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## Developments Relating to Payoffs and the Safety Net

### *Summary*

There was strong opposition in political quarters to the implementation of the protection of depositors and a safety net for the financial system as scheduled after the expiration of the special temporary measure to guarantee the entire amounts of bank deposits. Consequently, the three coalition parties and the Government decided to postpone the lifting of the ban on "payoffs" (the amount of deposits to be protected in the event of a bank failure). The Financial Council, mindful of this situation, proposed that, first, liquid deposits should be totally protected and, second, measures to stabilize the financial system including measures against systemic risk should be prepared.

In the period ahead, steps will be taken to give shape to specific measures along the lines of the proposal, but the measures will be implemented in and after April 2002, a full year later than previously scheduled. The preparation of a safety net for agricultural cooperative credit institutions will be carried out in line with these developments.

## **Arguments heated for and against lifting the ban on payoffs**

Deposits at financial institutions licensed to accept them will be protected in their entirety until March 31, 2001, under the supplementary provisions of the Deposit Insurance Law. Each of these financial institutions is being urged to establish a sound financial system by that time by making use of such laws as the Law Related to Financial Reconstruction and Financial Function Rehabilitation.

The problem is how to handle deposits after that. The so-called payoff system will take effect, requiring depositors to bear a portion of the losses under the Deposit Insurance Law in the event of a bank failure. (The payoff is the limit of ¥10 million on the guarantee that each depositor can withdraw in the event of the failure of a bank.)

Because public uneasiness about the nation's financial system remains, there are strong demands, mainly among small and medium-size enterprises, that the lifting of the ban on payoffs be postponed for such small financial institutions as credit unions and secondary regional banks. Amid these demands, the argument that the lifting of the payoff ban should be put off also found support in the Liberal Democratic Party. Then, it was reported that the Government had reached a compromise plan to postpone the lifting of the payoff ban

for credit unions only. As a result, the Government and the coalition parties made a political decision on this issue: to delay for one year the lifting of the payoff ban.

This decision is contrary to the conclusion of the Financial Council. As reported in the International Herald Tribune on Dec. 31, "many Japanese editorialists and banking-industry experts are decrying this political decision."

Not only the Government and the banking industry but also political circles were involved in the argument over the payoff issue because it posed a basic problem relating to financial administration: how to determine the relative importance of the public burden, the burden on depositors, and the regulatory and supervisory policies toward financial institutions.

Some people maintained that the lifting of the payoff ban would hit small and medium-size financial institutions whose managerial foundations have been severely weakened by the flight of funds to large financial institutions. These people proposed that the lifting of the ban should be postponed or the scope of depositor protection should be enlarged in order to prevent trouble in the financial system. Business circles and city banks, on the other hand, asserted that the payoff ban should be lifted in April 2001 as scheduled on the grounds that prolonging the protection period would tarnish international confidence in Japan, hamper finan-

cial institutions' efforts to place their management on a sound basis, pose a moral hazard for depositors and increase the cost of protecting depositors (in the form of public funds and insurance premiums).

### **Financial Council favors a "small-scale deposit insurance scheme"**

The Financial Council is an advisory body to the Minister of Finance in charge of formulating a government plan to address this issue. It took a cautious stance as it worked out the final plan, expecting the debate to meet with considerable difficulty.

First, in early July the council reduced the main problems to eight points in the form of "intermediate adjustments" (Note 1). The biggest issue at that stage came from differences in basic thinking: the argument favoring a "large-scale deposit insurance scheme" that calls for the postponement of the lifting of the payoff ban and broader protection of depositors, on one side, and the argument favoring a "small-scale deposit insurance scheme" which attaches importance to self-responsibility, on the other.

The position one takes on this issue leads to differences in conclusions about specific items discussed in the argument, such as 1) the scope of deposits to be protected, 2) the specific method of paying insured deposits (a payoff in the narrow sense or transfer of

claims) and 3) steps to be taken when systemic risk is feared.

The Financial Council further deliberated on these issues and announced a provisional conclusion in mid-October. The council came up with a basic policy to lift the payoff ban in April 2001 as scheduled and adopt a small-scale deposit insurance scheme as a rule. Underlying the policy is the assumption that investor protection fundamentally involves ensuring the managerial soundness of each financial institution and that each financial institution should endeavor to place its management on a sound basis. Also, inspection and monitoring by the supervisory authorities should be intensified and "prompt and corrective action" should be taken appropriately.

*Note 1:* The main points of debate at the Financial Council were as follows:

- (1) Basic thinking about the nature of the deposit insurance scheme (its purpose, role, function, etc.);
- (2) The method of paying insured deposits;
- (3) The general financial assistance method;
- (4) Steps to be taken when a receptacle institution for a failed financial institution is not found or when systemic risk is anticipated;
- (5) The objects of insurance;
- (6) The limit on the payment of insured deposits;

- (7) The deposit insurance premium and liability reserve;
- (8) Completion of an environment to enable depositors to assume self-responsibility.

