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Financial Market Regulation

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Summary

The aim of Japan's comprehensive financial reform program "Financial Big Bang" was to create an internationally competitive financial sector based on three principles: free, fair and global by 2001. Policy makers encountered two challenges: strengthening competitiveness of the financial sector in the long term, and solving structural problems as soon as possible. Five years after implementation of the "Big Bang", the country seems to have made much more headway in its long-term plan than in its short-term goal. The article shows that reform of financial administration designed a modern supervision concept comparable at least with its counterparts in Europe, although its development and implementation is still underway. Further, the article acknowledges that deregulation allowed competition to change the financial sector based on market principles. The entry of foreign and domestic competitors stimulated the introduction of new products and innovative business plans. However, structural problems, in particular the bad loan problem, still remain completely unsolved and therefore hamper completion of the process of reforming the financial system and the economy as a whole. The current government programs to write off bad loans do not promise to solve the structural problems in due time.

1. Introduction

The financial sector stood at the centre of Japan's recession in the last decade of the 20th century, and the reform program "Financial Big Bang" was a centrepiece of several economic and social reform measures that have been introduced since 1997. The policy aims of financial reform were twofold. Most importantly, the "Big Bang" aimed to form an efficient, internationally competitive financial system by introducing competition in the long term. In the short term, however, the banking system had to be stabilised as soon as possible and a systemic crisis had to be avoided. Structural problems such as bad loans had to be solved rapidly.

Initially, the whole reform process was set to be completed in 2001. Prime minister Ryutaro Hashimoto announced in November 1996 that he would revitalise the Japanese financial market within five years by 2001 while continuing to dispose of bad loans. He emphasised the need to form a more transparent financial administration based on market mechanisms, but also to vitalise the Tokyo market through structural reform (Hashimoto, 1996, 1). The reform was launched under the three principles free, fair and global. For a free market, market entry, development of new products and prices should be completely liberalised. Fairness stood for enhanced transparency of rules and investors' protection. With the establishment of new legal and accounting systems and a supervisory regime, Japan's financial market should become consistent with globalisation and attractive for foreign financial institutions, investors and companies.

Five years after this announcement, it seems worthwhile to take a look at Japan's banking system and ask what the financial reform has achieved. The problem for policy makers remains that both aims affect each other adversely. The following article outli nes the reform of financial administration, which was generally completed in 2001. It then describes the structural problems of banks, but also highlights the efforts that were made through financial restructuring.

It concludes that the "Big Bang" reform process led to substantial normative changes in the financial system, but that financial regulators failed to tackle the structural problems that are a prerequisite for long-run financial and economic recovery. Only if these problems are rapidly solved can the bold reform measures produce a valuable effect.

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2. Legal and Administrative Reform

Financial legislation made substantial progress since implementation of the "Big Bang" and especially during 2001.[1] The Financial Reconstruction Commission (FRC) was absorbed by the Financial Supervisory Agency (FSA) in January 2001, which then was renamed the Financial Services Agency (FSA). The FRC was established in October 1998 to deal with bank failures and to recapitalise sound banks, based on the Financial Reconstruction Law. The Financial Supervisory Agency was first entrusted with the supervision and inspection of financial institutions. In July 2000, the Financial System Planning Bureau of the Ministry of Finance (MOF) was transferred to the FSA. The MOF was blamed for lax supervision and delay of reform, and was thereafter involved in several scandals.

Since the FRC's incorporation this year, the Financial Services Agency has remained the single supervisory agency for the financial sector and is responsible for all aspects of financial regulation, from the designing of financial systems to inspection, supervision, and surveillance of financial activities. The FSA is also responsible for all kinds of financial services, such as banking, securities business, and insurance.

At the end of March 2001, the Financial Reconstruction Law ran its course. The Financial Reconstruction Act was enacted in the midst of the financial crisis in October 1998 in order to temporarily nationalise and restructure failed banks and to support major banks with public capital injections. The FRC governed the implementation of the emergency law. The Financial Reconstruction Law was replaced by the revised Deposit Insurance Law. This marked a significant change in the Japanese safety net for financial institutions: Provisions for injections of public money into private financial institutions expired. The revised Deposit Insurance Law created an account in the government's Deposit Insurance Corporation (DIC), through which public funds may be injected into financially troubled banks only when a national or regional financial crisis is threatening. This eliminates the possibility of pouring money into healthy banks to prevent a credit crunch or promote bad loan write-offs. Also, the temporary nationalisation of failed banks is no longer possible.

