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Provision of Subordinated Loans for Major Japanese Banks

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Abstract

During the international financial turmoil associated with the global financial crisis, Japan's financial institutions remained relatively sound because their exposure to overseas structured credit products was limited. Restructuring since Japan's own banking crisis in the late 1990s also contributed to making Japanese banks resilient to external shocks. Nonetheless, Japanese banks' profitability was at risk. Due to the large amount of stock holdings, major banks had large market risks which might significantly worsen their capital ratios. The increasing volatility of stock prices could make banks be conscious of capital constraints in the future and could trigger an adverse feedback loop between the financial system and the economy. Against the downside risks, on March 17, 2009, the Bank of Japan (BOJ) announced a new framework to provide subordinated loans to major banks that were subject to international capital standards as a safeguard. The framework was formally established at a regular meeting of the Policy Board of the BOJ on April 10, 2009. Four auctions were held under the framework, but only one bank made a bid. Reflecting the improvement of market conditions, the framework ended by the end of March 2010 as planned at the beginning. The scheme was completed when the bank fully repaid its 20 billion yen ($209 million) loan on the earliest day allowed under the contract.

Keywords: Recapitalization, Bank of Japan, Subordinated Loan, Stock Price

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Provision of Subordinated Loans for Major Japanese Banks

At a Glance

During the international financial turmoil associated with the global financial crisis, Japan's financial institutions remained relatively sound because their exposure to overseas structured credit products was limited. Restructuring since Japan's own banking crisis in the late 1990s also contributed to making Japanese banks resilient to external shocks. Nonetheless, Japanese banks' profitability was at risk. Due to the large amount of stock holdings, major banks had large market risks which might significantly worsen their capital ratios. The increasing volatility of stock prices could make banks be conscious of capital constraints in the future and could trigger an adverse feedback loop between the financial system and the economy.

Against the downside risks, on March 17, 2009, the Bank of Japan (BOJ) announced a new framework to provide subordinated loans to major banks that were subject to international capital standards as a safeguard. The framework was formally established at a regular meeting of the Policy Board of the BOJ on April 10, 2009. Four auctions were held under the framework, but only one bank made a bid. Reflecting the improvement of market conditions, the framework ended by the end of March 2010 as planned at the beginning. The scheme was completed when the bank fully repaid its 20 billion yen ($209 million) loan on the earliest day allowed under the contract.

Summary of Key Terms

Purpose: To provide subordinated loans for major banks that had large market risks, thereby reducing the risk of future capital constraints that could trigger an adverse feedback loop between the financial system and the economy.

Announcement Date	March 17, 2009
Operational Date	April 10, 2009
Expiration Date	June 29, 2012
Legal Authority	Bank of Japan, Authorization for the exception under Article 43(Minister of Finance Prime Minister)
Peak Utilization	1 bank with 20 billion yen ($209 million)
Participants	Bank of Japan

Summary Evaluation

There has been little evaluation of the provision of subordinated loans. It is difficult to assess the effectiveness of the program because the program was established as a backstop to prevent banks from becoming conscious of capital constraints in the future. The reactions of market participants at the announcement of the framework were mixed. Some analyst said that the program would help banks looking to issue subordinated debt and boost their Tier-II capital. On the other hand, another analyst argued that it was "more symbolic than anything" because core, Tier-I capital was what the market watched closely and because Japanese major banks were already able to raise subordinated debt in the market.

At the first auction on May 29, only Sumitomo Trust & Banking Co., the eighth largest bank in Japan at the end of March 2009, made a successful bid for a 20 billion yen perpetual subordinated loan at the minimum spread (210bp). There was no bid for 10-year subordinated loans at the auction, and no banks took part in the remaining three auctions

