Japan Begins Capital Injections for Financial Institutions in Response to COVID-19

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Original post here.

******The author would like to thank Junko Oguri for exceptional research support and comments.***

On June 13, the Japanese Diet passed an amendment to the Act on Special Measures for Strengthening Financial Functions (ASFF) extending the period of government capital injection to financial institutions from March 31, 2022 to March 31, 2026 and expanding the available public funds for the injection from ¥12 trillion to ¥15 trillion.

The ASFF, first introduced in 2004, has injected ¥674.84 billion into 30 institutions over the past 16 years. A YPFS case on the previous ASFF can be accessed here. ¥474.34 billion remains outstanding as of September 2019. (see here) The first amendment was during the 2007-09 global financial crisis (GFC) introducing a focus for SME-support. Under this amendment, the government had injected ¥309 billion to various financial institutions.

In proposing the new amendment this month, the Japan Financial Services Agency (JFSA) emphasized that the domestic financial system is currently sound and this is a preemptive measure ensuring the long-run soundness of the financial system so that it can continue to support small and medium-sized enterprises (SMEs) impacted by the COVID-19 crisis and revitalize the economy.

All financial institutions are eligible for capital injections, however, as the amended ASFF specifically focuses on SME lending, the main recipients of the capital injection are expected to be regional banks. Institutions must first submit an application to the JFSA. The application will include: (i) numerical targets for an institution's profitability and efficiency, and means to achieve those targets, (ii) related commitments by the management, and (iii) measures the institution will take to facilitate credit to SMEs and revitalize the local economy. (see here)

The Financial Functions Enhancement Examination Committee, currently composed of five members from the private sector, then will review each application. It will evaluate: (i) the feasibility of the targets, (ii) whether the institution will be able to repay within 15 years, and (iii) current asset value. (see here) The review meeting minutes and participants' list will be posted here.

However, the amended ASFF allows financial institutions "affected by coronavirus" to apply for an injection without meeting the first two hurdles. Such institutions must meet only the third hurdle, to describe measures they will take to facilitate credit to SMEs. "Affected" institutions are those whose "financial statements have gotten considerably worse due to the coronavirus or measures to prevent coronavirus, or if the financial institution needs to lend to companies that are affected by coronavirus or measures to prevent coronavirus."

Moreover, the review process for these "affected" institutions will neither consider the feasibility nor the 15-year deadline but only consider the best possible asset value of the institution based on available information. (see here) However, a news report notes that the JFSA had expressed intentions to set repayment dates for each bank receiving capital injection.

Once the application is approved, the Deposit Insurance Corporation of Japan (DICJ) will purchase preferred shares, as consistent with injections under the previous ASFF. However, the amended ASFF further allows the DICJ to purchase common stocks and subordinated debt from the "affected" institutions. It is not clear whether the common stocks will be voting or non-voting.

The JFSA notes that a wider variety of capital will meet the needs of different financial institutions. The JFSA also announced lower dividend rates than normal for shares purchased from affected financial institutions. (see here) The DIJC has existing guidelines on exercising voting rights and disposing of preferred shares but these have yet to be updated. The capital injection for affected financial institutions does not require recipient companies to limit dividend payments to existing shareholders.

A commentator questions the amended ASFF as it no longer sets a repayment deadline. Regional banks have already been struggling with the decline in population and in the number of borrowers. Some market observers are skeptical about whether banks receiving ASFF capital will be able to repay.

The same commentator notes that Mr. Toshihide Endo, the Commissioner of the JFSA, had denied that the amended ASFF would lead to nationalization. Although the JFSA has promised a rigorous review process for the application and its best efforts to improve profitability and management of the assisted institutions, the commentator remains pessimistic about the future of regional banks.

Takahide Kiuchi, a former Bank of Japan Policy Board Member, acknowledges that this amended ASFF may carry a risk of moral hazard in the long run but emphasizes that it is justified under the current unusual economic environment. Kiuchi also commends the government for implementing this difficult policy early on.

Ogawa and Tanaka examine the nature of the shocks that hit the SMEs during the GFC and how they responded to these shocks. They find that the capital injection under the ASFF may have acted to strengthen the role of financial institutions as a buffer for SMEs against these shocks.