BAD LOANS: A COMPARATIVE STUDY OF U.S. AND JAPANESE REGULATIONS CONCERNING LOAN LOSS RESERVES

MITSURU MISAWA

In this article, the author investigates the methods of processing bad loans and disclosures practiced by Japanese banks. The author also compares the differing United States and Japanese legal regulations and business practices, concluding that the various rules and regulations concerning loan loss reserves in Japan are very much behind those of the United States.

In the August 1995 annual report of the International Monetary Fund ("IMF"), Japan’s banking policy administration was criticized, accused of failing to take effective measures against the deterioration of its banking system. The report further pointed out that "waiting would not recover the loss, but rather increase it," and asked Japan to take speedy action to correct problematic banks. The report also stated that market mechanisms that were supposed to help depositors and investors in selecting banks were not working because of insufficient disclosures of the operating information of the banks, and it was necessary to establish a clear-cut rule specifying how the necessary funds for cleaning bad debts of the problematic banks, including public funds, were to be borne by the stakeholders.

In August 1999, it was revealed that the net asset deficiency of The Long Term Credit Bank of Japan, Ltd. ("LTCB") at terms-end (that ended on
March 31, 1999) was ¥2.78 trillion. The report also pointed out that the government of Japan had established the Financial Revitalization Law to pave the way for nationalization of an asset deficient bank and then transfer its business to other banks. On September 28, 1999, the Financial Reconstruction Commission decided to transfer LTCB to “partners” lead by Ripple Wood Holdings LLC of the United States. A sum exceeding ¥4 trillion of public funds was poured into the bank to cover its bad loans, including its secondary losses.

Upon the announcement of the examination results of 19 major banks by the Financial Services Agency (“FSA”), and immediately after the enactment of the Financial Revitalization Law, the Nippon Credit Bank, Ltd. (“NCB”) was suddenly nationalized by the FSA on the grounds that the bank was net asset deficient. It is important to note that the net worth ratios of the LTCB and NCB were published at 10 percent and 8 percent respectively.

As a result, criticisms against Japanese banks, claiming that they were not disclosing their operations accurately, were heard all over the world. This article investigates the methods of processing bad loans and the disclosures practiced by Japanese banks. It also studies the legal requirements and accounting standards behind them. It seems that there are systems as well as rules and regulations unique to Japan that are substantially dissociated from international standards. With the world’s second largest GNP, Japan is still an economic giant, making it important for the world to see full recovery of its economy. Proper disposal of bad loans held by Japanese banks is critical to the recovery of the Japanese economy. The IMF, as well as the entire world, is watching to see how Japan plans to take care of this problem.

BAD LOANS UNDER PROLONGED BUSINESS STAGNATION IN JAPAN

The Economic Planning Agency (“EPA”) strongly asserted that the major cause of the current deep downturn of the Japanese economy was the delay in the disposal of bad loans of financial institutions. This is primarily caused by the private sector and the government, which as a result aggravated the aftereffects of the burst of the “bubble” economy. It is said that reasons for delaying the disposal of bad loans were:
optimism that merchandise and land prices would eventually go up again;

(2) as a result of their traditional conservatism, waiting to see what others would do, the banks failed to take necessary action and;

(3) the financial institutions failed to sufficiently disclose information.\textsuperscript{12}

Simultaneous with the EPA's announcement, the FSA published the results of the thorough inspection conducted on major banks. The result of the inspections conducted over the major 19 banks (including LTCB and NCB) during the period of July through September 1998 indicated that even inspections of bad loans conducted by major banks were generally loose, revealing a total shortage of loan loss reserves of ¥5.40 trillion.\textsuperscript{13}

In an article that appeared in April 2001, the Nikkei stated that, according to an FSA estimate, a sum of approximately ¥150 trillion was loaned to questionable borrowers. In essence, it revealed that in addition to a sum of ¥81 trillion in questionable loans as previously identified by the FSA, ¥70 trillion continued to be lent out to questionable borrowers. Their contents are set forth in Table 1.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|}
\hline
 & FSA's new statistics & Newly published questionable loans & Previously published questionable loans \\
\hline
Normal loans & 522 & & \\
Loans needing cautions & 117 & 117 & 64 \\
Loans with concerns of failures & 21 & 21 & 11 \\
Failed or essentially failed loans & 13 & 13 & 6 \\
Total & 673 & 151 & 81 \\
\hline
\end{tabular}
\caption{Breakdown of Loans Lent out by Financial Institutions as of March 2000}
\label{table:loans}
\end{table}
In September 2001, Japan retailer Mycal Corporation, a failed business from all practical standpoints with a debt of ¥1.74 trillion that applied for court-mandated protection under the Civil Rehabilitation Law, was reported to have been classified by its main banks as a borrower needing cautions as its provision rate of loan loss reserve was believed to be no more than three to five percent. This provision rate was obviously too low. Although the financial institutions claimed that this provision rate was estimated based upon the past records of businesses going down together, it was a questionable undertaking in light of the following facts: that past records had little significance when facing an incredibly large amount of bad loans, which it had never previously experienced, and that the uncollectible amount was basically an estimate of the future amount, and should have been evaluated on a case by case basis. As can be seen from this example, all parties involved (the FSA, financial institutions, and auditors) in the issue of reserves for bad debts were governed by old corporate accounting principles.

A closer look at NCB showed an asset deficiency of ¥94.4 billion as of the March 1998 year-end and the net asset deficiency including the unrealized loss of negotiable securities at ¥274.7 billion, as well as its net worth ratio at zero, according to the FSA’s inspection result released in December 1998 (refer to Table 2). Since the bank announced in the closing public statement for the March 1998 fiscal year-end that its net worth ratio was eight percent, it was clear that there was a significant difference between its own publicized value and the net value based on the inspection.

