Japanese Banking: A Time of Crisis

by Valentine V. Craig*

Never really profitable, Japanese banks are in crisis—a crisis into which they have been sinking for most of the past decade. This article explores the root problems that have led to this crisis in Japanese banking and what is being done to resolve them. It begins by describing the different kinds of banks and the protected niches in which they have operated. It examines the banks' immediate problems: problem loans resulting from the bursting of the "bubble" economy, a continuing soft economy, and lending problems abroad. It then looks more closely at the competitive problems caused by the very integral role the banks have played, and continue to play, in promoting the government's industrial policy. The banks' efforts to deal with their lack of competitiveness, as well as the government's efforts to strengthen and recapitalize the industry in the short term are then described. Finally, the article touches on the government's proposals to deal with the financial industry's long-term structural problems, the so-called Big Bang financial deregulation proposals. A subsequent article will explore the Big Bang reforms in greater detail.

The Banking System

Since the end of the Second World War, the Japanese financial industry has been highly segmented at two levels. (Recent progress in this regard is explained later in the article.) It has also been heavily regulated, primarily by the Japanese Ministry of Finance (MOF).

The Banks

Immediately after the Second World War, in an attempt to eradicate the *zaibatsu* financial-industrial conglomerates blamed for leading Japan into the Second World War, the Japanese Diet (Parliament) passed a series of laws restricting bank activities. Holding companies were abolished. Banks were restricted from engaging in securities and insurance activities, and bank ownership of other Japanese companies was limited. In addition to this broad segmentation, the banking industry was further segmented into five distinct categories of banks,[1] each with its specialized financial niche and corresponding restrictions: ordinary banks; long-term financial institutions; financial institutions for small business; financial institutions for agriculture, forestry, and fishery; and public financial institutions.

Until very recently, ***ordinary or commercial banks***—which include "city" banks, regional banks and foreign-owned bank branches—were restricted to providing short-term financing. Certain investment

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[1]The definitions and powers presented here are from U.S. General Accounting Office, *Bank Regulatory Structure*, Japan, GAO/GGD-97-5, December 1996.

banking services were also permitted. Commercial paper underwriting, foreign exchange, trade financing and some international securities activities were permissible activities. As of February 28, 1997, there were 10 city banks, 129 regional banks, and 92 foreign-owned banks.[2] These commercial banks together provided approximately two-thirds of all industrial loans.

The *city banks* were based in the large cities and were supported by a network of nationwide branches. They traditionally focused on short-term lending to large corporations. They also engaged in some securities activities and international finance. All city banks were also licensed as foreign-exchange banks. For their funding, they relied on Bank of Japan (BOJ) borrowings, the short-term interbank market, and corporate deposits (approximately one-half of their deposits were from large corporate accounts). *Regional banks* were restricted to providing funding within their prefectures; their customers were primarily small and medium-sized corporations and the interbank market. More than half of their deposits came from individuals. *Foreign-owned bank branches* in Japan functioned like city and regional banks. They accounted for a negligible amount of industry deposits, loans or assets, but were active participants in the derivatives market.

Long-term financing in Japan has been traditionally provided by ***long-term financial institutions***, a group that includes 33 trust banks (8 of which belong to the Federation of Bankers Associations of Japan) and 3 long-term credit banks. Until recently, these institutions were the only financial institutions in Japan permitted to raise long-term funds.

The *trust banks* were licensed to conduct both banking and trust activities, and they and the life insurance companies were given a virtual monopoly over most Japanese pension fund investments. As major sources of real-estate and development loans during the "bubble years" (the period of rapid and unsustainable escalation in the stock and real-estate markets in the 1980s), the trust banks currently account for a large percentage of the banking sector's nonperforming loans. They were funded by individual and corporate deposits held in trusts. The *long-term credit banks* provided funds to businesses for the purchase of plant and equipment and for long-term working capital. Because these banks were restricted from accepting deposits from their own borrowers and the government, their major source of financing had been the issuance of debentures.

Nineteen large banks from these first two bank categories are considered Japan's "major" banks. They include the nine remaining city banks, seven of the trust banks, and all three long-term credit banks. The city banks are Dai-Ichi Kangyo, Sakura, Tokyo-Mitsubishi, Fuji, Sumitomo, Daiwa, Sanwa, Tokai, and Asahi. The seven major trust banks are Mitsui, Mitsubishi, Sumitomo, Yasuda, Nippon, Toyo, and Chuo. The long-term credit banks are Industrial Bank of Japan, Long-Term Credit Bank of Japan, and Nippon Credit Bank.

