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Abstract

Since the beginning of the 1990s, Japan has been suffering from the serious problem of non-performing loans in the banking sector. The government have struggled with this problem for longer than half a decade without remarkable success. This paper tries to give an answer to the question why Japan has suffered from so serious bank crisis from the perspective of corporate governance. Needless to say, the bank is a corporation managers of which must be monitored and disciplined by some means in order to keep their managerial efficiency. However, this paper stresses the bank management has not effectively been controlled. The deficiency of governance in bank management led to the current bank crisis. In particular, the lack of effective governance in bank management could account for the delayed responses of banks to the crisis. This is the conclusion of this paper.

1. Introduction

The period of the 1980s and the early 1990s was characterized by the global bank crisis. Not only many industrialized countries such as the United States and Japan, but also most developing countries and the economies transiting from the central planning to the market-oriented system experienced more or less bank crisis. Lindgren et al.(1996) describes "[a] review of the experience since 1980 of the 181 current Fund member countries reveals that 133 have experienced significant banking sector problems at some stage during the past fifteen years." (Page 20) After aggressively expanding their credit to risky projects like real estate developments, many banks were found trapped in the difficulty of a large amount of non-performing loans in those countries. The government had to step to bail out heavily damaged banks by pouring public money in some cases.

It may be a comfort for Japanese people to hear that the bank crisis is not peculiar to Japan. However, the Japanese bank crisis seems to be unique to its long duration and seriousness of its bad influence on the macro-economy. Japan has taken half a decade to deal with the bad loan problem in the banking sector without remarkable success. As many people had worried about, the bad loan problem has grown so serious as to endanger viability of the current financial system in the late 1997. This seriousness of bank crisis seems to be unique to Japan. Thus, we should be interested in why the banking crisis is so serious rather than why Japan has experienced the banking sector problem. After Japan, both South Korea and Thailand has fallen into the difficulty of serious bank crisis as well. We think there are common factors which can explain the banking sector problem in those countries including Japan.

This paper tries to give an answer to the question why Japan has suffered from

so serious bank crisis from the perspective of corporate governance. Needless to say, the bank is a corporation managers of which must be monitored and disciplined by some means in order to keep their managerial efficiency. However, this paper stresses the bank management has not effectively been controlled. The deficiency of governance in bank management led to the current bank crisis. This is the conclusion of this paper.

This paper is organized as follows. The next section, section 2 gives an overview of the current banking crisis in Japan. There still exists the danger of vicious circle between the degenerated bank capital and business setback. Section 3 examines the governance structure of Japanese bank management. First, we explain how the comprehensive safety net implemented by the government undermined the capital market mechanism of monitoring bank management. Then, we argue that the Japanese government has rigidly controlled the deregulation process in the financial markets so that the market competition was unable to exert disciplinary influence on bank management in Japan. Finally, we examine the monitoring by the regulatory authority of bank management. We claim that the pervasive relationship between the regulatory authority and private banks (so-called *amakudari*) increased fragility of the banking industry.

Our argument in section 3 suggests the management of the Japanese banks is "entrenched" in the sense that the managers are immune from external disciplinary influence. Section 4 argues the "entrenched management" in the banking industry delayed necessary structural readjustments and culminating in the financial crisis in 1997. Finally, section 5 summarizes the discussions of this paper and draws policy implications from them.

2. The Scale of Deterioration of Banks' Balance Sheets

Table 1 summarizes the official semi-annual figures of non-performing loans from March 1996 to September 1997 for the Japanese banking sector. According to this table, the average of non-performing loan ratio (the ratio of non-performing loans over the total loans) in the banking sector was around 4% as of September 1997. This is more than 0.8 percent point lower than the figure for March 1996. At the same time, more than half of the non-performing loan was covered by the provision for loan losses (i.e., the provision ratio was 2.37% at September 1997). On the whole, Table 1 appears to show that the problem of non-performing loans has already been settled and been reduced to a minor policy problem in Japan.

At the beginning of 1997, there were claims from authoritative bankers that the difficulty of non-performing loans had been overcome. However, a series of revelation of financial disorder late in the autumn of 1997 made clear that they were too optimistic. According to Figure 1 which shows the recent changes in the BIS capital ratios for the major banks, most of the major banks had been able gradually to increase their capital ratios until March 1997. However, the turmoil of 1997 retarded improvement in their capital ratios. If the government had not injected the public funds into their capital in March 1998, those major banks would have struggled more seriouslyto strengthen their capital bases.1) There remains rather serious problems with regard to capital shortage in the Japanese banking industry.

As Table 1 clearly shows, the cooperative credit banks have not recovered from serious situation of non-performing loans. Their non-performing loan ratio has kept higher than 10% with no signs of significant reduction. The coverage of provision for losses is still very low. Thus, the cooperative credit banks form a weak point for the Japanese banking sector. As for shinkin banks, it was reported that if they were to

subtract non-performing loans from their equity capital, almost 90 percent of these banks would be unable to satisfy the domestic standard of capital adequacy requirement (4 percent) imposed on commercial banks in Japan.2) This newspaper report suggests the serious difficulty of non performing loans for the cooperative banks.

There is ambiguity about the published figures of non-performing loans compiled in Table 1. Some people wounder whether the published figures underestimates the actual situation facing Japanese banks. This doubt was reinforced by the tentative report about the amount of problematic loans in the banking sector published by the Ministry of Finance (MOF) in January 1998. This MOF report is a survey of the loans that banks themselves recognized as "problematic" during the period from March to September in 1997 following the supervision criteria adopted by the MOF. According to this report, the total loans which are either impossible or very difficult to collect was ¥11.4 trillion for the major and the regional banks (i.e., just 1.8% of the total loans of these banks). However, in addition to this, they held 65.3 trillion yen of the problematic loans which are likely to be more or less difficult to collect. In total, the problematic loans was higher than 12% of the total outstanding loans for these banks. This figure is substantially higher than the non-performing loans ratios estimated by the published figures (i.e., around 3.8%). The MOF's tentative figures are estimated by different criteria from those utilized to calculate the official figures presented in Table 1. However, some of the "problematic loans" may easily change into non-performing ones in the near future.3)

A Danger of Vicious Circle

After the burst of "bubble" in 1990, the Japanese banks for the first time faced "the Japan premium" (defined by the difference between the yen LIBOR for Japanese

banks and for US and UK banks average) in international money market immediately after mid-summer of 1995, when some Japanese financial institutions went down due to the huge amounts of non-performing loans. After rapidly rising to higher than 30 basis point (in terms of 12 month yen LIBOR), the Japan premium had remained at around 10 basis point until the beginning of November 1997. In late November, the Japan premium jumped to 90 basis point reflecting the turmoil in the domestic money market.4) The development of the Japan premium suggests that the international money market had already started to give an alarming signal to the Japanese banking system in the summer of 1995. However, the Japanese government belatedly started to force bank recapitalization by announcing that the "prompted corrective action rules" would be introduced in April 1998. Both this announcement and the prolonged sluggishness of stock prices compelled banks to reduce credit supply in 1997. This is a "credit crunch phenomenon." The requirement of more comprehensive disclosure of non-performing loans seems to have worsened the credit crunch. Combined with the impact of the tax increases in the first half of 1997, the credit crunch has contributed to business setback which increased the amount of non-performing loans in the banking sector. Obviously, this is a vicious circle between deficiency of bank capital and the macroeconomic slowdown.5)

As will be discussed in the following, the policy measures of requiring both increases in bank capital and more comprehensive disclosure of non-performing loans are indispensable to reconstruct the banking system. However, they would worsen the crisis if the government does not deliberately counter the side effects of credit crunch with some other measures. Actually, the Japanese government was compelled to inject the public funds into bank capital at the beginning of 1998 with a view to mitigating the credit crunch in the financial market.6)

3. Governance Structure in the Banking Sector

Why have we suffered from so serious bank crisis? This paper proposes the hypothesis that the bank crisis in Japan is an issue of governance in the bank management. Generally speaking, the disciplinary influence could be exerted on bank management through the following three channels: i.e., (1) the capital markets where either investors including depositors would monitor bank performance or the threat of hostile takeover would discipline bank managers for their bad performance, (2) the competition in the banking industry which would weed inefficient banks out, and (3) the supervision of the regulatory authorities which would prevent banks from taking excessive risk and force managers to restructure their business in the case of crisis. In the following we examine how these disciplinary mechanisms have not effectively worked in the Japanese banking industry.