<table>
<thead>
<tr>
<th>Table 2: Correction for the NCB’s Closing Statement for FY 3/98</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net worth = A</td>
</tr>
<tr>
<td>Deficiency in loan loss amortization and reserves = B</td>
</tr>
<tr>
<td>Asset deficiency = (A-B)</td>
</tr>
<tr>
<td>Unrealized loss of negotiable securities = C</td>
</tr>
<tr>
<td>Net asset deficiency = (A-B-C)</td>
</tr>
</tbody>
</table>
More importantly, it was reported that NCB, which was under special state control (temporary nationalization), had approximately ¥3 trillion of asset deficiency as of December 1998 (the point the bank was placed under the state special control).18 This ¥3 trillion of asset deficiency was indeed ten times larger than the publicized ¥274.7 billion (Table 2) asset deficiency of the FY3/98 year-end. This indicated a large discrepancy between the publicized data and the actual data.

Realizing this ¥3 trillion asset deficiency, the Japanese government decided to infuse a sum of approximately ¥3.5 trillion of public funds and to transfer NCB to domestic financial institutions including SOFTBANK Corporation19 and ORIX Corporation20 (refer to Table 3).21

<table>
<thead>
<tr>
<th>Table 3: Infusion of Public Funds to NCB</th>
<th>March 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infusion of public funds</td>
<td></td>
</tr>
<tr>
<td>To cover the asset deficiency</td>
<td>Approx. ¥3.2 trillion</td>
</tr>
<tr>
<td>Infusion for enhancing the capital after the transfer (preferred stocks)</td>
<td>¥240 billion</td>
</tr>
<tr>
<td>Public funds infused in March 1998</td>
<td>¥60 billion</td>
</tr>
<tr>
<td>Burden sharing if a substantial loss occurs with the borrower after the transfer</td>
<td>Undetermined</td>
</tr>
<tr>
<td>Total</td>
<td>At least approx. ¥3.5 trillion</td>
</tr>
</tbody>
</table>

JAPANESE CORPORATE ACCOUNTING PRINCIPLES

Why were such loose loan loss reserve practices allowed in Japan? One of the reasons can be found in the “Corporate Accounting Principles” established in 1949 based on the Commercial Code of Japan.15 More specifically, the “Corporate Accounting Principles” were generated as an interim report by the Corporate Accounting Rule Investigative Committee of the
Economic Stabilization Agency\textsuperscript{24} in 1949 and the “Annotations to Corporate Accounting Principles” as an interim report by the Corporate Accounting Council of the Ministry of Finance\textsuperscript{25} in 1950.

According to its preamble, it states that “The Corporate Accounting Principles consist of the summary of practices recognized as generally fair and reasonable among those practices evolved within actual corporate accounting works and they represent the rules to be abided by all corporations in processing their accountings without really having to be regulated by the laws and regulations.”

In the “Corporate Accounting Principles,” there is a description entitled “On Reserves,” which states, “When there is a specific expense or loss that may result from a phenomenon occurred prior to the current term, whose probability of occurrence is high, and whose amount can be logically estimated, the amount that belongs to the burden of the current term is accounted for as the current term’s expense or loss in the reserve, and the balance of said reserve is written on the debt side or the asset side of the balance sheet.”\textsuperscript{26} It also shows 11 items including loan loss reserves as examples. It also states that “no reserve can be accounted for expenses or losses concerning a contingent phenomenon of a low probability of occurrence.” That is all that this accounting standard has and no specific rulings can be found.

Consequently, in Japanese accounting, it is customary to honor traditional accounting practices as the practical rule to follow. This has bred a tendency for companies to look around and follow whatever others do. This did not present any shortcoming when the economy was all but rosy in the years after World War II, but the same practice is now causing a problem as it inevitably creates loose reserve formats everywhere generating an enormous amount of bad loans, which no one has ever previously experienced. The reality of accounting scenes includes a backward calculation of “amortization source assets” such as unrealized stock profits. In other words, the total amount of funds that can be allocated for reserves is first determined, and then bad loans are assessed while adjusting the reserves so that they can fit into the range. Therefore, there can be no bad loan processing that exceeds the amortization source assets.\textsuperscript{27}

The “Corporate Accounting Principles” have the dominating power in Japan. For example, an auditor has to issue a favorable opinion as long as
accounting is done in accordance to “Corporate Accounting Principles.” Therefore, we can safely assume that the root cause of the delay in determining the amounts of bad loans lies in the basic philosophy of the “Corporate Accounting Principles.” A loan balance after deducting reserves must be indicated in a “net realizable value” if the U.S. accounting standard is applied. In this case, the particular Japanese accounting procedure can be considered a fraudulent act under the U.S. standard. This will be discussed below.

An accounting standard, from the international standpoint, is a generally accepted rule, resulting from research and development geared for proper representation of accounting practices. It is not something that evolved through mere practices, but rather something that has developed theoretically and is meant to be applied to the practices in order to provide proper information disclosure. The accounting standards used in the U.S. and Europe are researched and upgraded constantly by permanently established organizations in order to keep up with economic changes. The Japanese “Corporate Accounting Principles” that were developed more than half a century ago are extremely different from today’s international standards and are no longer fit for today’s economy.28

The problem is that even the FSA of Japan is still honoring the existing “Corporate Accounting Principles.” The FSA also provides administrative services for the Corporate Accounting Rule Council,29 which had prepared the accounting principles. In addition, it also has the Banking Supervisory Agency30 under its wing. It is in a position to improve the accounting principles if any problems with the principles are identified. The biggest problem lies in the fact that the administrative offices of the Japanese government are not realizing the importance of the accounting standard.31

JAPANESE LEGAL REGULATIONS ON BAD LOANS

Since an enterprise operates based on the profit ratio of capital, it must regularly identify the change in its assets and the profit/loss results. For a joint-stock corporation in which a plurality of stockholders participate with a common object of sharing the earned profit of the corporation, the only collateral for creditors is the asset of the corporation. The corporate
accounting, which is the technique of recording the performance of the corporation objectively and accurately, is not only necessary for rational management for the corporation but also indispensable for the protection of stockholders and creditors. Thus, the corporate accounting, in which a great many people have interest, incorporates regulations established along the purposes of the Commercial Code,32 the Security Exchange Law,33 and the Corporate Tax Law.34

