high dividends.

Ripplewood has as a result been the target of criticism, and is accused of being a "vulture fund reaping exorbitant profits from a bank cleaned up at the expense of Japan's taxpayers."

In response to such attacks, Shinsei Bank President Yashiro Masamoto observes; "The ¥8 trillion in public funds used should be seen in light of the additional ¥40 trillion (in public capital) that was put into other Japanese financial institutions." Yashiro emphasizes that the ¥8 trillion in public funds has developed a life of its own. Those who wish to take issue need to realize that other Japanese banks have received huge injections of public funds. To be sure, the ¥3.6 trillion used to replenish the negative equity of LTCB will not be returned, but this is a management issue of the bankrupt LTCB, and not the responsibility of Shinsei Bank. Loans bought by the government under the loan buyback provision are potentially recoverable, and the government may expect capital gains from ¥300 billion from the preferred shares issued by Shinsei Bank in return for injected public funds.

Prime Minister Koizumi Junichiro

noted in response to questions at a press conference, "Japanese companies also had the chance to make this acquisition, had they wanted to. But it was foreign capital that took the risks, and thus received the rewards." Kaneko Kazuyoshi, Minister of State for the Industrial Revitalization Corp. of Japan, who worked at the LTCB, lamented; "I wish Japanese financial institutions would have had the know-how and risk-taking capacity. Unfortunately, they didn't."

Shinsei Bank's purpose-driven, U.S.-type business style is yet another target of criticism. The bank's loan balance as of the end of September 2003 was ¥3.5 trillion. This volume amounted to one-fourth of the loan balance of the LTCB immediately before its default, and less than half of the figure when Shinsei Bank took over the LTCB's business in March 2000. This is because Shinsei Bank has been writing off loans on which it is unable to obtain risk-adjusted margins. In the context of Japanese business practices, this method is certainly exceptional.

Japanese banks sometimes continue or even increase loans despite a borrowers' poor business performance and remote prospects for rehabilitation. Their objective in doing so is not only to assist a borrowers' restructuring efforts. It is also because loans that become irrecoverable must be written off as delinquent assets. When write-offs threaten to weigh on the financial position of the bank, the situation may require turning a blind eye to a borrower's problematic future. Moreover, to call in loans often means inconveniencing other lenders, because the collected amounts must be substituted by a borrower's main bank. The culture of Japan's financial institutions rejects this type of behavior.

In contrast, Shinsei Bank's superior financial strength allowed it to proactively dispose of NPLs. Having executed the loan buyback provision, it was able to painlessly sell the government its loans to high-risk borrowers. Undeniably, in the process of loan collection, Shinsei Bank incurred the resentment of corporate borrowers and other financial institutions.

Regarding the loan buyback provision, however, the government at one point called a halt to a rigorous examination that Ripplewood was about to conduct of the LTCB's loan assets. After examinations by the Financial Services Agency, major banks have lately been applying stricter examination criteria and have increased loan-loss reserves. At the time, however, examinations had been lenient, and the government was concerned that Ripplewood's rigorous assessment of LTCB's asset quality might destabilize confidence. In fact, when the LTCB was handed over in March 2000, loans to Sogo, a major department store that later went bankrupt in the summer of the same year, were classified by many banks as claims on a normal borrower without risk of loan loss.

Had a foreign investment fund thoroughly examined LTCB's assets, it might have prompted examinations at other banks and jolted the financial system immediately after it had managed to get some room to breathe. The LTCB, if likened to a house, appeared to have a roof affected by slipshod work. Ripplewood understood that it should not acquire the LTCB at the government's indicated value, and this compelled the government to execute the loan buyback provision, disadvantageous as it was.

The desire to obtain a lending margin commensurate with risk is natural for bank managers. It was the Japanese banks' half-hearted support for companies with an uncertain future that degraded their strength. While there is no guarantee of success, Japanese banks have recently been eager to increase their lending spreads. In this sense, perhaps Shinsei Bank has set a good example.

Shinsei Bank does not rely on interest income alone. Fee income from corporate mergers and acquisitions (M&As) is a cornerstone of its business. Japanese banks would like to engage in this type of investment banking operation, but have little expertise. Additionally, with its 24-hour free-of-charge automated teller machine (ATM) service, Shinsei Bank is ahead even in retail banking. Therefore, the positive effects of the stimulus that Shinsei Bank has given to Japan's financial industry should find greater appreciation.

The recent public listing of Shinsei Bank's shares has brought to light a deep-rooted problem: Japan's hard-to-cure foreign-capital allergy.

For example, executives in the administration of Tochigi Prefecture who were searching for an institution to take over the operations of Ashikaga Bank (whose principal office is registered in Ashikaga City, Tochigi Prefecture), which, like the LTCB, was nationalized upon its default in November 2003, heard of the huge profits earned by foreign investment capital on the occasion of Shinsei Bank's stock exchange listing. These officials said they then felt that "foreign capital is out of the question" and "chopping up NPLs to pursue a single-focus profit motive is problematic." According to their reasoning, given that many local Japanese inns catering to tourists in Tochigi Prefecture were borrowers of Ashikaga Bank, funds would drain away from this tourist region in reaction to falling visitor numbers if those loans were acquired by a foreign-capital institution.

Sweeping judgment is unfair, and conveys an image of ill fortune for Japan itself. Shinsei Bank incorporates a new business model that will naturally gain appreciation as its financial operations unfold. I hope the allergy to foreign capital will be cured in the process. JS

Tani Sadafumi is an editor in the Economic Division of Jiji Press Co., Ltd. His work focuses on the Bank of Japan and the Ministry of Finance. At the Washington branch of Jiji Press, he specialized in matters of trade and industry.