Comprehensive Safety Net in Japan

For various reasons, the capital market has not effectively worked to monitor and discipline bank management. The most important reason is that the government has kept quite comprehensive safety net working thereby depriving the capital market of monitoring incentives. We define the financial safety net as a social system of dealing with distressed banks and of distributing social costs associated with bank failures among related parties. The government usually provides a financial safety net in order to minimize the spillover effects of failures of banks and other financial institutions on the financial system as a whole. The safety net also has important implications for risk sharing in the financial system. Specifically, the operation of the safety net changes the ex post distribution of social costs associated with bank failures. The safety net decreases monitoring incentives of depositors and other investors in bank debt who are either explicitly or implicitly protected from bank

failure losses.6)

The Japanese financial system operates under an extensive safety net provided by the regulatory authorities. The MOF has executed programs to rescue distressed financial institutions in tight collaboration both with the Bank of Japan (BOJ) and private financial institutions, particularly major banks. Before 1990 there occurred some bank failures though the number was quite small. In the all cases the MOF guided (more precisely ordered) private banks to rescue their distressed peers.7)

In addition, the MOF often placed its officers on the board of the distressed bank with a view to reorganizing its management. To dispatch officials to a distressed bank may be an effective signal by the MOF that the government has made a commitment to rescue the bank at any cost, thereby helping the MOF to persuade other banks to collaborate with the bailing out program. However, this signalling does not seem to be always successful.8)

Since the actions taken by the authorities in rescuing troubled banks have been covert, it is difficult to estimate the social costs of the safety net and the exact distribution of the burden among the various agents. However, it is obvious that the safety net was comprehensive in the sense that not only depositors but also almost all other debt holders (except for a few major banks) were exempted from the burdens of bailing out distressed banks.9) Even shareholders of failed banks seemed to be rescued from bank failures. For example, in the case of credit cooperative banks, their failures did not require equity holders to share the costs of failures, although the equity holders should have been responsible for monitoring and disciplining management. The costs of preserving financial stability have fallen disproportionately on sound private banks, particularly major banks. Until the early 1990s, the financial authorities rarely paid the costs of the bail-out procedure, confining their role to

coordinating the rescue program endured by private banks and other financial institutions.

In some cases, the BOJ may have extended loans to distressed banks at the official discount rate, which was substantially lower than money market interest rates, but it is impossible to obtain any information about these unofficial rescue programs. After the rescue of Yamaichi, the BOJ utilized emergency loans (authorized by Article 25 of the BOJ Act) for the first time to support the Tokyo Kyodo Bank, newly established in 1995 to take over two failed credit cooperatives in the Tokyo prefecture. The amount of the BOJ's emergency loans increased abruptly during 1995 due to managerial crises in several small and medium scale banks (including Hyogo Bank) to reportedly reach a little more than ¥1.0 trillion.

Deposit insurance in Japan

The experience of the US financial system suggests that deposit insurance should be an important element of the safety net. However, this was not the case in postwar Japan. Although the system of deposit insurance was introduced in 1971 in Japan, the facility of the deposit insurance system was not actually utilized until 1992. The MOF continued to implement the traditional safety net to avoid the straightforward bankruptcy of depository financial institutions. The MOF gave priority to the protection of weak (and therefore inefficient) banks over the promotion of competition in the Japanese financial industry, even after the introduction of deposit insurance. The Deposit Insurance Corporation (DIC) remained nominal for a long time. Its functions were limited compared with those of its US counterpart (the FDIC), being confined to paying off insured deposits in cases of bank failure, although the DIC has never resorted to paying off. In 1986, the Law of Deposit

Insurance was amended to strengthen the DIC's competence. For example, the amended law allows the DIC to support schemes of rescuing or disposing of distressed banks by giving the necessary funds to private agents involved in the schemes. The DIC functioned for the first time only in April 1992, when it supplied ¥8.0 billion to help a medium-sized regional bank absorb another small bank in distress.

The DIC has been equipped with a means of paying off insured deposits of failed banks from the time of its establishment. However, the government announced in December 1995 that it is not yet prepared to exercise it, although a quarter century had passed since the start of deposit insurance. In addition, in December 1997, the government was forced to make a commitment to protect all investments into deposits and other debts such as bank debentures issued by the banks and financial institutions participating in the Deposit Insurance System in order to calm down people's concern with the danger of bank failures caused by the financial crisis following the bankruptcy of Hokkaido-Takushoku Bank and failures of a few major securities companies including Yamaichi in the end of 1997.

Of course, this commitment by the government is likely to produce further moral hazard on the side of bank management by weakening incentives of depositors and investor to monitor bank management. However, the long-standing implementation of the comprehensive safety net has produced among depositors and other investors a perception that they will never be required to share the burden if their banks should go bankrupt. Because of this widespread perception, the government adoption of paying off insured deposits without rescuing investors of bank debts other than insured deposits would result in an unexpected shock to the financial system, thereby making the situation worse. Thus, at the year end of 1997,

the Japanese government could not but make a commitment to ensure that the wide spread perception about the safety net was valid.

The comprehensive safety net may have had the merit of freeing people from the need to bother with the soundness of individual banks' management. However, it has also deprived investors of incentives to monitor the performance of individual banks and hindered the development of the capital market mechanisms to discipline bank management. The lack of market mechanisms, in turn, has made it quite difficult for the government to abandon the traditional safety net. We learn from this experience how dangerous it is for the authorities to have people believe in effectiveness of too comprehensive safety net.10)

Disciplinary Influence of Market Competition

The comprehensive safety net deprived the capital market of incentives to monitor and discipline bank management in Japan. Then, what about the disciplinary influence of market competition on bank management? As Nickell, Nicolitsas, and Dryden(1996) show with regard to manufacturing industries, we may expect full-scale market competition exerts strong disciplinary influence on corporate management by weeding the inefficiently managed firms out. Regardless of its specific ownership structure or any other financial governance structure, corporate managers would be disciplined by fierce market competition. If they fail to achieve efficient management, their firms will be kicked out from the market. Many Japanese believe that the Japanese manufacturing firms have achieved excellent performance because they have been long faced with fierce competition in the global market. At present, this belief remains a conventional view. However, it seems fairly well-grounded. In contrast, the Japanese financial services industries including the banking have been protected from

full-scale competition by the competition restricting regulation. Thus, the market competition has not worked to discipline management in the banking and other financial services industries in Japan.