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I. Overview

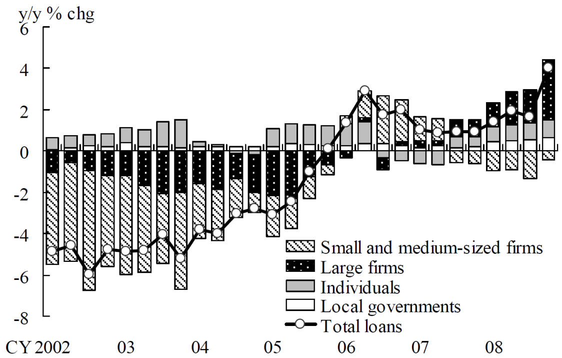
Background

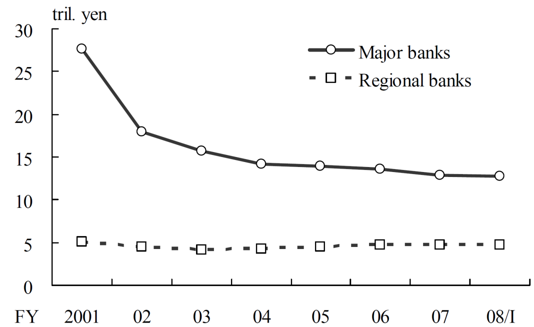
Although Japan's financial system remained relatively stable, on the whole, during the global financial crisis, the strains in global financial markets and worsening economic conditions at home and abroad negatively affected the financial intermediation function and robustness of the system in Japan. Reflecting the declining function of commercial paper and corporate bond markets, financial conditions for firms' funding in capital market had deteriorated since the autumn of 2008. Japan's financial institutions, which had shown robustness to a certain degree amid the turbulence of the global financial system, retained financial intermediation function and supported firms through the increase of lending as shown in *Figure 1* below. As Japanese banks had been fortifying their financial bases since Japan's own banking crisis in the 1990s and had limited exposure to overseas structured credit products, their business was relatively sound compared to foreign counterparts. However, market risk associated with stockholdings had increased, especially for major banks, and credit risk that had previously been in decline also turned upward as shown in *Figures 2-4* below. A substantial amount of both realized and unrealized losses on stockholdings had been reported amid a leveling off in the outstanding value of banks' stockholdings. Given the increased volatility of stock prices, the management of market risk associated with stockholdings remained an important challenge for banks. *The Financial System Report (FSR) in March 2009* pointed out that even under the assumption of future economic downturns with different degrees of severity, the banking sector's expected losses were not so large that banks' Tier-I capital ratios would substantially deteriorate. However, the FSR warned that if banks became more conscious of capital constraints in the future, the decline of stock prices could have a negative effect negatively on financial intermediation from a macro perspective.

Recognizing the risks of a potential adverse feedback loop between the financial system and the economy, the Bank of Japan (BOJ) announced a new framework to provide subordinated loans to banks after the regular meeting of the Policy Board on March 17, 2009. This measure aimed at ensuring the smooth functioning of financial intermediation and the stability of Japan's financial system, by enabling Japan's banks to maintain sufficient capital bases even in severe financial and economic environments.

Figure 1: Bank Loans Outstanding by Type of Borrower (Left)

Figure 2: Banks' Stockholdings (Right)



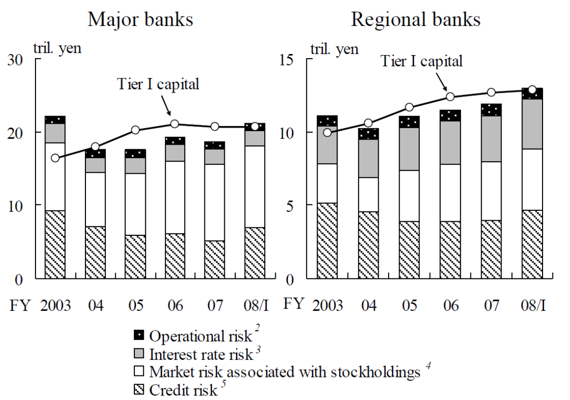


Notes: *1*. Figures are based on acquisition prices.
2. On a consolidated basis.

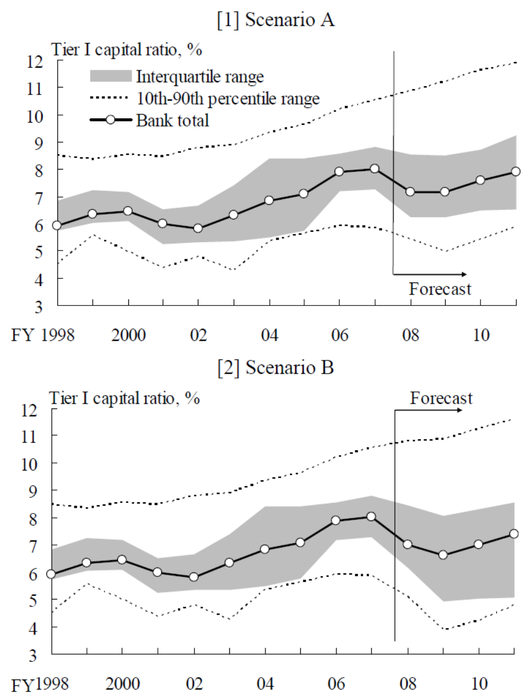
Source: *Bank of Japan. 2009*

Figure 3: Risks and Tier-I Capital (Left)