Financial institutions for small business are the third category of Japanese banks, which is composed of approximately 800 mutual (*shinkin*) banks, credit associations, and credit cooperatives. These institutions have traditionally provided funding to their members, who are primarily small- and medium-sized businesses, consumer cooperatives, and labor unions. Their sources of funds have been deposits and installment savings provided by members (the *shinkin* banks also accept deposits from nonmembers). Three national federations act as central banks for these cooperative banks. The Ministry of Finance supervises the mutual banks and credit associations, while regional governments supervise the credit cooperatives. The credit associations and cooperatives have not been required to disclose information about asset quality, but both types of institutions, particularly the latter, were large lenders in the Japanese real-estate market during the 1980s.

The fourth category of financial institutions consists of ***financial institutions for agriculture, forestry, and fishery***. As of February 28, 1997, there were 47 credit federations of agricultural cooperatives and 35 federations of fishery cooperatives. These institutions take deposits from and target their lending to local cooperatives. The cooperatives exist at two levels: the level of village, town, or city and the level of prefecture. Serving as the central bank for these institutions is the Norinchukin Bank, which is regulated by the Ministry of Finance and the Ministry of Agriculture, Forestry, and Fishery. During the 1980s, this sector was very active in lending to the housing loan companies, called *jusen*.

The fifth category of Japanese financial institution is that of ***public financial institutions***: 11 wholly owned government banks and 9 public corporations. These public institutions are used to supplement private-

[2]Updated February 1997 data on Japanese banks are from the Federation of Bankers Associations of Japan (*Zenginkyo*), FAQ about Japanese Banks, http://www.Zenginkyo.or.jp/en/faq/a.htm. One of the 10 city banks, Hokkaido Takushoku Bank, subsequently failed in November 1997.

sector financing. They are funded through the Ministry of Finance, which is funded through the Japanese Postal Savings System. The Japanese Post Office, although not considered a bank, is certainly a formidable banking competitor, for its savings system has taken in approximately $2 trillion in savings—45 percent of all Japanese deposits.

In addition to the five categories of banks, there are a number of unregulated nonbanks—lending institutions that do not take deposits. These consist of insurance companies, housing loan companies (the *jusen* mentioned above), leasing companies, consumer finance companies, securities companies, and money-market dealers.

Bank Regulation

The Ministry of Finance (MOF) and the Bank of Japan (BOJ) share responsibility for monitoring the safety and soundness of Japan's banking industry. Other Japanese bank regulators are the Deposit Insurance Corporation (DIC), which is responsible for insuring bank deposits, and the Resolution and Collection Bank (RCB), which was created in 1995 to receive the assets of failed financial institutions.

The MOF, which also supervises securities institutions, is the primary bank regulator. Its responsibilities approximate those of the U.S. Department of the Treasury, the Internal Revenue Service, the Office of Management and Budget, the Securities and Exchange Commission, and to some extent the Federal Reserve Board.[3] In its banking oversight, the MOF establishes bank standards and has sole responsibility for bank licensing and for development and enforcement of bank regulations. It also has sole legal authority to take enforcement actions against financial institutions, leading to fines, imprisonment, and revocation of licenses. For the most part, the MOF has taken supervisory action by issuing "administrative guidance" on a case-by-case basis. Although the guidance provided through such notifications is not legally enforceable, banks are expected to act upon MOF guidance.

The Bank of Japan—which until recently was under the control of the MOF—is the nation's central bank and has responsibility for maintaining and fostering a safe-and-sound financial system. Although the BOJ has no legal authority to take enforcement actions against financial institutions, it provides advice to these institutions through its frequent contacts with them. As with the MOF's guidance, BOJ advice is typically treated as binding by Japanese banks.

Effective April 1, 1998, the BOJ became independent of the MOF and its powers were expanded to accord with those of other countries' central banks. In light of recent scandals involving bribes to BOJ employees, the Bank is being reorganized to encourage central bank transparency and accountability.