Role of competition restricting regulations

The competition restricting regulations, such as interest rate controls and restriction on new entry into banking and other financial business through the system of compartmentalization, conferred a handsome amount of rents on existing banks and other financial institutions during the high growth era of the 1960s and 1970s. The primary purpose of the MOF's administrative guidance was to suppress full-scale competition in each of the compartmentalized financial businesses, thereby protecting the less competitive small-scale banks such as sogo banks, shinkin banks and credit cooperatives. The MOF's policy stance was often called the "convoy administration."11) The rents created by the competition-restricting regulations contributed to stabilizing the banking system under the Japanese comprehensive safety net in two ways. First, as economic theory shows, the existence of rents provides private banks with incentives to refrain from excessive risk-taking in order to continue enjoying handsome rents, even without effective prudential regulations (Hellman, Murdock and Stiglitz(1997)). Furthermore, thanks to protection offered by the competition restricting regulations, even inefficient banks rarely went to the brink of managerial difficulty that is particularly likely to induce moral hazard behavior.12)

Second, the regulatory authority was able to utilize the rents accumulated in the banking sector as a means of dealing with banks in financial distress. Specifically, the regulator relied on private banks' collaboration in implementing the safety net, and major banks faithfully bore a disproportionate share of the costs involved. This

mechanism would not have worked had the major banks not enjoyed the rents stemming from the competition-restricting regulations. The MOF also utilized the competition restricting regulations to give private banks an incentive to accept its initiatives in the process of dealing with bank failures. The MOF manipulated the regulatory means to do favors for those banks who toed the line and to penalize those who failed to heed their guidance. In other words, specific administrative guidance based on the competition- restricting regulations was an instrument for the MOF to determine the distribution of rents among banks. Thus, the competition-restricting regulation was strategically important for the MOF in order to maintain the viability of the comprehensive safety net.13)

Delayed deregulation in the financial markets

However, we should note the competition-restricting regulation has gradually weakened the capability of the Japanese banks and other financial institutions to adapt themselves to environmental changes since the mid-1970s. We may say that practically the financial deregulation has been tightly controlled by the government (more specifically by the MOF). The Japanese government took the policy of gradualism for the purpose of preventing "unduly destabilizing" impacts of financial deregulation. In reality, this gradualism was synonymous with the policy of protecting vested interests existing in the financial industries, thereby suppressing the disciplinary effects the financial deregulation was expected to exert on management in the financial industries including the banking.

The financial deregulation was promoted by the pressures from abroad, particularly from the U.S. rather than on the government initiative. For example, the ad-hoc Yen/Dollar agreement between U.S. and Japan realized through the strong

requirement by the Reagan administration in 1984 compelled the Japanese government to provide an explicit timetable of liberalizing financial markets.14) Compared to liberalization in international capital market, the Japanese financial markets have been belatedly deregulated. The so-called "big bang" proposed by Prime Minister Ryutaro Hashimoto in November 1996 was the government commitment of abandoning the policy gradualism. This is a sort of the shock-therapy to make up for lost time.

Of course, we should not totally deny the impact of financial deregulation on domestic financial markets during the 1980s. In particular, major companies reduced their dependence on bank borrowing by issuing a large amount of corporate bonds in international markets. This "internationalization" of corporate finance induced deregulation of domestic corporate bond markets since the mid-1980s (Horiuchi(1996)). However, generally speaking, the Japanese banks and other financial institutions were able to base their business on the huge amount of wealth accumulated by households. The gross amount of financial assets held by the households reportedly amounted to ¥1,200 trillion as of the mid-1990s. Thus, it would be an exaggeration to say that the internationalization of corporate finance exerted substantial influence on their way of business.

The Role of Government in Bank Managerial Governance

The previous sections stressed neither the capital market nor market competition was effective in disciplining bank management in Japan, mainly because the intervention of government (the MOF) into the financial markets through the comprehensive safety net and control of deregulation process suppressed those disciplinary influences. This is to some extent a natural outcome from the current

legal framework which assigns great responsibility in monitoring bank management to the Ministry of Finance and the Bank of Japan. The Banking Law authorizes the MOF to intervene into management of banks for purpose of prudential regulation. The BOJ is also in charge of monitoring bank management particularly from the viewpoint of money market adjustment. Thus, the current prolonged turmoil of the banking industries is mainly responsible for the financial authorities. In the following, we first examine how the Japanese government has implemented the prudential regulations, and next show that the weakness of regulatory monitoring led to fragility of the banking industry by examining the so-called "*amakudari*" relationships between the regulator and private banks.

Capital adequacy regulations

Capital adequacy requirements, accompanied with rigorous monitoring by regulators, are a typical means of prudential regulation. During the period of economic reconstruction immediately after World War Two, the MOF was seriously concerned about the prudence of bank management, because banks' equity capital per deposit had fallen sharply from 29.9 per cent in 1930 to only 5.6 per cent by 1953. With a view to strengthening banks' capital bases, the MOF started in 1953 instructing banks to reduce current expenses to 78 per cent or less of current revenues. This administrative guidance continued until 1973.

In 1954, the MOF introduced the capital adequacy regulation, which required banks to increase broadly defined capital to more than 10 per cent of total deposits.15) This could be regarded as a forerunner of the capital adequacy regulation introduced by the Bank for International Settlements (BIS) in 1987. However, some depository financial institutions were not covered by this capital adequacy regulation.

For example, the sogo banks were required only to maintain more than the prescribed minimum amount of equity capital (book value). Thus, they could have increased their leverage ratio without limit had they wished to do so. When the sogo banks converted to regional banks in February 1989, the MOF started to impose the same minimum capital adequacy ratio on the sogo banks (now called the regional banks of tier two) as for the city banks and the other regional banks. Shinkin banks, which are nonprofit financial institutions, had been free from the capital adequacy regulation until May 1986, when the MOF introduced administrative guidance in the form of a minimum capital adequacy ratio.

Thus, until the late 1980s, the capital adequacy regulation did not cover the whole range of depository financial institutions. Moreover, the regulation seemed to be ineffective. Figure 2 shows that, from 1960 to the mid 1970s, the average of the (broadly defined capital/deposits) ratio for the banking sector, which is comprised of city banks and regional banks, remained almost constant at 6 per cent, far below the MOF's requirement of 10 per cent. Furthermore, the average capital/deposit ratio dropped abruptly to below 4 per cent during the 1980s.16)

Bank capital and *amakudari*

The previous subsection suggests that the prudential regulation implemented by the MOF was ineffective in making banks management more sound than otherwise. If this suggestion is true, the Japanese banking system was fatally fragile because the comprehensive safety net was depriving the capital market of monitoring incentives, and because the competition in the financial industry was tightly controlled so as to protect the interests of existing banks and other financial institutions. However, Aoki, Patrick and Sheard(1994) argue that the financial authority has been disciplined to

monitor bank management through the so-called *amakudari* system; i.e., the system prevailing among private banks (and other firms) to accept post-retirement officials to their managerial board.17) According to their argument, this system have given regulatory officer incentives to rigorously monitor bank management faithfully playing the role delegated by depositor (and/or taxpayers) to them. If they fail in achieving good performance as a monitor, they will lose chances of obtaining good jobs in private banks after retirement. Thus, following Aoki, Patrick and Sheard (1994), the bank performance in terms of soundness will be positively influenced by or at worst be independent from *amakudari*.