The introduction of the pay-off scheme, a partial deposit insurance of up to 10 million yen plus interests per depositor originally planned for April 2001, however, was postponed until 2002. Some observers expect it to be extended even further. This would be a major step in creating the context for introduction of a market-oriented supervisory concept. Liquid deposits will already be fully covered until April 2003. Until full implementation of the pay-off scheme, the government will guarantee a 100% refund of deposits if a bank fails, as stipulated in the Financial Reconstruction Law. From fiscal year 2001 on, internationally recognised market value accounting rules require companies to book holdings of stocks, bonds, derivatives and other assets at current market value. This replaced the traditionally used cost-accounting method, which measures assets on the basis of their purchase price or cost.

The FSA itself made some progress in strengthening its supervision and regulatory framework. Until June 2001, the agency developed inspection manuals for deposit-taking financial institutions, insurance companies and securities firms. The development of such manuals corresponds with the reform principle of a fair market to clarify and enhance supervisory rules. While the FSA's first round of on-site inspections in 1998-99 targeted asset quality of major banks, the second round in the first half of 2001 concentrated on risk management systems. Inspections focus on valuation and soundness of financial assets, exposure limits to various types of market risk, and internal monitoring and controls.

The young agency grew rapidly in size and responsibilities, but still employs a staff of only 863, of whom just 264 are bank examiners. Even the requested increase of 246 new staff members in the fiscal year 2002 could barely be sufficient amid the coming reform of the securities market and the end of full government protection of bank deposits in April 2002. This development led to a normative assimilation of the Japanese banking administration, to internationally recognised patterns and to a modern concept of banking supervision.

3. Bad Loans

3.1 Non-performing loans at record-level despite write-offs

While financial administration underwent comprehensive restructuring and re-organisation, private financial institutions still suffer the same structural problems as almost ten years ago and have yet to go through drastic restructuring. As the most striking problem not only for banks but also for the whole economy, the bad-loan problem remains unchanged, and it re-emerged in media headlines in 2001 when the Financial Services Agency published alarming figures and a sharp drop in the stock market reinforced concerns over bank capitalisation.

According to the Financial Services Agency, non-performing loans at all domestic banks swelled to a record 32.5 trillion yen as of the end of fiscal year 2000, up by

[1] This section highlights only administrative reform measures in 2001. For a thorough description and analysis of the "Big Bang" reform program, see Suto (1998) and Hall (1998). For a timetable for financial system reform, see the MOF Homepage, *http://www.mof.go.jp/english/big-bang/ebb33.pdf* (revised version, April 2000).

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2 trillion yen from a year earlier and marking the highest level since banking regulators started announcing bad-loan figures in 1993. Non-performing loans at all deposit-taking financial institutions — a broader group that includes credit co-operatives, credit associations, etc. — also hit a new record, rising again by just over 2 trillion yen to 43.4 trillion yen, the FSA reported. With these figures, non-performing loans made up 5.4% of total loans of city banks and 7% of total loans of all deposit-taking financial institutions.

This record was marked despite continued efforts to write off non-performing loans in FY 2000. Losses on the disposal of bad loans amounted to 6.1 trillion yen in FY 2000, and aggregated from FY 1992 to 71.8 trillion yen. Banks recognised a sharp increase in bankruptcies among both smaller and well-known corporations and participated in debt forgiveness packages for companies. Once, reliable borrowers were downgraded as borrowers "requiring attention" or even failed. Further, banks acknowledged declining collateral prices as land and stock prices continually decreased. At last, the FSA emphasised that progress in the implementation of loan classification standards could have increased the figures of non-performing loans.

The dependency upon the real economy derives not only from possible bankruptcies in an unfavourable environment, but also from the high exposure of banks to the stock market — a relic of the tradition of cross-shareholdings to bolster business ties with corporate clients. Such holdings are estimated at around 150% of banks' capital. Due to the slump in stock prices in the second half of 2000, unrealised capital gains on securities holdings decreased from 10.8 to 2.6 trillion yen during FY 2000 (Bank of Japan, 2001, 13). In 1998 and 1999, unrealised capital gains on stocks were used to finance loan write-offs. But in FY 2001, banks can no longer rely on a favour from the stock market. Instead, they are in danger of unrealised capital losses from their stock holdings.

A downturn of stock markets affects banks in particular with the fair value accounting rules coming into effect from the current fiscal year 2001. The new rules require banks to deduct some 60% of latent losses on shareholdings from their net worth. If the market value of shareholdings drops more than 30% from their book value, banks are required to cover the unrealised loss with net profit.

The increased level of non-performing loan disposals continued to exceed operating profits from core business. Operating profits from core business amounted to 4.7 trillion yen in FY 2000, down to the level of the crisis in 1997. Banks managed to raise net fees and commissions for foreign exchange-related operations, sales of investment trusts and syndicated loans and to cut administrative expenses through restructuring, but were hit by shrinking net interest income.