### **Outline of Financial Council report**

The Financial Council proposed ample protection to prevent difficulties among depositors and stabilize the financial system. It proposed the following:

First, in handling the failure of a financial institution, priority should be given to the general financial assistance system in which the receptacle financial institution takes over the failed institution's financial functions, and the payment of insured deposits (a payoff in the narrow sense) is avoided (Note 2).

This stance is aimed at maintaining the account settlement function of a financial institution and protecting depositors on the assumption that the failed financial institution will not be allowed to continue doing business. It means introducing the purchase and assumption (P&A) system, a system that has been practiced widely in the United States in recent years. (Please see the addendum.)

In order to ensure smooth implementation of the business transfer formula, the Financial Council urges that necessary judicial procedures, including the introduction of the financial receiver system, should be

taken and the scope of financial assistance should be expanded (even in cases where only sound assets and insured deposits are transferred). It also urges the Government to quickly take steps to ensure smooth payment of insured deposits (such as "per-name summation," that is, identifying depositors whose names are scattered on two or more lists, and paying approximate sums of unprotected deposits) and to simplify the procedure for taking such steps.

Second, to make it easier for a financial institution to become the acquirer of a failed financial institution's business, stock acquisitions by other financial institutions that are covered by deposit insurance should be approved. Also proposed is the establishment of rules for bearing the secondary losses that may arise after the transfer. Further, the bridge bank system should be adopted as a stopgap measure to ensure the continuance of certain financial functions when no financial institution steps forward to accept the business of the failed bank, causing the transfer of business to take much time.

Third, to prevent systemic risk, the Financial Council has approved as an exceptional measure the infusion of public funds exceeding the cost of a payoff to a financial institution that is in a management crisis (explained below).

*Note 2:* Two alternative systems to settle the failure of a bank are envisaged. One is an insured-deposit payment system (a payoff in the narrow sense). The other is a general financial assistance system (under which financial assistance within the cost of the payoffs is extended to the financial institution that acquires a failed financial institution).

### Liquid deposits also to be totally protected

How to set the framework for deposits to be totally protected remained a knotty issue throughout the debate in the Financial Council, which was carried out in deference to the group demanding postponement of the lifting of the payoff ban (Table 1).

Conclusions were made rather easily to include in the scope of protection interest on deposits and bank debentures held by individuals and deposited for safe-

keeping and to exclude foreign-currency deposits from the cover of protection. Regarding what to do with "liquid deposits," on the other hand, the council postponed its conclusion until it submitted its final report in late December 1999. This is because secondary regional banks, Shinkin banks and credit unions, which are opposed to lifting the payoff ban, strongly demanded total protection, and local public bodies also demanded total protection of public deposits.

The council decided to totally protect liquid deposits under certain conditions (either allowing no interest to accrue or allowing interest of a very low rate to accrue) for a set period of two years to prevent a moral hazard for depositors. The council also decided to totally protect public deposits to ensure a balance with the total protection of liquid deposits. Moreover, to protect small and medium-size enterprises, the coun-

**Table 1. Coverage of the existing deposit insurance scheme**

Deposits covered by insurance	Deposits not covered by insurance
<ul style="list-style-type: none"> <li>○ Deposits not including those in the right column</li> <li>○ Current deposits</li> <li>○ Ordinary deposits</li> <li>○ Deposits at notice</li> <li>○ Deposits for tax payments</li> <li>○ Savings deposits</li> <li>○ Time deposits</li> <li>○ Special deposits</li> <li>○ Installment savings</li> <li>○ Installments</li> <li>○ Money in trust with a principal guarantee (loans in trust such as "Big" included)</li> </ul>	<ul style="list-style-type: none"> <li>○ Foreign-currency deposits</li> <li>○ Deposits at foreign banks' branches in Japan</li> <li>○ Offshore deposits</li> <li>○ Deposits from the central government, local public bodies, etc.</li> <li>○ Deposits from Deposit Insurance Corporation</li> <li>○ Anonymous deposits</li> <li>○ Deposits in fictitious names</li> <li>○ Induced deposits</li> <li>○ Money in trust without guarantee of principal (such as "Hit")</li> <li>○ Bank debentures</li> </ul>

Source: "Mechanism of the Deposit Insurance Scheme" by the Ministry of Finance

cil decided to approve offsetting debt against deposits in the event of the failure of a financial institution.