However, this *amakudari* system is accompanied with the danger of an agency problem, because the bureaucrats assigned a role of monitoring bank management expect to be employed by the banks to be monitored by themselves.18) If the financial authority and private banks bargain with each other through manipulating monitoring effectiveness and accepting *amakudari* officials, the *amakudari* system would undermine effectiveness of monitoring by the financial authority and allow banks to engage in unsound management at the expense of depositors and/or taxpayers (Horiuchi and Shimizu(1998)). This agency problem hypothesis predicts the banks accepting *amakudari* officials from the financial authority will show poor performance in terms of soundness. This is in sharp contrast with the hypothesis advocated by Aoki, Patrick and Sheard(1994).

We tentatively test the hypothesis whether or not the *amakudari* system undermines the prudence of the Japanese banking sector. Here, we take 125 regional banks existing as of March 1996 as a sample. We classify the sampled 125 regional banks into four categories according to whether or not they accept *amakudari* officers (their *amakudari* status). The first group (category MOF&BOJ) contains the banks which accept *amakudari* officers from both the MOF and the BOJ. The second one

(category MOF) consists of the banks accepting officers only from the MOF. The third one (category BOJ) is the group of banks accepting *amakudari* only from the BOJ. Finally, the fourth one (category NON) consists of the banks that do not accept *amakudari* officers at all.

Table 2 compares some performances of the five year average depending on the *amakudari* status as of the beginning of each period. For example, Panel A subdivides the sample banks into the four categories MOF&BOJ, MOF, BOJ and NON as of 1980, and then compares performance averages (i.e., capital/asset ratio EQT, the annual growth rate in the number of branches BRN, the annual growth of total assets GAS, and the current profits per equity capital PRO) during the first half of the 1980s (1980-1984) of each category. Panel B and C are those of the latter half of the 1980s (1985-1989) and the first half of the 1990s (1990-1994) respectively.

In all of the three panels A, B, and C, the capital/asset ratio (EQT) is significantly lower for both categories MOF&BOJ and MOF than for category NON. For example, during the first half of the 1980s, the capital/asset ratio (EQT) for category MOF&BOJ banks, which accepted *amakudari* officials from both the MOF and BOJ as of 1980, was on average 0.927 per cent point lower than that of category NON banks. The differences are statistically significant at the 1 per cent level. As Keely(1990) argues, the lower level of capital/asset ratio implies the higher level of risk. As for asset growth (GAS) and profitability (PRO), we find no significant difference between the banks belonging to either category MOF&BOJ or MOF, and the banks of category NON. Thus, Table 2 suggests that the banks accepting *amakudari* officials from the MOF tend to take higher level of risk.19)

As has been explained, the equity/asset ratio (EQT) is a conventional measure of risk taken by a bank. However, the bad loan ratio (i.e., the amount of

non-performing loans per total loan) may be an effective alternative to EQT. While the former is an ex-ante measure of bank risk, the latter is an ex post measure in the sense that the more aggressive a bank takes risk, the larger amount of non-performing loans will be incurred. The Japanese banks started to disclose comprehensively the amount of non-performing loans they held for the first time in March 1996. We may interpret the figures of non-performing loans as of March 1996 indicates the degree of risk the banks took during the latter half of the 1980s and the early 1990s.

The rows of BAD in Panel B and C of Table 2 present the bad loan ratio for each category of *amakudari* status. For example, Panel B shows the two groups of banks accepting *amakudari* officials from the MOF (i.e., MOF&BOJ and MOF) as of 1985 had almost twice higher bad loan ratio (4.145) than the bank totally independent from the *amakudari* relationship (i.e., NON). These differences are statistically significant at the 1% level. In contrast, the average level of bad loan ratio for the banks accepting *amakudari* from the BOJ (i.e., banks of BOJ status) is not significantly different from that of the NON. The same is true of Panel C which classifies sample banks according to their *amakudari* status as of 1990. Thus, if we measure (ex post) risk by the bad loan ratio, the results are consistent with the hypothesis that the *amakudari* relationship undermines monitoring by the MOF.20)

In sum, as our argument about influence of the *amakudari* relationship on bank management suggests, the financial authorities have been powerless in monitoring bank management. Rather the authorities tend to help incumbent bank managers to continue their operation. Thus, we conclude that the lack of effective monitoring by the outsiders is the most conspicuous feature of the governance in the Japanese bank management. This feature has produced inflexibility of bank management confronted by the serious crisis of non-performing loans since the early 1990s.21)

Of course, it may be an exaggeration to say that the MOF totally neglected the prudential regulation. Table 3 provides a list of prudential regulations for commercial banks, i.e., the city banks and the regional banks, as of 1974. The MOF has kept almost all of the prudential guidance listed in this table intact. However, on the whole, bankers did not consider that these official guidelines were to be met at any cost, and the MOF was generous enough to permit some divergence between required and actual figures attained by individual banks.

4. The Vacuum of Governance and Culmination of Crisis

This chapter has stressed that the Japanese bank management has enjoyed independence from the outsiders' disciplinary influence. This is an entrenched management phenomenon. Entrenched bank managers tended to take excessive risk under the comprehensive safety net during the latter half of 1980s. At the same time, entrenched managers tended to delay structural changes after recognizing their failure of risk-taking (Boot(1992)). In particular, we should note this point because the seriousness of the Japanese bank crisis is due to the delayed response on the side of bank management to their critical situation rather than due to the absolute amount of non-performing loans. The Japanese banks hesitated to take the drastic restructuring policy necessary to deal with crisis. The MOF's forbearance policy supported the hesitation of banks to restructure making the situation worse.

Delayed Restructuring in Japanese Banking

As Lindgren, Garcia, and Saal(1996) show, the bank crisis is not peculiar to Japan. However, Japan has taken too long time to deal with this problem without any

remarkable success. Figure 3 presents international comparison of banking restructuring during the first half of the 1990s based on the BIS Annual Report(1996). This figure shows that, except for the U.S. the profitability of commercial banks decreased in the first half of the 1990s compared with the latter half of the 1980s in all of the major industrial countries including Japan. When we look at (1) the growth rate in the number of bank branches, (2) the growth rate in the total number of employees, and (3) the changes in wage index, Japan was unique in the sense that none of these measures decreases during the 1990s compared with the later half of the 1980s. In other words, the commercial banks in the other major industrialized countries reduced their scale of business after recognizing a fall in profitability during the 1990s. Thus, Figure 3 shows how the Japanese banks were hesitant to restructure their business in spite of decreasing profitability after 1990.

Limitation of the Traditional Rescue Method

Since the "bubble" burst at the beginning of the 1990s, it has become increasingly difficult for the MOF to maintain the traditional procedure of bailing out bank failures. This is symbolized by the fact that the deposit insurance system has been intensively utilized by the MOF to deal with banks in distress. The scale of the DIC is as yet limited, but its increasing use marks a significant change in the operation of the Japanese safety net. From April 1992 when the DIC played a role in bailing out a distressed bank for the first time to January 1998, the DIC intervened into 22 cases of bailing troubled banks out and provided the banks cooperating the bail-out schemes with subsidies of more than ¥2.4 trillion.

One of the reasons for this shift is that structural changes in financial markets have decreased the rent accruing to major banks so that the MOF has been unable to

totally depend on collaboration of those banks in implementing safety net. The financial deregulation made it difficult for the MOF to compensate major banks for their participation in rescue programs by manipulating regulatory means. As has been mentioned, the administration of branch networks used to be a powerful weapon for the MOF. However, the interest rate deregulation has reduced the meaning of branch offices for individual banks, reducing the MOF's branch administration to a mere nothing.22) The traditional methods of dealing with bank failures have not yet disappeared, and many private banks are still playing an important role through collaboration with the regulators. However, it is likely that the deposit insurance system will be utilized substantially in the future.