COMMERCIAL CODE

The part of the corporate accounting regulations related to the Commercial Code are used to place its evaluation basis for the corporation asset on liquidation and conversion into money from the standpoint of protecting corporate creditors. In other words, its basic philosophy is centered around the asset purpose, wherein a balance sheet is prepared by the inventory method based on a list of assets prepared in accordance with the current value principle. This position of asset calculation is definitely unreasonable. The investment attitude of a stockholder is usually determined by the profit and loss of the corporation as an on-going concern in an operating year, its causes, and its contents, rather than by the quantity of the assets the corporation holds. The profit and loss calculation method by means of distributing costs and profits over periods based on the assumption of the corporation being a going concern is more agreeable with the corporation’s creditors as well, if not neglecting the assets held by the corporation totally. Thus, the current Commercial Code upholds the period profit and loss calculation method, and its balance sheet is prepared directly from accounting books by means of the derivative method.35

Although a detailed regulation concerning the accounting of a joint-stock corporation can be found in the Commercial Code,36 the rules of the Commercial Code's General Regulations Concerning Commercial Books37 are applied to items that are not specifically defined there. It is also requested that "fair accounting practices should be considered" in interpreting the existing rules.38 While the accounting of a joint-stock corporation is interpreted as being intended for adjusting personal interests between individuals, especially for regulating the dividends, there are overlapping areas between the afore-
mentioned “Corporate Accounting Principles” and the Commercial Code in terms of rules for representation. The Commercial Code seems to have a higher weight on the “fairness” portion in the “fair and reasonable” practices that the “Corporate Accounting Principles” is asking for.

The rules of the Commercial Code regarding bad loans specify that if concerns exist about being unable to collect the money claims written in the liquid asset category, it should be written in such a manner as to deduct the estimated uncollectible amount (bad loan reserve) for each item that each money claim belonged to, or showing only the balance after deducting the estimated uncollectible amount indicating the estimated uncollectible amount as a footnote.39 It is also stipulated that if a reserve is to be accounted for, with respect to an amount that is expected to be uncollectible, the said reserve is not necessarily a liability in the legal sense. It is a reserve prepared for a specific expense in the future or an estimate of a cost so that it is allowed to be written in a section of reserves provided in the liabilities area, wherein that reserve needs to be entered with a specific label indicating the purpose of its entering.40

That is as far as the Commercial Code goes, and there are no specific rules that advise how bad loans are to be handled. This also leaves a corporation to openly maneuver for bad loans as it wishes.

SECURITIES EXCHANGE LAW

The Securities Exchange Law41 stipulates the terms, formats and methods in the preparation of a balance sheet, a profit and loss statement, and other documents related to financial calculations. Items that are submitted in accordance with the law have to also be prepared in accordance with the rules generally recognized as fair and reasonable using the terms, formats and method of preparation specified in the Ministry of Finance ("MOF")42 Ordinance.43

The essence of this ordinance is, first, from a formatting perspective, to define the method of preparing the documents and others based on an assumption that issuing companies are obligated to submit financial calculation documents.44 Next, from a more practical standpoint, financial calculation documents provide extremely important information as they are relat-
ed to the evaluations of the subject negotiable securities among the variety of information provided concerning the issuing company at the time of share placement or public offering of stocks. Based on this, the ordinance favors regulating representations in such a way that they be prepared based on a non-interruptive, uniform standard so that period and position comparisons can be easily performed. Therefore, this ordinance supports making administrative investigations smoother and faster, and increasing the fairness of transactions by providing more accurate representations while allowing them to be handled in a smoother fashion through a rational format that facilitates faster analyses.

The orders of the MOF, created in line with the rules of this ordinance are known as the Rules on Financial Statements, the Rules of Consolidated Financial Statements, and the Rules of Intermediate Financial Statements. In these ministerial orders and related notices, the items that are not specified are supposed to follow the “corporate accounting practices generally accepted as fair and reasonable.” For example, the Rules on Financial Statements explain, “The items that are not defined in these rules shall follow the corporate accounting practices generally accepted as fair and reasonable.” In other words, the Rules on Financial Statements is a ministerial order consigned by the Securities Exchange Law to add rules on representation in order to accomplish the object of the law. We must pay attention to the fact that the basic philosophy of the rules promotes healthy, democratic development of the national economy, which is the purpose of the “Corporate Accounting Principles” under the Commercial Code. The concept of the “corporate accounting practices generally accepted as fair and reasonable” mentioned here matches the concept of the “Corporate Accounting Principles,” which has a ruling capability as a custom.

A concept of the modern accounting philosophy was clearly shown in the “Corporate Accounting Principles” under the Commercial Code as it placed importance on the profit and loss calculation for a particular period, assuming that the particular corporation is of on-going concern. However, the “Corporate Accounting Principles” does not have any enforcing power so its ability to perform as a legal code depends on how it is defined and interpreted in the Commercial Code and the Securities Exchange Law.

The corporate accounting principles also based on the Securities
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Exchange Law define the standards for processing bad loans as shown above, but it is also notable that they do not require them to be disclosed by footnotes. The Securities Exchange Law was introduced after World War II copying the same laws established in 1933 and 1934 in the United States. When it comes to the corporate accounting principles and other rules that are required for the full implementation of the laws, it has yet to be developed to reach the international level. This is why one wonders whether the Japanese accounting standard can be trusted.

It is worth noting that some of the financial statements are required to include a legend as requested by the U.S. According to the current rule, it is necessary for financial statements of some Japanese corporations written in English to have notations (legends) such as “This is prepared in accordance with the Japanese Securities Exchange Law and accounting standard, and not under the accounting standards of any other countries.” This means that the Japanese accounting process is no longer trusted internationally because of Japan’s closed-mindedness and its insensitivity to what is happening internationally. The problem does not lie with the corporations that are forced to write such statements but rather the problem is derivative of the accounting system of Japan. The parties who are negatively affected as a result of these immature accounting standards are the corporations who fail to be trusted and investors (users of the financial statements) who cannot obtain accurate information.