Figure 4: Dispersion of Tier-I Capital Ratios where both Economic Downturn and Stagnating Stock Price Occur (Right)



Notes: *1*. Bank of Japan estimation.
2. Operational risk is defined as 15 percent of gross profits based on the Basel II basic indicator approach.
3. Interest rate risk is limited to yen-denominated bond portfolios and calculated by the same method as in Chart 3-13.
4. Market risk associated with stockholdings is measured using TOPIX as a risk factor, given 1-year holding period and 99 percent VaR.
5. Credit risk is calculated by subtracting the expected loss (EL) from the maximum loss (EL + UL) based on the Basel II risk weight formulas with a confidence interval of 99 percent. In the estimation, borrowers classified as requiring "special attention" or below (in terms of credit quality) are considered to be in a state of default. The relaxation of requirement for restructured loans is not taken into account.



Note: *1*. Bank of Japan estimation.

Source: *Bank of Japan. 2009*

Program Description

On April 10, 2009, the BOJ decided to set "*Principal Terms and Conditions for Provision of Subordinated Loans*" at a regular meeting of the Policy Board and released the outline of the framework on the same day. The program was created as a temporary measure and planned to close new loan disbursement by the end of March 2010.

Under the new framework, the BOJ offered 10-year subordinated loans and perpetual subordinated loans, which could be counted as Tier-II capital under Basel II, to the banks that were subject to international capital standards up to 350 billion yen[2] for each bank and 1 trillion yen in total. The loan did not require collateral. Recipients of each loan had the right to redeem the loan beginning three years later after disbursement. To incentivize financial institutions to repay the borrowed funds as soon as possible, the interest rate would increase by 1.5% after five years of loan disbursement.

The amount of each loan and interest rates for the first five years on the 10-year and perpetual loans were determined at auctions using a premium over the six-month yen LIBOR.

A multiple-price competitive auction was conducted for each loan in which banks bid "yield spreads," which were calculated by subtracting the "minimum spreads" determined by the Bank of Japan from the spread which banks desired to add on the base rate (six-month yen LIBOR).

The minimum spread was set by the BOJ at each auction for 10-year loans and perpetual loans, in light of market conditions, so as not to interfere with capital raising by financial institutions through markets. The minimum spread for each auction was released about ten days before each auction.

The auction schedule was published on May 8; the auctions were held on May 29, August 27, November 26, and February 24, 2010. The total amount of loans and the average spread in each auction were released after each auction. The names of recipients of the loans were not published after each auction but were released around the end of May 2010.

The new scheme was designed to complement the two other channels for financial institutions to raise capital: (1) capital raising by financial institutions themselves in the market and (2) capital raising based on the Act on Special Measures for Strengthening Financial Functions, which was amended on December 16, 2008,[3] and provided public funds as Tier-I capital. The provision of subordinated loans aimed to provide another channel for major banks, which were directly affected by the potential decline of stock prices, to raise Tier-II capital. For banks that were not eligible for the provision of

[2] In April 2009, the monthly average exchange rate was 1USD = 99JPY. (Source: International Monetary Fund)

[3] The Act on Special Measures for Strengthening Financial Functions, which enabled Japanese government to inject capital into financial institutions, was first introduced in 2004 but expired in March 2008. In December 2008, the law was amended to extend the scheme to the end of March 2012 and to lower the bar for banks to apply for the scheme.

subordinated loans, including regional banks and cooperative banks, public fund capital injection based on the Act on Special Measures for Strengthening Financial Functions would be the measure to help them to strengthen their balance sheet.