Use of the deposit insurance system to facilitate reorganization does not, however, imply that banks will undergo formal bankruptcy procedures. The MOF has continued to avoid explicit bank failures, instead by using the deposit insurance system intensively, rather than preferential regulatory treatment which used to be adopted, to provide sound banks with incentives to merge with insolvent ones or to collaborate with the authorities in restructuring troubled banks. This implies a slow reorganization of the financial system and a marked increase in the burden borne by the DIC. This policy stance adopted by the MOF reached a dead end when the principle of "too big to fail" was abandoned by allowing Hokkaido-Takushoku Bank to go bankrupt in November 1997. Obviously, both domestic and international financial markets recognized that the Japanese traditional safety net would be sustainable no longer. This market perception of regime change caused turmoil in Japanese money markets as well as a sharp jump of the Japan premium in the international money market at the year-end of 1997.

5. Concluding Remarks

This paper is a tentative overview of the governance structure in the Japanese banking industry. We stressed that the bank management has been independent from outsider's control. More specifically, the comprehensive safety net has prevented the capital market from exercising discipline for bank management, and there has existed no significant disciplinary pressures from the market competition because of the deliberately controlled deregulation of financial services industries including banking. Thus, the regulatory authority should have actively monitored bank management in order to keep soundness in the banking sector. However, the regulatory authority (i.e., the MOF) was concerned with viability of existing banks and other financial institutions rather than effective monitoring from the viewpoint of managerial soundness. In addition, the traditional human ties between the MOF and private banks seems to have undermined the effectiveness of regulatory monitoring, thereby making the banking industry more fragile. Obviously, we have not resolved the issue "who monitors the monitor" in the Japanese financial system.

The vacuum of governance in the banking sector is responsible for the delayed restructuring in the banking industry which has been suffering from the bad loan problem since the beginning of the 1990s. Quite recently the Japanese government started policy of introducing the prompt corrective action rule in April 1998 and of ordering banks to submit explicit time schedule of managerial restructuring under the condition that the government injects the public funds into banks capital. These policy measures seem to have at last induced hesitant banks to start restructuring their businesses. This fact in itself tells us that Japanese banks have no strong incentive to drastically reform their way of business on their own initiative.

The recent government policy of strengthening both bank supervision and prudential regulations make sense from the long-term perspective of building up the stable financial system. This policy will substantially fill up the vacuum of

governance in the Japanese bank management. However, we need to note two issues related to the strengthening bank supervision. First the supervision of bank management by the government would not be perfectly reliable in regaining prudent banking. The supervision would be very costly. Moreover, we would have to make the system of bank supervision incentive compatible as the episode of *amakudari* suggests in this paper. In order to deal with this difficulty, we need to rely on the market competition and the capital market in disciplining bank management. The "Japanese Big Bang" advocated by the government is expected to promote the capability of the market mechanisms.

Second, the strengthening of prudential regulation in the crisis situation would at least temporarily weaken the banks' intermediary capability. As has been explained in section 2, the quick strengthening of prudential regulations has led to "credit crunch" since 1997 exacerbating slowdown of the Japanese economy. We are afraid that this side effect of strengthening prudential regulations would hinder full-scale strengthening government supervision. Thus, we need to prepare the supplementary measures to mitigate the side effect brought forth by the strengthening prudential regulations. What are the supplementary measures? They should be purely temporary ones which could mitigate the side effect but not hinder the implementation of the prudential regulation based on the long-term perspective. The government should not hesitate help bank restructuring by injecting "public funds." However, this policy should not allow survival of "zombi" banks, but promote the necessary downsizing of the banking industry. At the beginning of this year, the Japanese government decided to inject capital into all existing banks regardless of their performance to overcome the current bank crisis. We doubt whether this policy is compatible with the long-term objective of strengthening bank soundness.

NOTES

1) In March 1998, the government injected the public fund of a little more than ¥1.8 trillion into major 21 banks (nine city banks, three long-term credit banks, six trust banks, and three big regional banks) by buying either preferred stocks or perpetual subordinated debt. This injection is estimated to have increased capital of those banks by 5.14%.

2) Nihon Keizai Shimbun, May 16, 1996.

3) The definition of non-performing loans in Table 1 is (1)"nonaccrual loans", (2) loans past due over 180 days, plus (3) a part of "restructured loans". This is much narrower than the definition adopted by the SEC in the United States which includes loans past due over 90 days and more comprehensive "restructured loans." Addition to the non-performing loans defined above, the Japanese banks has disclosed the loans for purposes of rescuing borrowers since March 1997. These "rescue loans" are also continued in the SEC's "restructured loans." (The total amount of rescue loans held by the major and regional banks amounted to 3.4 trillion and 3.1 trillion at March and September of 1997 respectively.) According to advice of the MOF, the Federation of Bankers Associations of Japan decided to widen the definition of disclosed non-performing loans comparable to the SEC definition in March 1998. I guess the amount of non-performing loans defined by the SEC criteria is near to the amount of "problematic loans" reported by the MOF.

4) A note "The Japan Premium: Work in Progress" submitted by Joe Peek and Eric S. Rosengren to the NBER-Japan Project on April 17-18, 1998 gives us the information about changes in the Japan premium.

5) It should be noted, as Gibson(1995) points out, the deterioration of bank performance would weaken competitiveness of industrial firms, particularly those

heavily depending on bank credit, by increasing cost of capital for them. This bad influence of the bank crisis may endanger the long-run growth capability of the Japanese economy. However, we may be optimistic about the bad influence on the major companies, because they have substantially reduced their dependence on bank credit since the early 1980s. According to the BOJ statistics, the average of blue chip companies' dependence on bank credit in their total finance was just 6% and 5% respectively during the second half of the 1980s and the first half of the 1990s whereas their dependence on bank credit was higher than 30% during the high growth era until the mid 1970s (The Bank of Japan, Analysis of Major Companies Management). The major companies would be able to raise funds in international capital markets independently from the intermediating capability of Japanese banks.

6) Total abolition of the financial safety net would strengthen the incentives of depositors and investors to monitor and discipline bank management. However, since most of depositors are small-size wealth-holders enjoying no economy of scale in collecting and analyzing information about bank management and since there exists a "free-riders" problem to hinder efficient information production, it would be unrealistic to totally depend on the market discipline to keep stability of the banking system. As Dewatripont and Tirole(1994) argue, we need to have a sort of the financial safety net in order to protect small-seize investors in the banking sector.

7) Until the end of the 1980s, the number of banks that came close to failing was small, with the largest rescue program involving not a bank but Yamaichi Securities Company in 1965. In this rescue, coordinated by the MOF, the BOJ provided emergency loans of ¥28.2 billion to Fuji Bank and two other banks which functioned as conduits supplying financial support to Yamaichi. Probably, the most important rescue program implemented by the MOF before 1990 was the case of merger of Heiwa-Sogo Bank by Sumitomo Bank in October 1986. Heiwa-Sogo got

into managerial difficulty during the first half of the 1980s. In 1985, the MOF made a bail-out plan for this bank to prevent the crisis of Heiwa-Sogo from destabilizing the Japanese banking industry as a whole. Finally, in 1986, the MOF succeeded in persuading Sumitomo to absorb Heiwa-Sogo. Despite de facto bankruptcy, the closure of Heiwa-Sogo did not cause damage to depositors and other holders of debt issued by this bank. Sumitomo bore the cost of dealing with the distressed bank. On the other hand, Sumitomo was able to expand its branch network at once by absorbing Heiwa-Sogo's branches.