Corporate Tax Laws

There is a specific and detailed rule in Japanese tax law outlining the limit that can be reserved for bad debts. The corporate tax law stipulates the following four kinds of limits of the loan loss reserves:

1. a method of reserving at a fixed rate for each business type;
2. a reserving method based on the rate of lending loss in the past;
3. reserving 50 percent of the outstanding loans as the fixed outstanding loan depreciation special account when the debtor is banned from bill clearing transactions, applies for the protection under the corporate
reorganization law\textsuperscript{55} or the bankruptcy law,\textsuperscript{56} or declares the account clearance; and

(4) a method of appropriating the reserve amount approved by the director of the governing tax office as a loss when the debtor is incapable of repayment and an asset deficient condition is continuing for a substantial period.\textsuperscript{57}

Since the tax law includes such specific and detailed rules, a consensus and custom have developed to show that it is safe to follow the abovementioned first method, i.e., “a method of reserving at a fixed rate” as specified in the tax law. It seems that corporations conveniently relied on the tax law as the accounting standard lacks detailed regulations. In other words, we cannot deny the fact that the tax law played the role of the general accounting standard.

Thus, the rules of the corporate tax law played a major role in the accounting practices for loan loss reserves until the calculation of limits for loan loss reserves was fundamentally changed in 1998.\textsuperscript{58} Thus, the difference between the corporate accounting and the tax accounting was not recognized until the rule of statutory reserve rate as mentioned above in the first method, i.e., appropriating a fixed rate of loan loss reserves, was cancelled by the tax law revision in 1998 to be gradually implemented by 2002. The tax law and the corporate accounting principle are essentially two different things as the tax law is determined by the Diet in order to pursue various policies from time to time, while the corporate accounting is for showing the performance of a corporation. As the rule of the abovementioned tax law indicates, the rule of the tax law is a calculation method that cannot be an evaluation standard for securities on the closing date. The loan loss reserves in corporate accounting are used for estimating the loan loss reserves on the closing date, so that the credits, less the loan loss reserves, should show the “collectible amount,” but the tax law does not use it as the basis of the calculation.

\textbf{LEGAL PRECEDENTS}

There has been no legal case concerning the amount of loan loss reserves
fought on any civil court in Japan. However, there have been several cases wherein the responsibilities of bank managements are challenged, accused of having failed to appropriate sufficient amounts of reserves while realizing that they are dealing with bad loans and thus camouflaging the existences of the bad loans.

Consider the situation of LTCB as the leading case. This is a case in which the court denied any claim of responsibility of the managers.

**Outline of the Case**

This was a case wherein the plaintiff (bankruptcy administrator) sued the defendants (the bank president and other directors at the time of the incident); the defendants’ bank, which was known as the Japan Long Term Credit Bank of Japan, Ltd. (“LTCB”) at the time of the incident, lent ¥6 billion to E.I.E. International ("Non-Litigant Company") on April 27, 1990 ("Loan") and further extended the repayment term of the Loan on July 26, 1990 ("Extension"). The plaintiff, still unable to collect a portion of the loan because the Non-Litigant Company subsequently bankrupted, asked the defendant directors for payment of a portion of the uncollectible money and the delay damages thereof based on the right to seek damages on the reason of breach of fiduciary duty on the director’s part approving the Loan and the Extension.

**Issues**

The plaintiff claimed as follows citing that there was a breach of fiduciary duty on the part of the defendants:

Bank directors should manage their banks with a priority focus on maintaining health and safety, limiting the directors’ judgment power in situations of loaning needs. As a person authorized to decide the lending, the director has to make an appropriate judgment on the probability of loan collection only after thoroughly investigating the borrower’s financial and operating conditions, manager’s capability, assets, credit information of the past, the loan amount and purpose, repayment capability,
method of acquiring funds for repayment and probability (including other outstanding loans and repayment statuses), collaterals that can be offered and the values thereof, etc., as well as the present and future economic trend (business trend and asset price trend including the expansion or decline). Also, if borrowers whose financial status is deteriorating as a result of deteriorating profit and fund liquidity request additional loans, the director must make proper judgment on whether such an additional loan should be executed based on aggressive investigations of the borrower company’s management status and future outlook, as well as comparison of the portions of the total loan estimated to be collectible in cases the additional loan is made and also based on the reason for the borrower’s request for the additional loan and collateral.

In reality, the Loan lacked a decent collectibility outlook and needs, so that the execution should have been stopped.

**Court’s Judgment**

The Loan was approved on a judgment based on the related departments’ analyses and evaluations of information collected and accumulated systematically by the bank through its historical transactions with the Non-Litigant Company, under a constraint of time limitation, coming to a conclusion that there was a need for the Loan and that there was no concern about loan collection in consideration of the measures taken for securing debt collection. One has to see that there is no evidence that there was any error beyond the scope of the judgment requirements either on the fact recognition, which is the basis of the judgment, or in the contents of the judgment under the circumstance.

Therefore, it seems that there was no breach of fiduciary duty by the defendants as the loan approval decision makers in the decision made on the Loan.

**Comment**

The problem with the decision of this case is that the court only decid-
ed that there was no fiduciary duty on the part of the directors concerning the point that the problem of insufficient collateral for the Loan was temporarily camouflaged by executing an additional loan. However, the suit was not fought on the point if there was a sufficient loan loss reserve against the possibility of the borrower becoming unable to pay back, and the court did not either make any judgment on that point or seek potential negligence of the defendants. As seen later it looks as if it is possible to make a claim of breach of fiduciary duty on the part of the defendants on said point for cases in the U.S. In essence, it seems that it is difficult to seek legal responsibility for such negligence in Japan because there is no solid legal requirement for loan loss reserves, as seen above.

REGULATIONS ON BAD LOANS IN THE U.S.

SEC Laws

The SEC relies on an independent, private sector standards-setting process that is thorough, open, and deliberate. While the SEC has the statutory authority to set accounting principles, it has looked to the private sector for leadership in establishing and improving accounting standards. Therefore, the quality of U.S. accounting standards may be attributed in large part to the private sector standards-setting process, as overseen by the SEC.