### Safety net to provide against systemic risk

Even after the nation's financial system begins to stabilize as a result of self-help efforts by financial institutions to place their management on a sound basis, systemic risk that makes it difficult to maintain the entire credit order or that destabilizes the national or regional economies may emerge if a financial institution goes bankrupt, and it is expected that no ordinary framework for the disposal of failed banks will be able to counter such risk. To provide against such an emergency, Japanese authorities should prepare exceptional measures, measures that are also provided for in the United States.

Regarding the method, the Financial Council has proposed specific framework steps such as extending temporary financial assistance that exceeds the cost of a payoff, increasing the troubled bank's capital,

and placing such banks under special public management. Because a strict procedure must be followed to take exceptional measures, the Government is scheduled to set up a "Financial Crisis Countermeasures Council" to replace the Financial Reconstruction Committee after the reorganization of ministries and agencies.

The tariff of deposit insurance premiums, which are the revenue source for deposit insurance, will be kept unchanged, and the planned introduction of a variable insurance premium requested by city banks will be shelved. As a result, the special insurance premium (0.036% as the revenue source for financial assistance in excess of the payoff cost), considered to be a temporary measure included in the sevenfold increase (from 0.012 percent to 0.084 percent) since fiscal 1996, will be continued. The framework on public funds will be retained, though reduced.

### Another amendment may become necessary in the future

The report by the Financial Council urges financial institutions to ensure market discipline through the lifting of the payoff ban as scheduled and the introduction of a "small-scale deposit insurance scheme." However, the coalition parties and the Government decided to postpone the lifting of the payoff ban for one year. The

Table 2. Changes in the deposit insurance premium (%)

	Ordinary insurance premium	Special insurance premium*
Fiscal 1971	0.012	—
1982	0.012	—
1986	0.012	—
1996	0.012	0.036

\*To be abolished after the ban on payoffs is lifted.

report also contains such measures as broadening the scope of protection to include liquid deposits and preparing for countering systemic risk.

Legislative action will be taken in line with the above policy toward enactment of law in or after April 2002. But the Government will have to amend the payoff system again when the financial system is normalized (explained below). Pending the legislation, progress will be made in solidifying the management of financial institutions, particularly regional ones, and in disposing of failed financial institutions through the use of public funds. But, at the same time, accelerated reorganization of the financial industry is unavoidable.

In order to prevent excess debts from swelling further after a failure, the Government will have to actively apply "prompt and corrective action" and quickly dispose of a failed bank (Note 3).

*Note 3:* This is the reason that Michio Ochi, minister in charge of financial affairs, said he would urge financial institutions to bolster their core capital by using public funds in addition to capital expansion through the allotment of new shares to third parties (he said he would not stick to 8 percent after the infusion of public funds) and he would carefully watch financial institutions whose capital-adequacy ratio is 5 percent or less.

### **Viewpoints lacking in the Financial Council's report**

Both the above-described report by the Financial Council and the present deposit insurance scheme have problems. There are demands from various quarters that the following problems be studied when the scheme is reexamined:

The first problem is the lack of coordination with the postal savings program. In the case of private financial institutions, the principle of self-responsibility and market discipline underscores the structuring of a safety net, but the principal of postal savings is totally guaranteed, and there is no burden of deposit insurance premiums. Moreover, postal savings collected at a high interest rate will come due in and after the summer of 2000. Further, the practice of depositing postal savings with the Ministry of Finance's Trust Fund Bureau will be abolished in April 2001 in a system reform. As a result, a massive movement of funds now in postal savings is foreseen. In order to keep the market orderly, the ministry has agreed to sell government bonds held by the Trust Fund Bureau to the Bank of Japan under a repurchase agreement. Regarding this issue, the Regional Banks Association of Japan has asked the ministry to ensure fair conditions of competition between the postal savings program and private financial institutions. Certainly, a reexamination is

desirable for the sake of balance.

The second problem is to determine how to handle public deposits. Public deposits are managed by designated financial institutions under the Local Autonomy Law and differ in character from the deposits of companies and individuals, which are managed on the depositors' own responsibility. Therefore, there is a strong body of opinion in the banking industry that even if public deposits are totally protected for the time being, a different scheme and a different way to bear costs from those for private deposits should be adopted in the future.

A new financial environment should be considered with attention paid also to these points. For example, the relationship between the safety net on the one hand and the regulations and supervisory policy regarding financial institutions on the other should be reexamined. What to do with the insurance premiums, which are the cost of the protection, should also be studied on the assumption that a bank specializing in settlement will come into being and that there will be new entries in the banking industry from other industries.

### **Progress made toward completion of safety net for co-ops**

In parallel with the Financial Council debate, a council of experts in agriculture, forestry and fisheries

finance is studying ways to expand the safety net after the ban on payoffs is lifted. The council consists of people from such quarters as the Ministry of Agriculture, Forestry and Fisheries, the Central Union of Agricultural Cooperatives (Zenchu) and the Norinchukin Bank.