8) One of the most recent cases was Hyogo Bank, to which the late chief of the Banking Bureau was sent to reorganize its management. Despite this intervention, Hyogo finally went bankrupt in October 1995. This paper will later examine how the human relationship between regulatory authorities and private banks, which is called "*amakudari*" in Japanese, influences the stability of the banking sector.

9) More precisely, until the late 1960s, there were a few cases in which depositors were forced to bear some part of losses associated with bank failures. See Yamawaki(1996).

10) Needless to say, before adopting the policy of paying off deposits, the MOF should introduce more perfect disclosure of individual banks' bad loans to help investors outside the deposit insurance coverage to select sound banks.

11) The MOF's administration of branch offices was another significant area of regulation. During the high growth period, when almost all deposit interest rates were under regulation, branch offices were an important means of non-price competition for banks and essentially the vehicle by which they competed for deposit funds. Under the MOF's administration, banks were not free to either expand or change the location of their branch networks. In permitting new branches, the MOF reportedly

gave preferential treatment to small banks. The number of branches of small-scale banks increased more rapidly than did that of city banks, both during and after the high growth period. See Horiuchi(1984).

12) Aoki(1994) argues, by assuming asymmetric information about banks' monitoring activities, that the rent was necessary to motivate private banks to faithfully and efficiently monitor their borrowers. He suggests that the long-term relationship between major banks and borrower firms, called the "main bank relationship," in Japan was crucially dependent on the competition restricting regulations. However, the restricting full-scale competition was not always necessary to motivate banks to supply a "high quality" level of monitoring. The laissez-faire market would be able to motivate banks to conduct good monitoring. See Klein and Leffler(1981).

13) Even now, the MOF manipulates its administrative guidance with a view to induce private banks to collaborate with its rescue program. In 1994, for example, Mitsubishi Bank obtained preferential treatment from the MOF in exchange for rescuing Nippon Trust Bank, which had been seriously damaged by the accumulation of a huge amount of bad loans since the early 1990s. Mitsubishi Bank was 'rewarded' by being allowed to pursue a full complement of trust banking business through Nippon Trust, which is now its subsidiary. Other banks are prohibited by the MOF from engaging in full-line trust banking business through their trust bank subsidiaries. The same story is true of the case in which Daiwa Bank financially supported Cosmo Securities Company, which was seriously damaged by the depression in the securities market after the "bubble" burst at the beginning of the 1990s. Cosmo has been a subsidiary of Daiwa Bank. However, Cosmo retained its stock brokerage business which, has not yet been permitted to the securities subsidiaries of other banks.

14) Frankel(1984) explains the process of the Yen/Dollar agreement. Takeda and Turner(1994) discusses the relationship between the internationalization of Japanese financial markets and domestic financial deregulation in great detail.

15) Broadly defined capital includes not only equity capital (book value), but also some reserve items.

16) The MOF amended the capital adequacy regulation in 1986 when the accounting rules governing bank financial statements were changed. Through this amendment, the MOF probably intended to make the capital adequacy regulation more practical and realistic, and it is unclear whether the MOF was yet aware of the increasing need for prudential regulations in banking as of the mid 1980s. The new capital adequacy rule required banks' broadly defined capital to be at least 4 per cent of total assets, hardly a stringent requirement. Since 1987, banks with branches or offices in foreign countries have been subject to the BIS capital adequacy rule, but other banks continue to face only this domestic capital adequacy requirement of 4 per cent.

17) There are a number of hypotheses to explain why the Japanese financial system has accepted the amakudari system. Rixtel(1994) provides a useful overview of these hypotheses. Neglecting all other hypotheses, this paper concentrates on analyzing amakudari from the viewpoint of effectiveness of the financial safety net.

18) Kane(1989) points out there exists a similar agency problem in the U.S. banking system.

19) The performances of the banks belonging to category BOJ (i.e., the banks accepting *amakudari* officials only from the BOJ) are similar to those of category NON banks for all the sample periods except for EQT in panel C. Since the BOJ does not play a significant role with respect to prudential regulation, this result is

plausible.

20) According to Table 2, capital ratios (EQT) were raised more at both the MOF&BOJ and the MOF banks than at the NON banks from the 1980-1984 period relative to the 1990-1994 period. This relative improvement of capital at the banks accepting *amakudari* from the MOF reflected the strengthening of capital adequacy regulation started by adopting the BIS r
ules at 1988. However, The improvement was not sufficient enough to prevent the relative increase in non-performing loans of those banks as Panel B and C show in Table 2.

21) Unfortunately, we have observed a number of cases which suggest the weakness of regulatory authority during the early 1990s. The failure of Musashino Shinkin Bank in 1996 gives an example. Musashino Shinkin had been in trouble since 1993 and the MOF was in charge of examining the bank's account statements before publication. The MOF reportedly allowed the bank to engage in window dressing to record positive profits even as of March 1996, when the estimated amount of problem loans was nearly 70 per cent of total loans. The MOF guided the bank to conceal its difficulties by allowing managers to manipulate financial statements. In September 1996, the MOF decided to introduce an explicit system of ordering banks in trouble to improve their management based upon officially announced criteria (Nihon Keizai Shimbun, October 11, 1996). According to the National Federation of Credit Cooperatives, nearly 40 per cent of credit cooperatives had violated the regulation limiting loans to a single party (to 20 per cent of capital in the broad sense) as of September 1994. This episode also suggests how ineffective the regulatory monitoring has been in Japan.

22) The MOF partially abandoned branch administration by allowing regional

banks and shinkin banks to freely increase the number of branch offices in May 1993. At that time, the MOF announced that the branch regulation for city banks would be gradually liberalized while taking into account the influence on small and medium sized financial institutions. In May 1995, the MOF totally liberalized the regulation regarding the number of branch offices for all banks.

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Table 1 Non-performing loans in the Banking Sector
(¥ 100 billion)

	March 96	Sept. 96	March 97	Sept. 97
Major banks				
(a) Total loans	3918.5	3868.0	3953.1	3804.0
(b) Non-performing loans	218.7	174.1	164.4	161.3
(b/a: %)	(5.58)	(4.50)	(4.16)	(4.24)
(c) Provision for losses	103.5	82.4	93.9	103.3
(c/a: %)	(2.64)	(2.13)	(2.38)	(2.72)
Regional banks				
(a) Total loans	1896.8	1876.5	1902.9	1900.0
(b) Non-performing loans	66.4	55.8	53.5	56.0
(b/a: %)	(3.50)	(2.97)	(2.81)	(2.95)
(c) Provision for losses	29.5	24.7	29.5	33.6
(c/a: %)	(1.56)	(1.32)	(1.55)	(1.77)
Total cooperatives				
(a) Total loans	1312.1	1299.3	1285.4	1270.7
(b) Non-performing loans	63.0	62.3	61.1	63.5
(b/a: %)	(4.80)	(4.79)	(4.75)	(5.00)
(c) Provision for losses	17.6	18.6	26.6	28.1
(c/a: %)	(1.34)	(1.43)	(2.07)	(2.21)
Shinkin banks				
(a) Total loans	696.0	696.7	702.0	701.3
(b) Non-performing loans	32.0	33.7	32.4	33.8
(b/a: %)	(4.60)	(4.84)	(4.62)	(4.82)
(c) Provision for losses	10.3	11.3	16.2	16.7
(c/a: %)	(1.48)	(1.62)	(2.31)	(2.38)
Credit cooperatives				
(a) Total loans	173.7	172.8	172.1	165.1
(b) Non-performing loans	20.5	21.3	21.2	20.0
(b/a: %)	(11.80)	(12.33)	(12.32)	(12.11)
(c) Provision for losses	1.8	1.8	3.0	2.6
(c/a: %)	(1.04)	(1.04)	(1.74)	(1.57)
Total				
(a) Total loans	7127.4	7043.8	7141.4	6974.7
(b) Non-performing loans	348.0	292.3	279.0	280.8
(b/a: %)	(4.88)	(4.15)	(3.91)	(4.03)
(c) Provision for losses	150.5	125.7	149.9	165.0
(c/a: %)	(2.11)	(1.78)	(2.10)	(2.37)

(Note) Those banks which went down during the sample period are excluded from the table.