Both the MOF and the BOJ may inspect or examine banks at any time and with any frequency, although each typically examines the average bank once every two to three years. The MOF and the BOJ coordinate their monitoring efforts to ensure that most banks are examined annually. Since 1987, the MOF has used a rating system similar to the CAMELS rating system used by bank regulatory agencies in the United States.[4]

The DIC was established in 1971 to protect depositors and maintain the stability of the financial system. It is supervised by the MOF; the Minister of Finance appoints its governor; and the MOF approves the appointments of its executive directors and committee members. In addition, the MOF must initially approve all applications from financial institutions for financial assistance.

The DIC has authority to collect insurance premiums, pay insurance claims and advance payments, provide financial assistance, purchase assets from failing or failed financial institutions, and manage funds. It insures deposits up to a maximum of 10 million yen per depositor (approximately $73,400).[5] Excluded from coverage are interbank deposits, deposits in foreign currency, deposits in foreign banks and in overseas branches of Japanese banks. Membership in the system is mandatory for city banks, long-term credit banks, trust banks, and certain other banks.

In 1991, for the first time in its history, the DIC arranged an assisted merger of an insolvent institution with a stronger institution. Between 1991 and 1993 there were four more assisted mergers. In 1995, the RCB, modeled after the U.S. Resolution Trust Corporation (RTC), was created to receive the assets of failed financial institutions.

The Diet recently enacted legislation that (1) granted the DIC the authority to issue 3 trillion yen ($22 bil-

[3]"Scandal Erodes the Power of Japan's Bastion of Fiscal Austerity," *The New York Times* (March 17, 1998), D1.

[4]The acronym CAMELS refers to capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.

[5]All dollar-yen exchange rate calculations are based on an exchange rate of 136.27 yen to the U.S. dollar, the late New York spot rate on May 14, 1998.

lion) of government bonds; (2) provided government guarantees for the DIC to borrow 10 trillion yen ($73.4 billion); and (3) amended the Deposit Insurance Law to allow issuance of 7 trillion yen ($51.4 billion) of government bonds to compensate for commercial bank losses. Previously, the DIC had been allowed to borrow up to 2 trillion yen ($14.7 billion) from the BOJ.

The Problems

Japanese banks' distress is caused by both immediate and long-term problems. Speculative lending in Japan during the bubble years of the 1980s created a severe domestic bad-loan problem, and a more recent concentration of lending to Southeast Asia businesses resulted in foreign loans that also are expected to be problematic. The more difficult problems facing Japanese banks, however, are longstanding competitive problems resulting from the government-industry-bank relationship.

Bursting of the "Bubble" Economy

The immediate problem facing Japanese banks is their bad loans. The Japanese Ministry of Finance reported in January 1998 that its best estimate of the extent of domestic bad loans was 77 trillion yen (approximately $565 billion)—approximately 14 percent of total domestic loans. Although MOF audit requirements were used to arrive at this estimate, the estimate is based upon bank self-assessment and may therefore underestimate the extent of the problem. Since the January announcement, bad-debt levels have also reportedly increased quite substantially and are expected to continue increasing in the coming months.[6]

Many of these problem loans were made during the bubble years, when the long-term financial institutions and the financial institutions for agriculture, forestry, and fishery, the latter particularly, lent vast sums to commercial real-estate developers and home buyers either directly or through the *jusen* (housing loan companies financed by the banks). But the real-estate and stock markets began to crash in earnest in 1990, bringing an end to the bubble economy. By some estimates, today's real-estate prices in Japan represent an amazing 80 percent decline from their highs in the 1980s.[7] Although some major banks have made large provisions to cover *jusen*-related exposures, overall the banks have been slow to recognize their losses and rid themselves of these problem loans. With this overhang of unsold problem real-estate loans, the real-estate market continues to languish.

In the mid-1990s a government effort to bail out the *jusen* with taxpayer funds was met with tremendous resistance by the Japanese people; and until recently, that resistance deterred the government from providing taxpayer funds to deal with the banking crisis. A complicating factor in the resolution of the bad-loan problem in Japan, and a reason for public opposition to a government bailout of the *jusen*, is that many of the borrowers from the *jusen* are rumored to be members of the *yakuzi*, the Japanese underworld. A very detailed report on the *jusen* by the MOF and the Ministry of Agriculture, Forestry, and Fisheries, issued in January 1998, reinforced this belief when it inexplicably omitted the names of the largest *jusen* borrowers, all real-estate brokers.