To take thorough measures to protect depositors at agricultural cooperative credit institutions, the underlying thinking in regard to the safety net includes these points: First, coordination with the Financial Council's policy on the handling of other financial institutions should be ensured, and self-responsibility and cost minimization should be basic principles. And second, an effective framework should be prepared that fits the specific credit system for agriculture, forestry and fisheries. Such efforts by the agricultural cooperative credit institutions are welcome, in contrast to the stance of credit unions, which are cautious about lifting the payoff ban.

As shown in Table 3, the main items being studied are 1) what to do with the savings insurance scheme (the coverage of insurance, the method and system for handling failures and insurance premiums), 2) how to handle the prefectural credit federations and the Norinchukin Bank under the Savings Insurance Scheme, and 3) other stabilization measures (early detection and disposal of bad loan claims).

In view of the distinguishing characteristics of agri-

**Table 3. Issues related to agricultural cooperative credit institutions' safety net**

Items to be studied	Main points and opinions
<b>Savings Insurance Scheme</b>	
(1) Savings Insurance Scheme after the ban on payoffs is lifted	Basically the same approach as in the case of the Deposit Insurance Scheme, but JA's characteristics should be taken into account.
(a) Objects of insurance	● Basically the same as in the case of the Deposit Insurance Scheme
(b) How a failed bank should be disposed of; system of disposal	● Public management, etc., to ensure smooth and prompt disposition of a failed financial institution ● P&A scheme or a similar scheme
(c) Insurance premium	● Advisability of introducing a variable insurance premium to be studied.
(2) Method of handling prefectural credit federations and the Norinchukin Bank under the Savings Insurance Scheme	● Need to counter systemic risk ● Need to handle prefectural credit federations of agricultural cooperatives and the Norinchukin Bank in order to promptly counter a crisis in the management of agricultural cooperative credit institutions and minimize the cost ● Advisability of making them objects of the Savings Insurance Scheme to be studied.
<b>Multifund system and setup to support agricultural cooperative credit institutions</b>	
	● Need to complete preparations to avert handling through a payoff ● How a support system considering the organizational consolidation of various enterprises should be studied.
<b>Other measures to managerial soundness and stability</b>	
(1) Efforts to prevent failures and for early detection	● Need to complete a system for early detection of management deterioration and early guidance for improvement ● Need for close cooperation between prefectural governments and agricultural cooperative credit institutions
(2) Disposal of bad loan claims	● Need to establish a Servicer for agricultural cooperative credit institutions to ensure smooth disposal and collection of bad loan claims ● Participation in investment in and loans to a Servicer for agricultural cooperative credit institutions from the Savings Insurance Organization (RTC for the savings insurance organization)

Source: "Q&A about Payoffs for JA Personnel"

cultural cooperative credit institutions, one problem is the diversification of the periods in which receptacle institutions take over business transfers from failed banks. Another is the framework to be established if systemic risk is anticipated. In this connection, how to handle prefectural credit federations and the

Norinchukin Bank under the Savings Insurance Scheme will be a focus of study.

In that case, it is very likely that a safety net that ensures alignment among different business categories will be structured, considering, among other things, compatibility with the federations of financial organi-

zations that are not yet members of Deposit Insurance Corporation, such as the Zenshinren Bank and the

National Federation of Labor Credit Associations (Rokinren). (By Hiroaki Aramaki)

**Addendum: The U.S. practice of purchase and assumption (P&A) provides an example**

Purchase and assumption (P&A) is the most common method of handling failed financial institutions in the United States. There are two types of P&A: one is total-deposit P&A in which the acquirer inherits all deposits and the other is insured-deposit P&A in which the acquirer inherits the insured deposits and the remainder of liabilities are liquidated and covered by the Federal Deposit Insurance Corporation (FDIC). It works as a way of insured deposits rather than payment or the transfer of deposits, but this accounts for only about 15 percent of deposit cases in the year 2002. Moreover, there are such methods as the bridge bank system and open bank assistance in which the financial assistance is extended to sound financial institutions that absorb failed banks or takes them as a subsidiary.

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    graph TD
      Depositors[Depositors]
      Failed[Failed financial institutions]
      Sound[A sound financial institution]
      FDIC[FDIC]

      Failed -- "Suspension of deposit repayments" --> Depositors
      Sound -- "Repayments of deposits" --> Depositors
      FDIC -- "Financial assistance" --> Sound
      Failed -- "Inheriting assets and liabilities" --> Sound
  
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\*There are cases in which that part of a deposit in excess of \$100,000 is cut off.