(Source) Federation of Bankers Associations of Japan, Analysis of Financial Statements of All Banks.

Table 2: *Amakudari* and performance of regional banks

Panel A: Period 1980-1984

	MOF&BOJ (42)	MOF (48)	BOJ (19)	NON (16)
EQT	2.648***	2.739***	3.484	3.575
BRN	3.388	3.325	3.047	3.006
GAS	8.736	7.908	7.953	7.984
PRO	8.001	8.096	8.456	7.604

Panel B: Period 1985-1989

	MOF&BOJ (41)	MOF (43)	BOJ (21)	NON (20)
EQT	2.849***	3.008***	3.390	3.411
BRN	2.513	2.430	2.777	2.206
GAS	10.945	9.927	10.526	9.815
PRO	8.913	9.087	8.641	8.610
BAD	4.145***	4.145***	2.205	2.200

Panel C: Period 1990-1994

	MOF&BOJ (40)	MOF (43)	BOJ (20)	NON (22)
EQT	3.427***	3.698**	3.696*	4.046
BRN	1.877	1.853	1.795	1.698
GAS	1.985	2.570	2.359	2.405
PRO	4.054	4.148	4.809	4.950
BAD	4.225***	3.843**	2.761	2.159

(Note) The asterisks *** , **, and * indicate the figures are different from the those of "NON" significantly at 1%, 2.5%, and 5% respectively. Panel A and B delete Daiko Bank because of its abnormal performances during the 1980s, and Panel C deletes Kumamoto Family Bank because of merger with regional financial institutions at the beginning of the 1990s. The figures in parentheses are the numbers of banks belonging to respective categories.

Table 3: Prudential Regulations as of 1974:
The MOF designated the following items as the desirable standards under administrative guidance.

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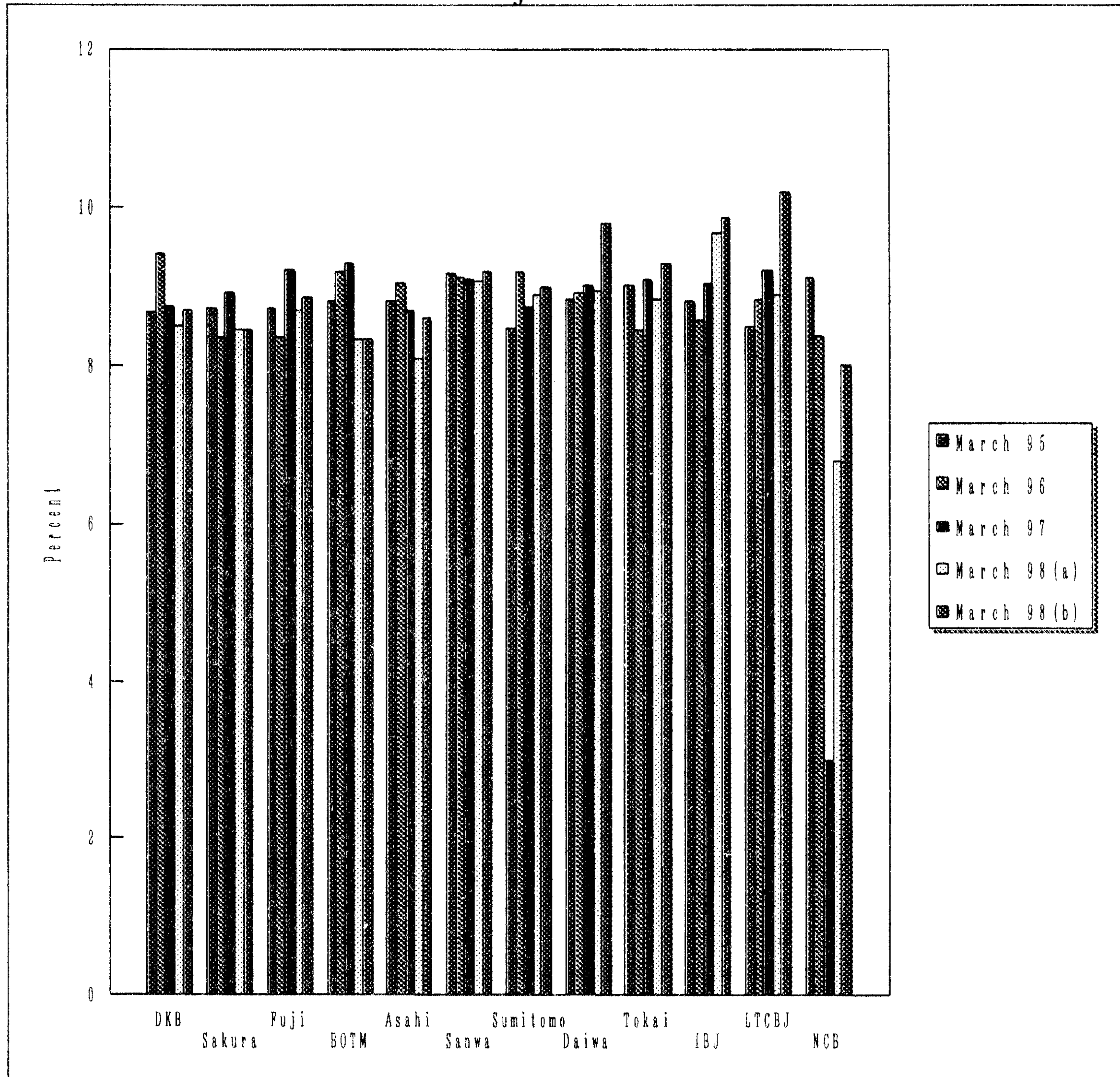
1. Loans/deposits ratio is to be no higher than 80 per cent.
2. (a) Liquid assets/deposits ratio is to be higher than 30 per cent.
   (b) For the banks that do not satisfy (a), increment of liquid asset/increment of total deposits ratio is to be higher than 30 per cent.
3. Ratio of current expenses (excluding tax) to current revenue is to be constantly decreased. (Until 1973, the MOF indicated a maximum level of 78 per cent for this ratio.)
4. Annual dividend per share is to be less than 12.5 per cent of the face value of the share.
5. Broadly defined capital/deposits ratio should be higher than 10 per cent.
6. The amount of loan to a borrower is to be less than
   (a) 20 per cent of the bank's equity capital for the city banks and regional banks;
   (b) 30 per cent of the bank's equity capital for the long-term credit banks and the trust banks;
   (c) 40 per cent of the bank's equity capital for the foreign exchange banks.