Japanese banks were also substantially affected by the precipitous drop in the Japanese stock market that began in 1990. As with the real-estate market, the stock market has declined dramatically—approximately 60 percent from its highs during the bubble years. Although Japanese banks were not permitted to hold directly more than 5 percent of the shares of another company, an estimated 30 percent of the equity of Japanese industrial companies is held by banks indirectly.[8] Larger banks in particular are thought to have effective control over other companies by their indirect ownership through subsidiaries and affiliates and by cross-shareholding arrangements, interlocking directorships, and credit relationships.

Until recently, bank stock investments in Japan had to be valued at the lower of cost or market, and banks were allowed to use 45 percent of their "hidden reserves"—the unrealized gain on equity holdings—to meet international capital requirements. Any decline in the Japanese stock market therefore decreased the banks' capital and their lending ability. Because of continuing slippage in the Nikkei, it has been estimated that the largest banks' hidden reserves at the end of fiscal 1998 (March 31) represent 10 percent of their level a year earlier, with 8 of the 19 largest banks no longer having any hidden reserves left. It has been calculated that no hidden reserves will be left at any of the largest banks if the Nikkei goes beneath 16,201.[9]

[6]"Japan Banks Dumping Bad Debts, Incurring Large Losses, Sources Say," *BNA's Banking Report* 70, no. 14 (April 6, 1998): 583–84.

[7]"The Japan Puzzle," *The Economist* (March 21, 1998): 22.

[8]Anthony Saunders and Ingo Walter, *Universal Banking in the United States: What could we gain? What could we lose?* New York, Oxford University Press (1994), 84–86.

[9]"Japanese Banks Dumping Bad Debts, Incurring Large Losses, Sources Say," *BNA's Banking Report* 70, no. 14 (April 6, 1998): 583–84. The Nikkei was 15,014 on June 11, 1998.

The economic problems that have so seriously affected Japan, and Japanese banks, show no sign of abating. In fact, they appear to be worsening. Japan's Economic Planning Agency reported in June that the country had entered its first recession since the oil crisis in the 1970s. Its gross domestic product shrank an annualized 5.3 percent in the first quarter of 1998, following a 1.5 percent annualized decline in the fourth quarter of 1997. Its gross domestic product for the fiscal year (ending March 31, 1998) also fell—by 0.7 percent—the first fiscal year decline since 1975. The unemployment rate has been steadily rising, reaching 4.1 percent in April. This level, although low compared to international norms, is remarkably high for Japan. Additionally, as of June 12, the yen had sunk to an 8-year low against the dollar. The stock market remains in the doldrums, and recently, at the 15,000 level, the Nikkei has been testing its 1995 lows. Bankruptcies, both corporate and personal, are on the rise, and finally, it is not at all clear that real-estate prices, down an estimated 80 percent from their highs in the 1980s, have bottomed out.

Problems in Foreign Lending

The foreign lending of Japanese banks has also produced problems. As big lenders to Southeast Asia, Japanese banks are expected to suffer substantial losses from this exposure.

Many Japanese banks responded to the poor conditions in the domestic market by stepping up their foreign lending. Foreign loans and other assets account for approximately 22 percent of the assets of Japan's 20 largest banks.[10] However, foreign lending has produced problems of its own. Because much of it is done in dollars and accounted for in yen, recent appreciation in the dollar has resulted in an increase in the yen-amount of loans outstanding, forcing banks to set aside more capital to meet Bank for International Settlements minimum reserve requirements. But a more pressing problem is that much of Japanese banks' foreign lending was made to Southeast Asian companies. The Bank for International Settlements reports that Japanese banks hold at least $276 billion in loans to businesses in Asia. This Asian exposure by Japanese banks is approximately six times that of U.S. banks and twice that of German banks.[11] While some of these loans are reportedly to Japanese companies operating in Asia, much of this foreign lending may be unrecoverable. Even more ominously, these Asian economies have been major markets for Japanese goods, accounting for more than 40 percent of Japanese exports. The crisis in Southeast Asia is therefore expected to reverberate throughout the Japanese economy.

Structural Problems

The greater problem for Japanese banks is that they are not competitive, because of structural reasons. According to Moody's Investors Services, Japanese banks—with historical return-on-assets ratios of 0.43 percent—are the world's least profitable, even disregarding problem loans.[12] Thus, if and when the problem loans are disposed of, Japanese banking will still remain unprofitable and unable to compete internationally unless structural changes are made. To understand the reasons for this lack of competitiveness, one must understand two relationships: the one between Japanese industry and the Japanese government, the other between the banks and other Japanese businesses (called the *keiretsu* relationship).