At a press conference on March 18, where the BOJ released the idea of providing subordinated loans, BOJ Governor Masaaki Shirakawa said that the new scheme was created as a safeguard and funding in the market was preferred. He indicated that the value of the scheme could not be assessed simply by the amount of loans under the scheme as the scheme was designed as a safeguard.

Outcomes

The auctions were held on May 29, August 27, November 26, and February 24, 2010. At the first auction on May 29, only Sumitomo Trust & Banking Co., the eighth largest bank in Japan at the end of March 2009, made a successful bid for a 20 billion yen perpetual subordinated loan at the minimum spread (210bp). There was no bid for 10-year subordinated loans at the auction, and no banks took part in the remaining three auctions.

Although the BOJ did not publish the name of banks that bid for loans, Nikkei reported on May 29 that six banks did not take part in the auction and Sumitomo Trust & Banking Co. would receive a loan.

As planned in the "Principal Terms and Conditions for Provision of Subordinated Loans," the period of new loan disbursement came to an end in March 2010. On June 11, 2012, just three years after the disbursement, Sumitomo Trust & Banking Co. fully redeemed the loan, and the scheme was complete.

II. Key Design Decisions

1. **The provision of subordinated loans was intended to complement capital raising in the market and through the Act on Special Measures for Strengthening Financial Functions.**

The provision of subordinated loans for banks by the BOJ was designed to fill the gap of financing tools for banks. The BOJ expected that the new framework would contribute to strengthening the banks' capital base in combination with capital raising in the market by the banks themselves and from the Deposit Insurance Corporation of Japan (DICJ) under the Act on Special Measures for Strengthening Financial Functions, which was amended in December 2008 to encourage broader use.

2. **The BOJ resumed stock purchasing program in February 2009 to reduce banks' market risks.**

To reduce the risks associated with banks' stockholdings, the BOJ also decided to resume purchases of stocks held by financial institutions in February 2009 (*Bank of Japan 2009*) so that they could handle the risk associated with stockholdings. The BOJ continued these purchases until the end of April 2010. The BOJ introduced the stock purchasing program in November 2002, but it expired at the end of 2004.

3. **The framework was established as an exception to the Bank of Japan Act by obtaining authorization from the Minister of Finance and Prime Minister.**

Although the BOJ recognized that the provision of subordinated loans to banks by a central bank was an extremely extraordinary measure, no additional legislation was required to establish the new framework. Under Article 33 of the Bank of Japan Act, the BOJ, as the lender of last resort, could provide financial institutions with loans against collateral in the form of negotiable instruments, government securities, and other securities. However, the BOJ could not extend loans without collateral under Article 33 of the Act. Instead, the new framework for the provision of subordinated loans was introduced as "Other Business" that was authorized by the Minister of Finance and the Prime Minister. Article 43 of the Act stipulates that the BOJ may not conduct any business other than that specified by the Act as the business of the Bank; however, the BOJ can conduct other business that is necessary to achieve the Bank's purpose specified by the Act by obtaining authorization from the Minister of Finance and the Prime Minister. The BOJ requested authorization from the Minister of Finance and Prime Minister to introduce the framework to provide subordinated loans to maintain of stability of the financial system. This exception was also applied to the stock purchasing program by the BOJ that started in 2002 and resumed in 2009.

4. **The overall size of the program was set at 1 trillion yen**.

The total amount of loans available through the program was set at 1 trillion yen.

5. **The cap on a single bank's participation was set at 350 billion yen.**

In addition to the limit on total amount of loans, there was a limit on the amount of loans per bank at 350 billion yen.

6. **The capital was provided via subordinated loans.**

This program focused on providing a channel to strengthen the balance sheet of major banks through providing Tier-II capital. Since the government had already enacted the Act on Special Measures for Strengthening Financial Functions in December 2008, financial institutions had a tool to raise Tier-I capital outside the market. The provision of subordinated loans by the BOJ can be seen as a supplemental measure to provide capital.

7. **Maturities of the loans were either 10-year or perpetual.**

The term of the loan provided under this framework was either 10-year or perpetual that meet the requirement for Tier-II capital under Basel II. Auctions were held separately for 10-year and perpetual loans.

8. **Loans were uncollateralized.**

In principle, loans provided by the BOJ had to be collateralized. However, this framework for the provision of subordinated loans was established as an exception to the Bank of Japan Act: "other business" authorized by the Finance Minister and Prime Minister.