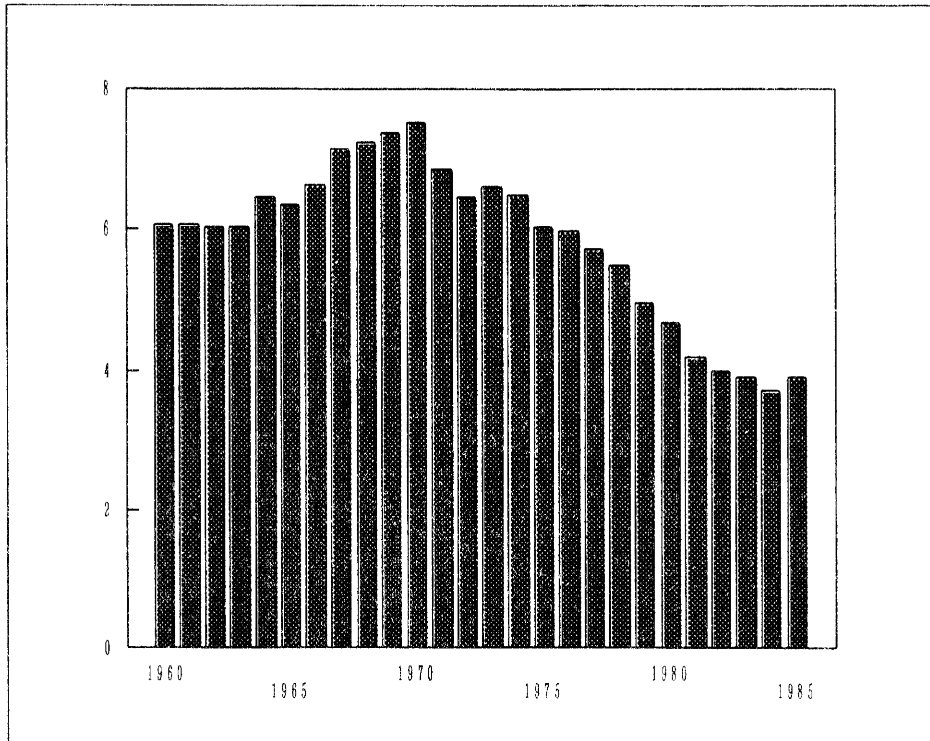
(Note) The MOF has since altered prudential regulations to some extent. For example, as the Banking Law was substantially revised in 1982, ceilings on credit to a borrower were introduced by the Banking Law; the total amount of credit to a borrower should be less than 20 per cent of the bank's equity capital.
(Source) The Banking Bureau of the MOF.

Figure 1: The Recent Changes in the BIS Capital Ratios
Major Banks



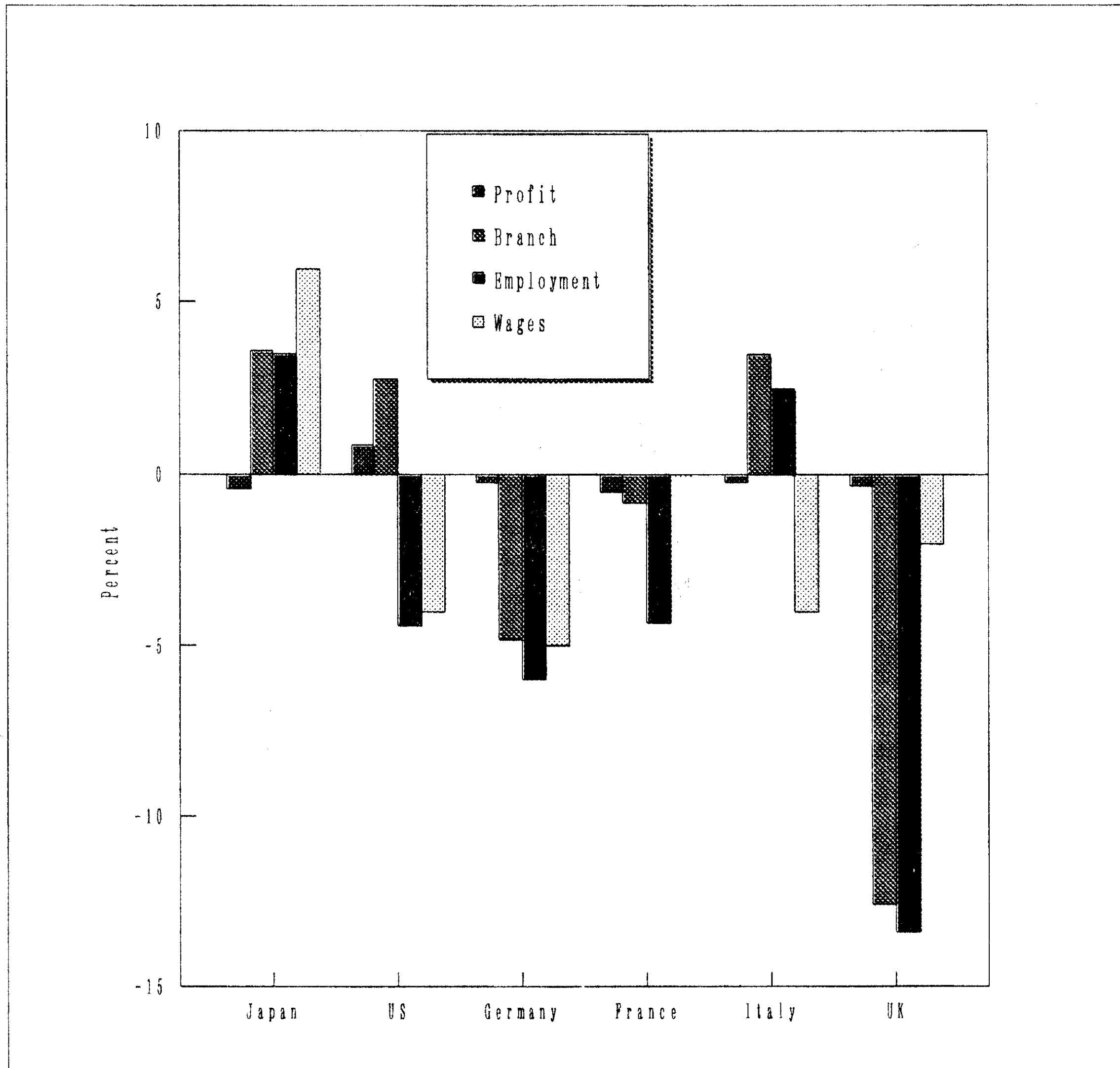
(Notes) Figures for March 98(a) are the BIS ratios expected if the public funds were not injected into bank capital, and March 98(b) are the ratios the banks attained with the help of capital injection at March 1998.
(Source) The statistics submitted by the banks to the DIC.

Figure 2: Capital/Deposit Ratio of Japanese Commercial Banks
1960-1985



(Source) Federation of Bankers Associations of Japan, Analysis of Financial Statements of All Banks.

Figure 3: Restructuring in the Banking Industry
International Comparison



(Notes) Profit (total profit per total assets), the difference between the average of 1986-1988 and 1992-1994: No. of branches, the growth rate in the total number of branches from 1990 to 1995: No. of employees, the growth rate in the total number of employees from 1990 to 1994: Wage index (the ratio of wage payment over total revenue), the difference between the average of 1986-1988 and of 1992-1994.

(Source) The BIS 66th Annual Report.