The power of the Japanese government over the financial affairs of Japanese banks is tremendous. For example, until the summer of 1991, the BOJ, under the direction of the MOF, assigned each bank each quarter the net amount of new lending it was authorized to make.[13] This power is exerted to achieve one objective. As set forth by the Japanese government, the overriding purpose of Japanese banks has been to act as intermediaries in recycling Japanese savings to Japanese industry. Following the Second World War, the government—particularly the very powerful Ministry of Finance—successfully built and directed a banking system whose single goal was to support Japanese industry with the cheapest possible cost of capital. As one analyst has said, Japan has the only banking sector in the world dedicated to the cause of full employment.[14] Bank loans in Japan remain the major source of corporate finance, far overshadowing the stock and bond markets as sources of capital. Savers (who receive 0.1 percent annual interest on their time-deposit accounts) and the banks (whose large customers typically pay loan interest rates of between 12.5 and 25 basis points above the bank's cost of funds) have been sacrificed by the government to the cause of industrial production.

[10] "Raging Dollar Threatens Tokyo's Banks," *The Wall Street Journal* (February 13, 1997), A12.

[11] "Moody's Gauges Risk Exposure of Worldwide Banks to Asian Crisis," *BNA's Banking Report* 70, no. 10 (April 10, 1998): 407.

[12] "Japan's Sick Banking System," *The Economist* (March 9, 1996): 71

[13] Ibid.

[14] "Why Japanese Banks Don't Care about Profits," *Euromoney* (February 1998): 66–70.

But in return for carrying out national industrial policy and lending at rock-bottom rates, banks were protected from global and domestic competition and received tacit government assurance of a bailout should problems arise. Historically, when a Japanese financial institution was in difficulty, other healthy institutions, at government urging, would act as a "convoy" and rescue the failing institution by providing liquidity to it, or agreeing to merge with it.

This tacit government-directed guarantee allowed Japanese banks to ignore credit quality in pricing loans. Thus, they severely underpriced their products; and low margins, in turn, pushed them to pursue a strategy of volume lending. The average spread between loans and deposits has also narrowed over time, declining to 171 basis points in September 1995 from 230 basis points in March 1991.[15]

Inherent conflicts of interest have allowed this lack of bank profitability to go unchallenged. Large corporate customers reportedly own more than 50 percent of the shares of Japanese banks, so it is easy to understand the lack of stockholder attention to loan mispricing.[16] Here it is important to grasp the concept of the *keiretsu*. *Keiretsu* are closely knit groups of Japanese businesses that, sanctioned by the government, work together cooperatively to achieve group goals. They are affiliated through cross-shareholding agreements. Six *keiretsu* in Japan have a large commercial bank at their center, with the rest of the group composed of trust banks, life and nonlife insurance companies, and trading, construction, finance, and real-estate companies. The banks in the *keiretsu* are both lenders to and stockholders of the other businesses; the other businesses are both stockholders of the banks and the prime beneficiaries of the banks' low-cost loans. *Keiretsu* members are also frequently on the bank's board of directors, and bank officials are frequently on the boards of the other firms.

Government industrial policy and the inherent conflicts of interest in the *keiretsu* relationship have produced an unprofitable banking sector. However, because banks operate in protected niches, with a guaranteed level of "appropriate" profits, they have not pursued more-profitable financial services. For instance, two lucrative services provided by global banks today—loan securitization and interest-rate swaps—are foreign innovations that Japanese banks have ignored. Until very recently, Japanese banks rarely engaged in securitization, and their use of derivatives was severely restricted. Some Japanese banks have begun securitizing their problem-loan portfolios, but have used foreign financial institutions, mostly located in London, to do so—even for Japanese securities issued in yen and sold back to Japanese investors. Japanese banks are also markedly low-tech, and they have not been able to take advantage of arbitrage opportunities created by disequilibriums in foreign or domestic markets.

Unlike the situation in most countries, the two most powerful departments in Japanese banks are corporate planning (whose members interact with the MOF) and personnel (whose members oversee the careers of bank employees). The careers of Japanese bankers are still virtually governed by seniority. An employee's bonus is guaranteed; his rank and pay are basically identical to all other employees of his age (Japanese bankers continue to be predominantly male); and the route to promotion is inflexible.[17] Heads of departments or major branch managers are often elevated to board membership as recognition of their service. Boards tend to be very large (Tokyo–Mitsubishi, for instance, has 60 board members), and it is not considered respectful for board members to question corporate decisions.[18]

What Is Being Done

In response to their problems, some banks, most particularly the major banks, have begun to dispose of their problem loans and to undertake modest downsizing, cost-cutting, and business-shifting activities. The Japanese government has also initiated some short-term fixes to help the banks; and has proposed some reforms, some of which have been enacted, to deal with the underlying lack of competitiveness of the Japanese financial sector, the so-called Big Bang reforms.