9. **Loans were redeemable after three years.**

Recipients of each loan had the right to repay the loan beginning three years after disbursement.

10. **The amount and the spread for each loan were determined by auctions.**

The amount of each loan and interest rates for the first five years on the 10-year and perpetual loans were determined at auctions using a premium over the six-month yen LIBOR. Targeted banks were not required to take part in the auction. The potential drawback of using auction was that banks might avoid participating in the auctions for fear of suffering stigma. The BOJ determined minimum spread at each auction for 10-year loans and perpetual loans respectively, in light of market conditions so as not to interfere with capital raising by financial institutions through markets. Banks were incentivized to raise capital through markets and repay the loan as soon as possible.

11. **The interest rate would rise after five years to penalize banks that did not exit.**

The interest rate would increase by 1.5% after five years of loan disbursement. This increase may have reflected the intention of the BOJ that the provision of subordinated loans under the framework should be used only as a temporary measure.

12. **Eligible institutions were Japanese banks that were subject to international capital standards.**

Only the banks that were subject to international capital standards were eligible. As a result, most regional banks and all cooperative banks and credit associations were not eligible for the loans. The BOJ created the framework to support large banks that were expected to suffer significant losses directly from sharp declines in stock prices, to raise Tier-II capital as a complementary measure for capital raising through the market. Banks that were not eligible for the provision of subordinated loans, including regional banks and cooperative banks, could raise Tier-I capital under the Act on Special Measures for Strengthening Financial Functions, which provided public funds in exchange for priority stocks.

By setting a relatively limited target, the BOJ was able to reduce the risk of default. To receive loans under the framework, banks were required to be deemed creditworthy, but the BOJ did not conduct any additional investigation when it conducted the loan.

13. **Nondisclosure rules were applied for the auctions.**

The BOJ decided that it would not release the names of banks that participated in the auctions until the end of May 2010. Only the total amount of loans and the average spread in each auction were released after each auction. The anonymity could have been intended for banks to avoid the stigma associated with accessing capital from the BOJ. However, the name of the participant was reported on media just after the auction as shown in *Figure 5* below.

Figure 5: Articles that reported the participants of the first auction

"(BN) Six Banks Won't Take Part in Bank of Japan Auction, Nikkei Says"
2009-05-28 17:12:30.693 GMT Bloomberg By Heather Burke

May 29 (Bloomberg) -- Bank of Tokyo-Mitsubishi UFJ Ltd. and Sumitomo Mitsui Banking Corp. are among six financial institutions not participating in the Bank of Japan's first auction to offer subordinated loans to help the banks shore up capital, Nikkei English News reported, without saying where it got the information.

"Sumitomo Trust to Get Loan Under Bank of Japan Plan, Nikkei Says"
2009-05-29 17:14:15.608 GMT Bloomberg By Bill Koenig

May 30 (Bloomberg) -- Sumitomo Trust & Banking Co. will receive a 20 billion yen ($209 million) subordinated loan under a framework established by the Bank of Japan, Nikkei English News reported, without saying how it obtained the information. The Bank of Japan in March disclosed plans to auction subordinated loans to banks with international operations as part of a plan to boost their capital, Nikkei said.

Source: Bloomberg

14. End date of the program was set on March 2010

The framework was established as a temporary measure which would end at the end of March 2010. Reflecting the recovery of the financial market, the framework was not extended. The last auction was held in February 2010 and closed new loan disbursement as initially scheduled.

III. Evaluation

There has been little evaluation of the provision of subordinated loans. It is difficult to assess the effectiveness of the program because the program was established as a backstop to prevent banks from becoming conscious of capital constraints in the future. Only one bank received a subordinated loan under the framework, but the limited number of uses does not imply the ineffectiveness of the policy. If the stock price had slumped further, more banks could have relied on the framework to strengthen their capital bases.

The reactions of market participants at the announcement of the framework were mixed. Some analyst said that the program would help banks looking to issue subordinated debt and boost their Tier-II capital (*Reuters 2009*, *Financial Times 2009*). On the other hand, another analyst argued that it was "more symbolic than anything" because core, Tier-I capital was what the market watched closely and because Japanese major banks were able to raise subordinated debt in the market (*Reuters 2009*).