The primary private sector standards-setter is the Financial Accounting Standards Board (the “FASB”), which was established in 1972. The FASB’s standards are designated as the primary level of “generally accepted accounting principles,” which is the framework for accounting. The FASB’s standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

The accounting principles are contained in Statement of Financial Accounting Standards ("FAS") No. 5, "Accounting for Contingencies" and FAS No. 15, “Accounting for Debtors and Creditors for Troubled Debt Restructurings,” issued by the FASB. These standards determine the timing and adequacy of specific provisions. Specifically, an estimated loss should be accrued by a charge to income (provision) if it is probable that an asset has been impaired or a liability has been incurred and if the amount of...
the loss can be reasonably estimated. There are further standards as to
impaired assets and loans. It requires that impaired loans be measured based
upon the present realizable cash value. It requires that impaired loans be measured based
upon the present realizable cash value.64 The present realizable cash value is
the present value of expected cash flows discounted at the loan’s effective
interest rate.65

Tax Laws

Under the law, a portion of the bank’s current earnings may be sheltered
from taxes to help prepare for bad loans. The annual loan-loss provision is
deducted from current revenues before taxes are applied to earnings.
Prior to passage of the Tax Reform Act of 1986,66 all U.S. banks could figure
their loan-loss deductions using either:

(1) the experience method (in which the amount of deductible loan-loss
expense would be the product of the average ratio of net loan charge-offs
to total loans in the most recent six years times the current total of out-
standing loans), or

(2) the reserve method (which allowed banks to automatically deduct, with-
out being taxed, up to 0.6 percent of their eligible loans at year-end).

Among the two methods, U.S. banks could choose the particular loan-
loss expensing method that resulted in the greatest tax savings.

The Tax Reform Act required large U.S. banks and bank holdings com-
panies to use

(3) the specific charge-off method, which allows them to add to loan-loss
reserves out of pretax income each year no more than the amount of
those loans actually written off as uncollectible. The expensing of a
worthless loan usually must occur in the year that loan becomes worth-
less. However, small banks and banking companies (under $500 mil-
lion in assets) could continue to use the experience method or switch to
the specific charge-off method.
Legal Precedents: Case 1

This is a case that the court held that the defendant kept a loan loss reserve artificially low.

For the financial statements of ASB Bank, the court said:

“Like other banks, ASB had a loan loss reserve to cover all losses in its loan portfolios as well as other potential losses. If the loan loss reserve was understated for any given period, ASB’s income would be overstated as it would not accurately reflect the bank’s true assets. At ASB, Whitmore (the defendant) had the sole responsibility for determining the loan loss reserve and had no formal method of making this determination.

“In 1987, Whitmore kept the loan loss reserve artificially low in ASB’s reports so as to mask the financial difficulties the bank was facing. Despite opposition from ASB officers who refused to sign such falsified financial forms, Whitmore’s loan loss reserve calculations for 1987 misstated the true financial status of ASB.”

Legal Precedents: Case 2

In this case, the court concluded that the plaintiff adequately set forth the necessary *prima facie* case for negligent misrepresentation, based on the allegations set forth in the complaint. The complaint alleged that, “the individual defendants knew, based upon their business sophistication, experience, and knowledge of accounting, that Boston Chicken’s (the lender’s) financial statements were false and misleading. It alleged that a loan loss reserve was required, but was not taken against the substantial loans made to the FADs (the borrower) because the loans were impaired; the Boston Chicken’s reported revenues, being largely the result of loans made the FAD’s and recycled bank to Boston Chicken, were fictitious. The complaint also alleged that the individual defendants knew the financial statements audited by Arthur Andersen were false and misleading. Apparently, these false and misleading financial statements enabled Boston Chicken to raise hundreds of millions of dollars of debt and equity capital from the investing public.”
There are many cases regarding loan loss reserves in the U.S. such as those holding that statements characterizing a loan loss reserve as “soundly underwritten” are actionable.  

OFFICIAL VIEWS OF THE JAPANESE GOVERNMENT ON BAD LOANS

In October 2002, FSA revealed its policy to tackle with bad loan problems of banks by issuing a paper titled, “Financial Revitalization Program — Economic revitalization through solutions to bad loan problems of major banks.” In other words, it made clear that the agency will review the standard for the asset evaluation in order to tighten further on asset evaluation of financial institutions.

According to the paper, the agency says that it will seek consistencies in the asset evaluation standard with the market value. With reference to loan loss reserves, the agency says it will apply the American style DCF (discount cash flow) technique. It will use the individual reserve method based on the DCF technique concerning large borrowers on the warning lists of major banks.

What FSA is intending to do is to introduce DDF, an American style quantitative measurement technique, addressing the point that there has been chronic insufficiency in reserves for problematic borrowers, in order to force the banks to do more accurate market value evaluations and to make them appropriate more reserves to fill the gaps between book values and market values. This is a very aggressive banking policy unheard of from the Japanese government up until this time.

In implementing the DCF method, FSA revised its financial inspection manual and asked major lenders to use it starting with the FY2003. However, little is known as to its specificity of its contents and techniques involved.

DCF essentially predicts future cash flow and seeks its present value, and the biggest hurdle in applying the DCF method is how to select an appropriate discount rate reflecting the risk premium. In case of a bad loan with a risk of default, it is necessary to consider the risk (credit risk). In such a case, it is not enough to calculate just the estimated default probability. It is
necessary to use a discount rate obtained by applying the risk premium on top of the market interest rate. In dealing with a corporation with an especially high borrowing rate, it may be necessary to use a higher risk premium. If a contracted interest rate is used as a discount rate, it may result in evaluating the value of a loan extremely large. Although the DCF method is a correct method, the result can be misleading if a wrong discount ratio is used. Although it is difficult yet to judge how the DCF method will be used in Japan and if it meets the expectation of FSA, it is no doubt that a new system has begun.