Banks' Actions

The major Japanese banks have begun to deal with their problem loans. Many other Japanese banks, however, have been slow to dispose of their problem loans because lending opportunities have been limited, bond

[15]"Japan's Banks Struggle with Many Problems, Spur Slump in Stocks," *The Wall Street Journal* (January 22, 1997), A1.

[16]"Why Japanese Banks Don't Care about Profits," *Euromoney* (February 1998): 66–70.

[17]*Euromoney* reports that bank presidents must serve a stint as director of corporate planning, with approximately 23 years necessary for advancing from an entry-level bank employee to a division head in corporate planning.

[18]"Why Japanese Banks Don't Care about Profits," *Euromoney* (February 1998): 66–70.

yields low, and a government bailout (now announced) was long expected. For the 1996 fiscal year ending March 31, 1997, the 19 major Japanese banks disposed of 6.17 trillion yen ($45.3 billion) in nonperforming loans,[19] double the volume disposed of the previous year. The Bank of Tokyo–Mitsubishi reported that it wrote off $8.4 billion in problem loans, and Fuji Bank reported plans to sell $25 billion in loans to build its capital base.[20] Fiscal 1997 bank records are not scheduled for release until later in 1998, but it has been reported that the large banks will be writing off 10.219 trillion yen ($75 billion) in nonperforming loans for this period.[21]

Virtually all buyers have been foreigners, for Japanese life insurance companies have shown little interest in entering this market. E&Y Kenneth Leventhal estimates that by the beginning of 1998, $20 billion in foreign money had been invested in problem loans and distressed properties. Most of the deals were bulk sales; buyers were expected to securitize and sell them when restrictions on securitization end this year.

In addition, some banks have initiated modest downsizing, salary decreases and branch closings. Downsizing and cost cutting was required initially for all banks planning to take advantage of the DIC's 13 trillion yen assistance program (described below). Among the larger banks, the Bank of Tokyo-Mitsubishi announced planned staff reductions, branch closings, and pay cuts. Sanwa Bank is planning staff reductions of 1,300 employees over the next three years. It also plans to reduce the number of directors from 43 to 30; to cut compensation; and to consolidate or to close 60 branches in Japan and 5 branches overseas during the next three years. Sakura Bank will close as many as 23 overseas branches.[22] Sumitomo Bank's California-based operations are being purchased by Zions Bancorporation (Utah).[23] However, despite some cost cutting, Japanese bank salaries continue to be higher than salaries in other Japanese industries. They are also higher than bank salaries in other countries, a fact that is particularly interesting inasmuch as Japanese banks, unlike many of their international peers, do not provide investment banking services, typically a more lucrative banking specialty.

The *keiretsu* relationships are also changing. According to recent reports, cross-shareholdings (the glue of the *keiretsu* arrangements) have declined, dropping from 55 percent of total shareholdings 10 years ago to 47 percent today.[24] And the "convoy" system has begun to unravel. Nissan Mutual Insurance Company, Sanyo Securities, Hokkaido Takushoku Bank, and Yamaichi Securities are all companies that were recently allowed to fail. It was reported that nine life insurance companies rejected Sanyo's request for a postponement of its loan payments. However, the convoy system is not completely finished. Many analysts see the recent requests by the major banks for government financial assistance as their capitulation to MOF demands that they provide protective camouflage for weaker banks in need of assistance. In particular, Sanwa Bank, one of the healthiest Japanese banks, recently applied for a loan of 100 billion yen that was generally seen as unneeded.[25]

In response to changing conditions, some banks have changed their business mix. Lending activity has been curtailed; construction companies, in particular, report that their lines of credit have been shut down. Larger numbers of commercial banks have been entering the bond business, gaining a market share of 60 percent in the year ending March 1997, up from 36 percent a year earlier.[26] Long-term credit banks, having lost their monopoly on providing long-term credit, have shown an interest in entering asset management. Two of the three long-term credit banks, Nippon Credit Bank and Long-Term Credit Bank of Japan, allied themselves last year with Bankers Trust and Swiss Bank Corp., respectively, to strengthen their global asset management capabilities. The third long-term credit bank, Industrial Bank of Japan, is actively seeking a comparable alliance.