IV. References

Bank of Japan. 2009. "Financial System Report March 2009."
https://www.boj.or.jp/en/research/brp/fsr/fsr09a.htm/

V. Key Program Documents

Summary of Program

- Establishment of "Principal Terms and Conditions for Provision of Subordinated Loans" – *BOJ document outlining the key terms of the Provision of Subordinated Loan Program. https://www.boj.or.jp/en/announcements/release_2009/fsky0904a.pdf*

Implementation Documents

- Establishment of "Principal Terms and Conditions for Provision of Subordinated Loans" – *BOJ document outlining the key terms of the Provision of Subordinated Loan Program.*
  https://www.boj.or.jp/en/announcements/release_2009/fsky0904a.pdf

- Schedule and Results of Auctions for the Provision of Subordinated Loans – *schedule of auctions and the results of all auctions*.
  https://www.boj.or.jp/en/announcements/release_2010/fsky1002d.pdf

Legal/Regulatory Guidance

- Bank of Japan Act – *unofficial translation of the Bank of Japan Act*.
  http://www.japaneselawtranslation.go.jp/law/detail/?id=92&vm=02&re=01

- 日本銀行業務方法書(Bank of Japan Statement of Operation Procedures) – *Operational procedures of the BOJ defined the terms of the Provision of Subordinated Loan Program. Since the program had already expired in 2012, the relevant article was deleted.*
  https://web.archive.org/web/20110504064653/https://www.boj.or.jp/about/boj_law/ghousyo.htm/

Press Releases/Announcements

- Provision of Subordinated Loans to Banks (03/17/2009) – *BOJ press release introducing the provision of subordinated loan program.*
  https://www.boj.or.jp/en/announcements/release_2009/fsky0903a.htm/

- Address at a Meeting with Banks' Top Management on Provision of Subordinated Loans (03/24/2009) – Then-Governor Masaaki Shirakawa *explaining the background* *and the BOJ's view on the decision. https://www.boj.or.jp/en/announcements/press/koen_2009/data/ko0903c.pdf*

- Establishment of "Principal Terms and Conditions for Provision of Subordinated Loans" (04/10/2009)– *BOJ press release document outlining the key terms of the Provision of Subordinated Loan Program.* https://www.boj.or.jp/en/announcements/release_2009/fsky0904a.pdf

- 劣後特約付貸付にかかる貸付先名の公表について(05/31/2010) – *BOJ press release document announcing the borrower bank of the subordinated loan under the program.* https://www.boj.or.jp/announcements/release_2010/fsky1005a.pdf

- 劣後特約付貸付の任意弁済について (06/11/2012)– *BOJ press release document announcing that all the loan under the program was redeemed.* https://www.boj.or.jp/announcements/release_2012/rel120611b.pdf

- The Bank of Japan to Resume Stock Purchases Held by Financial Institutions (02/03/2009) – *BOJ press release announcing the resumption of the stock-purchasing program.* https://www.boj.or.jp/en/announcements/release_2009/fss0902a.pdf

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- BoJ drafts Y1,000bn of bank loan aid (Financial Times – 3/17/2009) – *article discussing the introduction of the Provision of Subordinated Loans Program*. https://www.ft.com/content/0190e230-12d7-11de-9848-0000779fd2ac

- UPDATE 2-BOJ offers $10.2 bln subordinated loans to banks (Reuters – 3/17/2009) – *article discussing the introduction of the Guarantee Program*. https://in.reuters.com/article/financial-japan/update-2-boj-offers-10-2-bln-subordinated-loans-to-banks-idINT32233520090317

- Six Banks Won't Take Part in Bank of Japan Auction, Nikkei Says (Bloomberg – 05/28/2009) – a*rticle reporting that six banks would not participate in the first auction of the Provision of Subordinated Loans Program*.

- Sumitomo Trust to Get Loan Under Bank of Japan Plan, Nikkei Says (Bloomberg – 05/29/2009) – a*rticle reporting that Sumitomo Trust & Banking Co. would receive a 200 billion yen subordinated loan under the Provision of Subordinated Loans Program*.

Key Academic Papers

Reports/Assessments

- Financial System Report (March 2009) (Bank of Japan. 2009) – *The BOJ's analysis on the market development and the robustness of the financial system.* https://www.boj.or.jp/en/research/brp/fsr/fsr09a.htm/