CONCLUSION

In order to restore the Japanese financial system and the financial administration to trustworthiness, and to rebuild a financial market that can be respected by the world, it is mandatory first to solve the bad loan problems of the major banks. It is not only the expectation of IMF as mentioned above, but it is also the whole-hearted expectation of various countries including the United States that believe that the economic recovery of Japan will lead to the economic recovery of the world. It is necessary to aim for building a more solid financial system that can lower the bad loan ratios of major banks, fix various related problems, and support the overall restructuring of socio-economic systems, which mandates major banks more stringent evaluations of their assets, enrichment of their own capitals, and strengthening of their governances.

There are a few noteworthy cases in this area in Japan. In one civil case, directors of the bank were asked for payments of a portion of uncollectible money and the delayed damages due to alleged breach of fiduciary duty. The court judged that there was no breach of fiduciary duty. However, the problem was that the court did not either make any judgement on the point of whether there was a sufficient loan loss reserve against the possibility of the borrower becoming unable to pay back to seek potential negligence of the directors.

For the criminal case concerning a criminal responsibility related to an accounting procedure for bad loans, the defendants were indicted on account of a violation of the Commercial Code. However the judgement is question-
able since it created a criminal based upon unclear accounting standards.

It is clear now that the problems of the judgments in both cases were caused by the fact that there is no express law in Japan concerning the “fair accounting practice.”

Above all, it is necessary for them to appropriate necessary minimum reserves against loan losses through more stringent evaluation of bad loan risks. Japanese banks must improve their shortcomings in this area to regain their international credibility. This article pointed out that various rules and regulations concerning loan loss reserves in Japan are so much behind those in the United States.

Bad loans are not limited to banks, but can occur accidentally in any business operations. Therefore, there is a need to have a clear-cut standard for loan loss reserves. Although there should be a range from the lowest to the highest in the estimation of a bad loan loss, there should be an accounting standard for an accidental phenomenon. However, there is no clear-cut accounting standard on that in Japan.

Cases where banks that were making profits and distributing dividends go under in just six months leaving huge asset deficiencies in the corrected balance sheets are actually happening in Japan as in the cases of Nippon Credit Bank and Long Term Credit Bank of Japan, reviewed above in this article. This is a phenomenon that cannot happen under the accounting standard of the United States. This is because, in the United States, an accounting auditor expresses its opinion that a financial statement is properly prepared according to the generally accepted accounting standards. Since the accounting auditor is supposed to express its opinion whether a financial statement is prepared according to an accounting standards, the accountant’s opinion becomes unclear if said accounting standards do not clarify the standard for accounting procedures and the standard for disclosure. The reason accounting auditors can function in the U.S. is partially because they have clear-cut accounting standards they can rely on.

The question of how to identify the real status of bad loans and how to deal with them can be essentially reduced to the question of accounting standards. The entire accounting standards, not just on loan loss reserves, should be reviewed and revamped in Japan, so that the Japanese market can regain the world’s trust. Japan should deeply recognize the need that Japan should
try on its own to improve the world's trust on Japan in order to achieve the recovery of the Japanese market and economy, which is essential for the world economy.

NOTES

2 An article titled, “Japanese disclosures not showing real pictures,” appeared on the January 25, 1995 issue of Nihon Keizai Shinbun (Japan Economic Journal, hereafter “Nikkei”), and discussed a way to solve the bad debts, referring also to the IMF’s report.
3 Following the selection of the preferred acquirer of the LTCB on March 1, 2000, all common shares of the LTCB were transferred to New LTCB Partners C.V., an investment group comprising leading U.S. and European financial institutions and other investors. As a result the temporary nationalization came to an end. On June 5, 2000, the LTCB changed its name to Shinsei Bank, Limited. It began operations anew as a private bank under new management. But with the change of the bank’s name, a new beginning was forged. To emphasize this, it selected the name “Shinsei,” which in Japanese means “new birth.” Shinsei Bank, Limited is now located at 1-8, Uchisaiwaicho 2-chome, Chiyoda-Ku, Tokyo, Japan with a capital of 451.296 million yen and with 2,055 employees. For details see http://www.shinseibank.co.jp.
5 The Financial Reconstruction Commission (“FRC”) was merged into the Financial Services Agency on January 6, 2001. The FRC had been working to restore stability and vitality in the financial system through quick resolution of failed financial institutions under the Financial Revitalization Law and capital injection into viable institutions using public funds under the Financial Function Early Strengthening Law (Law No. 143, 1998). With these efforts, the environment surrounding financial institutions had on the whole regained stability. For details, see http://www.fsa.go.jp.
6 “Partners” was established as a partnership by Ripplewood Holdings, L.L.C., of the United States, and other leading international financial institutions as well as other investors with the aim of acquiring LTCB. All investor groups participating in “Partners” were expected to have a long-term view of the bank’s development to
sustain their investment for 10 to 15 years or longer.
Principle investors in “Partners” were as follows:
Paine Webber (United States)
Deutsche Banc Alex Brown (Germany)
Mellon Bank Corporation (United States)
The Bank of Nova Scotia (Canada)
Banco Santander (Spain)
St. James Place Capital plc (United Kingdom)
GE Capital Commercial Finance, Inc.
Travelers Investment Group, Inc. (United States)
ABN-Amro Bank (Netherlands)
Ripplewood Group (United States)
For details of “Partners,” see LTCB’s Annual Report 1999.
7 In view of the large amount of losses incurred in the disposal of non-performing assets, at the time of the termination of temporary nationalization LTCB made an application for Special Financial Assistance (a monetary grant and a supplement to offset losses incurred in the conduct of the activities of a bank under temporary nationalization) to the Japanese Deposit Insurance Corporation (“DIC”). The total amount of this assistance was ¥3,588.0 billion. For details, see LTCB’s Annual Report, 2000.
8 The Financial Services Agency (“FSA”) was created as of July 1, 1997, with the integration of the Financial Supervisory Agency and the Financial System Planning Bureau of the Ministry of Finance. The new FSA has integral responsibility over planning of the financial system and supervision and inspection of financial institutions. In view of the rapid changes in the environment surrounding the economy and financial markets, the planning of the financial system focused on building a stable and vigorous financial system, and securing the efficiency and fairness in the financial markets. In the supervision and inspection of financial institutions, further efforts to maintain and improve the soundness of financial institutions were made. Coordination with foreign financial authorities was strengthened to cope adequately with the globalization of finance. For the details of FSA, visit http://www.fsa.go.jp.
9 On December 13, 1998, NCB was notified of the decision by the Prime Minister to initiate Special Public Management of NCB pursuant to the Financial Revitalization Law (Law No. 132, 1998). As a result, NCB was nationalized and all of its shares were acquired by the Deposit Insurance Corporation (“DIC”) on December 17, 1998. A new management team was appointed by the DIC effective December 25, 1998. On September 1, 2000, NCB ended its period of special public management that began on December 13, 1998 upon the closing of a Share