Short-Term Government Fixes

The Japanese government has tried to help the banks both indirectly, by stimulating the economy, and directly, by providing cash to the industry. It has pur-

[19]"Japanese Banks Dumping Bad Debts, Incurring Large Losses, Sources Say," *BNA's Banking Report* 70, no. 14 (April 6, 1998): 583–84.

[20]"Bank of Tokyo-Mitsubishi Write-off of $8.4 Billion Could Spur Other Banks," *The Wall Street Journal* (September 12, 1997), A16.

[21]"Japanese Banks Dumping Bad Debts, Incurring Large Losses, Sources Say," *BNA's Banking Report* 70, no. 14 (April 6, 1998): 583–84.

[22]"Top Japanese Banks Seek Help to Show Intent to Fix Sector," *The Wall Street Journal* (March 5, 1998), A19.

[23]"Sumitomo Bank Seeks to Sell Some U.S. Lines," *The Wall Street Journal* (December 5, 1997), A3.

[24]"Japan Girds for Changes on Lending," *The Wall Street Journal* (October 24, 1997), A14.

[25]"The Japanese Banks Seek Help to Show Intent to Fix Sector," *The Wall Street Journal* (March 5, 1998), A19.

[26]"Japanese Securities Firms: Once There Were Four," *The Economist* (September 27, 1997): 80.

sued a very easy monetary policy, dropping the official discount rate to 0.5 percent in 1995, where it remains. However, many analysts feel that this loose monetary policy, rather than restarting the economy, has caused excessive borrowing and overcapacity. With rates this low, the government is also no longer in a position to use monetary policy as a tool to spur the economy.

The government has also tried to export its way out of its problems. But because of resistance from the United States and Europe and the financial problems in Southeast Asia, an export-led expansion no longer appears a viable strategy for overcoming domestic Japanese stagnation.

The Japanese government has also tried to stimulate the economy by direct infusions of money. It injected 75 trillion yen ($550.4 billion) into the economy between 1992 and 1995, with approximately half dedicated to public works investments. The economy began to show some signs of growth in the spring of 1997, at which point, to gain control of its budget deficit, the government raised the consumption tax, slashed public spending, raised welfare contributions, and withdrew temporary tax concessions, throwing the country into recession.

Another stimulus package has recently been announced. On March 26, 1998, the Liberal Democratic Party announced a plan, subsequently enacted, to spend 16.6 trillion yen ($121.8 billion) in public works investments and temporary tax cuts to stimulate the economy. This is the largest stimulus package ever enacted in Japan. Approximately two-thirds of the money will go to public works, including less traditional targets of public investments such as information technology, telecommunications, education, urban redevelopment, and disaster prevention. Supporters of the plan also claim it includes "decisive" measures to address the bad-loan problem, including tax incentives to encourage the disposition of bad loans more quickly and a promised overhaul of the tax system. Many analysts are not optimistic about this new stimulus package, because much is concentrated on public works spending which, in the past, appeared to help only the construction industry, and only in the short run at that. Without permanent tax cuts—which are politically difficult to enact because they would require the issuance of deficit-financed bonds, currently prohibited by a fiscal reform law—it is feared that the Japanese people will use any temporary windfall for savings rather than consumption.

The government has directed special assistance to the banks. Some of this assistance has manifested itself in government actions to disguise the true extent of the banks' financial problems. For instance, for years the Japanese government used "price-keeping operations"—government manipulation of the stock market—to improve the balance sheets of financial and other companies. Just before the end of the fiscal year, the government would purchase huge amounts of stock on the Nikkei, thereby artificially inflating the financial statements of the banks, which are large holders of publicly traded stock. As discussed above, the banks were permitted to use some of the unrealized gains on these stock investments as hidden reserves to meet capital requirements.

Price-keeping operations were discontinued in the mid-1990s but were resurrected this year to improve the banks' reported financial condition for the 1997 fiscal year, which ended March 31, 1998. On March 30, 1998, the Postal Ministry announced that $7 billion from postal savings and insurance accounts was being transferred to trust banks for their purchase of stock in Japanese companies. Unlike in previous years, however, this time the strategy did not work. It is unclear whether the trust banks participated to the degree expected, but in any case, sellers quickly jumped into the market, causing the Nikkei to fall to 16,527 on March 31, far short of the government goal of 18,000.[27]

The government, in an act reminiscent of the behavior of U.S. regulators during the savings-and-loan crisis, has recently initiated accounting rule changes to allow the banks to meet their capital requirements. Financial reporting requirements have been changed to allow banks to value their equity holdings at historical cost, a change that effectively places a floor on expected capital losses caused by the prolonged stock market decline. Another change allows banks the option of carrying their real-estate holdings at market.

The government has postponed implementing reforms that would cause some banks to be declared insolvent. In 1996, the Diet passed several bills to strengthen the deposit protection system. In particular, a "prompt corrective action" system, changing the method for calculating capital adequacy ratios to follow international standards more closely, was to have been adopted on April 1, 1998. These capital adequacy ratios would have required specific corrective actions: institutions with less than 8 percent capital would have been required to prepare a management improvement

[27] "Japanese Plan to Boost Nikkei Stock Index Fails," *The Washington Post* (April 2, 1998), C1.

plan; those below 4 percent capital would have needed to implement specific corrective measures; and those below 0 percent would have been required to suspend operations. Implementation of this system for institutions involved in domestic business has been postponed until April 1999 to give the affected banks time to clear up their bad-loan problems. Internationally active banks are still subject to the rules.

The government is now also supplying cash directly to the banks. The Liberal Democratic Party recently announced a 30 trillion yen ($220.1 billion) program to stabilize the financial system. Thirteen trillion yen—in the form of purchases of preferred stock, subordinated bonds, or loans—was to be made available by the Deposit Insurance Corporation for selected investments in weak but viable banks that were implementing prompt corrective action measures. As announced, the terms of the assistance required the banks to cut costs, write off problem loans, prepare ethics guidelines, and provide more information on their activities. However, the standard-setting committee established by the legislation backed away from these requirements and recently held that the criteria were not binding and that all banks, regardless of financial or ethical weakness, could apply.[28] In fact, as mentioned above, all banks have been encouraged to apply in order to provide camouflage for the truly needy banks applying for assistance. The remaining 17 trillion yen of the 30 trillion yen financial stabilization package is being provided to the DIC to shore up its deposit fund.

Long-Term Government Fixes

Stock market manipulation, accounting rule changes to improve reported financial results, financial infusions—these are the short-term government fixes to the banks' problems. The government has also initiated dozens of reforms designed to make the Japanese financial industry more competitive over the long run. Announced by Japanese Prime Minister Ryutaro Hashimoto on November 11, 1996, these reform proposals are called Japan's Big Bang, in reference to the decade-earlier British experience in deregulating its securities markets.

The Big Bang proposals are designed to make the Japanese financial industry as a whole more competitive, and are directed to securities firms and insurance companies as well as to banks. They create a different competitive structure, authorizing financial holding companies, heretofore banned in Japan, and eliminating most of the restricted powers enjoyed by the different kinds of financial firms. They allow for broad-based competition and even permit foreign entities to enter the Japanese market. The reforms eliminate the distinctions between the different kinds of banks, allowing them to compete in one another's territory. They also eliminate a bank monopoly—foreign exchange—but permit banks to enter other, potentially lucrative financial areas, such as mutual fund distribution, underwriting and trading of securities, asset management, and eventually, perhaps, insurance sales (not yet decided). The Big Bang proposals also promote increased transparency and Western standards of governance. A new agency, the Financial Supervisory Agency (FSA), reporting directly to the prime minister and independent of the MOF, has been created to assume supervisory control over the financial entities currently supervised by the MOF.

Increased competition and greater transparency, goals of the Big Bang financial industry reforms, have much more potential to change the economic outlook for Japanese banking than cash infusions or other short-term government fixes. However, many of the Big Bang reforms have been put on hold while the government deals with the immediacy of the banking crisis. And unfortunately it is not at all clear that either the financial industry or the still powerful MOF is fully committed to the idea of unfettered competition. The verdict on the Big Bang financial reform proposals is therefore still out. The Big Bang reforms, and the opportunities and problems they present, will be the subject of a subsequent article in the *FDIC Banking Review*.

[28] "Japan's Bailout Fund Won't Squeeze Banks," *The Wall Street Journal* (February 27, 1998), A13.