NCB changed its name to Aozora Bank, Ltd. on January 4, 2001. Aozora Bank, Ltd. is located at 1-3-1, Kudanminami, Chiyodaku, Tokyo, Japan with capital of 419.6 billion yen and 1,395 employees. For details of Aozora Bank, Ltd., see http://www.aozorabank.co.jp/.


In 1997, the Economic Planning Agency (“EPA”) was absorbed into the Cabinet Office of the government due to the restructuring of Japanese government agencies. Most of the information about the EPA can be found in the web site of the Cabinet Office at http://www.cao.go.jp/index-e.html.


At the time of the application, Mycal Corporation was located in Osaka, Japan with capital of ¥74 million and with 20,178 employees. For details, see http://www.mycal.co.jp/.


Holding company, started out as wholesaler of PC software and publisher of PC magazine. Head office located at 24-1, Nihonbashi-Hakozakicho, Chuo-ku, Tokyo 103-8501, Japan. Sales as of March 2003 were 440,000 million yen.

Largest general leasing company. Diversifying into life insurance, securities, and trust banking. Head office located at 3-22-8, Shiba, Minatoku, Tokyo 105-8683, Japan. Sales as of March 2003 were 600,000 million yen.
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24 It was established in the government as a control organ to restore the Japanese economy after World War II in 1946 and was abolished in 1952 since it finished the functions. See the details at http://www.nira.go.jp/pubj/seiken/v08n07.html.

25 The Ministry of Finance was reorganized on January 6, 2001. The name was changed from Okurasho to Zaimuco in Japanese, but the English name still remains the same. For the more information about the reorganization, see http://www.mof.go.jp.

26 Corporate Accounting Principle, Art. 18.

27 Refer to “BOJ and FSA, Which is Wrong?” by Tsuyoshi Kimura, pp. 118-125. Bungei Shunju, October 2001 issue. According to the author, a strange phenomenon is that the total amount of reserve is decreasing while the remaining balance of the bad loans is increasing, exemplifying the abovementioned condition occurring in the actual process. He also criticizes the Japanese banks for unduly delaying the clean up process of bad loans.


29 See supra note 24.

30 See supra note 8.

31 Prime Minister Koizumi frequently conferred with Minister of the FSA, Yanagisawa, in order to press forward on the fundamental clean up of the bad loan problems as his pet project of the reform he is pushing. The FSA resisted the change claiming that they “cannot issue policies that contradict with the traditional financial administration policies and accounting principles,” which clearly shows FSA’s poor understanding of the bad loan problems. For detail, see Nikkei, September 21, 2002 issue, p. 3.

32 See supra note 23.


34 Law No. 34, enacted on March 31, 1965, amended many times, (hereinafter
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cited the “Corporate Tax Law”). For the details, see http://www.houko.com/00/01/S40/034.htm.

35 Commercial Code, Article 33 provides,
1. The following matters shall systematically and clearly be stated in the accounting books:
   (1) Business properties and values thereof at the commencement of business and once in each year at a fixed time, as for a company, business properties and values thereof at the time of incorporation and at each settlement of accounts;
   (2) Transactions, and other matters which give influence to business properties.

2. A balance sheet shall be prepared based on accounting books at the time of commencement of business and once in each year at a fixed time; and a company shall prepare it based thereon at the time of incorporation and at each settlement of accounts.

3. A balance sheet shall be compiled and bound together, or shall be entered in a book specially kept for that purpose.

4. A balance sheet shall contain the signature of the person who prepared it.

36 Commercial Code, Article 281 provides;
1. The Directors shall prepare the following documents and the annexed specifications thereof every period for settlement of accounts:
   (1) A balance sheet;
   (2) A profit and loss account;
   (3) A business report;
   (4) Proposals relating to the reserve fund and the distribution of profits or interest.

2. The documents under the preceding paragraph need be audited by the auditors.

37 Commercial Code, Articles 32-36. Commercial Code, Article 32 provides:
1. Every trader shall prepare accounting books and balance sheets for making clear the conditions of business properties and profit and loss.
2. In construing the provisions concerning preparation of the books of account, authentic accounting practices shall be taken into consideration.

38 Commercial Code, Article 285-4 provides:
1. The monetary claims shall be valued at the nominal amount thereof; provided that, if they were purchased at the proceeds lower than the nominal amount or there is any reasonable ground, they shall be valued with reasonable decrease.
2. If there is a fear of being impossible to collect the monetary claims, the estimated amount of being impossible to collect shall be deducted in valuation.

39 Commercial Code, Article 287-2 provides:
1. When the preparation money is accounted on the debit side of the balance sheet for preparing against a specified defrayal or loss, the purpose thereof shall be made clear in the balance sheet.

2. If the preparation money under the preceding paragraph is used for the purpose other than its proper purpose, the reason shall be stated in the profit and loss account.

40 Article 287, Section 2.
42 See supra note 25.
43 Article 193.
44 Article 24 stipulates that the issuer of securities must submit a Securities Report ("Yukashoken Hokokusho").
45 The MOF Ordinance No. 36, issued on November 27, 1963. For details see http://www.mof.go.jp/hourei.htm.
46 The MOF Ordinance No. 28, issued on October 30, 1976. For details, see http://www.mof.go.jp/hourei.htm.
47 The MOF Ordinance No. 24, issued on March 30, 1999. For details, see http://www.mof.go.jp/hourei.htm.
48 Article 1-1.
50 Refer to Mitsuru Misawa, Securities Regulation in Japan, 6 Vanderbilt Journal of Transnational Law 447-510 (1973), on the history of how the Japanese Security Exchange Law was established.
51 This inclusion of the legend was requested by the Big 5 accounting firms of the U.S. For the details of the backgrounds of the requests, see http://glovia.fujitsu.com/jp/cybersmr/e4-1.html.
52 The following is an example of a legend. "Summary of Significant Accounting Policies. Basis of presentation, Nissan Motor Co., Ltd. (the "Company") and its domestic subsidiaries maintain their books of account in conformity with the financial accounting standards of Japan, and its foreign subsidiaries maintain their books of account in conformity with those of the countries of their domicile. The accompanying consolidated financial statements have been prepared in accordance with accounting principles and practices generally accepted in Japan and are compiled from the consolidated financial statements filed with the Minister of Finance as
required by the Securities Exchange Law of Japan. Accordingly, the accompanying consolidated financial statements are not intended to present the consolidated financial position, results of operations and cash flows in accordance with accounting principles and practices generally accepted in countries and jurisdictions other than Japan.” For detail, please obtain a pdf file of Nissan’s Annual Report from the Nissan’s home page on the Internet. The legends of cautionary statements can only be found in the English version of financial statements based on the Japanese Securities Exchange Law, not in any financial statements of SEC registered companies prepared based on the U.S. Accounting Standards. See, for example, Nissan Motor's Annual Report, 2002, p. 57. (http://www.infinitinews.com/nav.html).

53 Nippon Keidanren (Japan Business Federation, equivalent to the Business Round-table in the U.S.), in which its mission is to achieve a private sector-led, vital and affluent economy and society in Japan, for which it is demonstrating its leadership in setting the path for the country, is officially against the inclusion of the legend, and advocates the necessity of internationalizing Japanese accounting standards. For Nippon Keidanren's announcement of the issue, see http://www.keidanren.or.jp/japanese/policy/2001/013/honbun.html. For the Keidanren, see http://www.keidanren.or.jp/english/profile/pro001.html.

54 Law No. 34 enacted on March 31, 1965, amended 46 times thereafter. See details at http://www.houko.com/00/01/S40/034.htm.


56 Law No. 71 enacted on April 25, 1922, amended 11 times thereafter. For details, see http://www.houko.com/00/01/T11/071.htm.

57 Article 52.

58 Revised on April 1, 1998.

59 Claim for damage, Tokyo District Court, Heisei 11 (Wa) No. 28167, Judgment delivered on July 18, 2002.

60 The company, a resort development company, filed a bankruptcy claim on June 21, 2000 with the debt of ¥ 609 billion. For details, see http://www.tv-tokyo.co.jp/wbs/2000/06/21/news_day/f3.html.


62 FAS, Statement No. 5, “Accounting for Contingencies,” March 1975, is summarized as follows:

“This Statement establishes standards of financial accounting and reporting for
loss contingencies. It requires accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and (b) the amount of loss can be reasonably estimated."

For the details, see wysiwyg://28/http://www.fasb.org/st/summary/stsum5.

63 FAS, statement No. 15, “Accounting for Debtors and Creditors for Troubled Debt Restructurings (Issued 6/77),” is summarized as follows:

“This Statement establishes standards of financial accounting and reporting by the debtor and by the creditor for a troubled debt restructuring. This Statement requires adjustments in payment terms from a troubled debt restructuring generally to be considered adjustments of the yield (effective interest rate) of the loan. So long as the aggregate payments (both principal and interest) to be received by the creditor are not less than the creditor’s carrying amount of the loan, the creditor recognizes no loss, only a lower yield over the term of the restructured debt. Similarly, the debtor recognizes no gain unless the aggregate future payments (including amounts contingently payable) are less than the debtor’s recorded liability.”

For the details, see wysiwyg://28/http://www.fasb.org/st/summary/stsum15.

64 See, Accounting Research Bulletin No. 43, “Restatement and Revision of Accounting Research Bulletins,” June 1953 (replaced ARB’s issued September 1939-January 1953), Chapter 3A-9. It stipulates:

“The amounts at which various current assets are carried do not always represent their present realizable cash values. Accounts receivable net of allowances for uncollectible accounts, and for unearned discounts where unearned discounts are considered, are effectively stated at the amount of cash estimated as realizable.”

65 FAS, Statement No. 114, “Accounting by Creditors for Impairment of a Loan — an amendment of FASB Statements No. 5 and 15 (Issued 5/93)” says:

“It requires that impaired loans that are within the scope of this Statement be measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate or, as a practical expedient, at the loan’s observable market price or the fair value of the collateral dependent.

“This Statement amends FASB Statement No. 5, Accounting for Contingencies, to clarify that a creditor should evaluate the collectibility of both contractual interests and contractual principle of all receivables when assessing the need for a loss accrual. This Statement also amends FASB Statement No. 15, Accounting by Debtors and Creditors for Trouble Debt Restructurings, to require a creditor to
measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with this Statement.”

Further, FAS, Statement No. 118, “Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures — an amendment of FASB Statement No. 114 (Issued 10/94)” says:

“This Statement does not change the provisions in Statement 114 that require a creditor to measure impairment. This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.”


— For example, the Third Circuit in Shapiro v. UJB Financial Corp., 964 F.2d 272 (3rd Cir.), cert. denied, 121 L. Ed. 2d 278, 113 S. Ct. 365 (1992), held that statements characterizing loan loss reserve as “adequate,” describing the loan portfolio as “well collateralized” and of high “quality,” and praising internal controls as properly centralized, supervised, and managed, could state a claim. Also, the Sixth Circuit in Mayer v. Mylod, 988 F.2d 635 (6th Cir. 1993), held that statements characterizing the loan portfolio as “soundly underwritten” were actionable along with allegations of misrepresentation concerning non-performing assets and inadequate loan loss reserves.