The huge amount of non-performing loans compares with 11.6 trillion yen in general and specific allowance for possible loan loss at all banks, roughly unchanged from a year earlier. However, a large amount of performing loans

Table 1

Performance of non-performing loans in FY 2000

In trillion yen

	Non-performing loans		Classified assets based on the Financial Reconstruction Law[3]		Specific allowance for loan loss	
	03/2000	03/2001	03/2000	03/2001	03/2000	03/2001
Major banks (excluding NCB[1] [Aozora Bank])	19,8	19,3 18,6	20,4	20,0 19,3	5,0	3,9 3,8
Regional banks[2]	10,6	13,2	11,4	13,6	3,4	3,3
Total of all banks (excluding NCB [Aozora Bank])	30,4	32,5 31,8	31,8	33,6 33,0	8,4	7,2 7,1
Cooperatives	11,0	10,9	9,1	9,4	3,1	2,8
Total of all deposit-taking financial institutions (excluding NCB [Aozora Bank])	41,4	43,4 42,8	40,9	43,0 42,3	11,5	10,0 9,9

[1] Nippon Credit Bank (NCB) was nationalised and not included in the figures of March 2000. It relaunched as Aozora Bank in 2000.
[2] Financial institutions that declared bankrupt are excluded.
[3] Figures in "Classified assets based on the Financial Reconstruction Law" are the sum of the assets classified as uncoverable or valueless, risk, and special attention as the results of self-assessment of asset quality based on the Financial Reconstruction Law.
[4] Figures even of the same source may differ slightly to other tables owing to different dates, definitions or included banks.
Source: Financial Services Agency, 2 August 2001.

Table 2

Classification of non-performing loans as of end of March 2001

In billion yen

	No.	Total loans	Outstanding of non-performing and restructured loans					Loss allowance
			Total	LBB	PDL	3PDL	Restructured	
Major banks	18	313.588	19.281	1.783	10.316	513	6.668	6.939
Regional banks	119	180.601	13.234	1.547	7.474	160	4.054	4.616
Total of all banks	137	494.189	32.515	3.330	17.790	673	10.722	11.555
Cooperatives	711	132.268	10.934	1.568	6.165	154	3.047	3.719
Total of all deposit-taking institutions	848	626.457	43.449	4.898	23.955	827	13.769	15.274

1) LBB: Loans to Borrowers in Legal Bankruptcy. PDL: Past Due Loans in arrears by 6 months or more. PDL are loans of which interest is not collected and are not recognized as earnings, excluding LBB and loans of which payment of interest is in a grace period for the purpose of reconstructing the borrower. 3PDL: Loans in arrears by 3 months or more and less than 6 months. 3PDL are loans of which principal or interest is in arrears by 3 months or more from the date of default on payment of interest or principal under terms of the related loan agreement, excluding LBB and PDL.
2) Tokyo Sowa Bank, Niigata Chuo Bank and Credit Cooperatives that declared bankruptcy are excluded.
3) Some financial institutions conducted "partial direct write-offs" (to write-off uncorrectable portions (category 4) of loans to bankrupt/ effectively bankrupt borrows with collateral/guarantee, instead of making specific allowance for loan losses), which amounted to was 10,107 billion yen on non-consolidated bases,

Source: Financial Services Agency, 2 August 2001.

Table 3

Loss on disposal of bad loans of all banks

In billion yen

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Loss on disposal of bad loans	1.640	3.872	5.232	13.369	7.763	13.258	13.631	6.944	6.108
Net transfer to allowance for loan losses[1]	945	1.146	1.402	7.087	3.447	8.403	8.118	2.531	2.732
Direct write-offs	424	2.090	2.809	5.980	4.316	3.993	4.709	3.865	3.072
Others[3]	271	636	1.022	302	0	863	804	548	304
Aggregate from FY 1992	1.640	5.512	10.744	24.113	31.877	45.135	58.766	65.710	71.818
Risk management loans[2]	12.775	13.576	12.546	28.504	21.789	29.758	29.627	30.366	32.515
Outstanding amount of allowance for loan losses	3.698	4.547	5.536	13.29	12.334	17.815	14.797	12.230	11.555

1) "Net transfer to allowance for loan losses" refer to the total amount of net transfer to specific allowance for loan loss and net transfer to general allowance for loan loss, etc.
2) "Risk management loans" figures had been composed of Loans to Borrowers in legal Bankruptcy (LBB), Past Due Loans (PDL), and restructured loans for FY 1995 and FY 1996. For FY 1992 to FY 1994, the figures had been composed of LBB and PDL.
3) "Others" in loss on disposal of bad loans refer to the total amount of allowance for expected losses brought by the loans sold to CCPC, Allowance for expected losses brought by the supports to subsidiary, etc.

Source: Financial Services Agency, 2 August 2001.

currently classified as needing attention, known as grey zone loans, might turn into non-performing loans if the current increase in bankruptcies continues. During FY 2000, 8.4% of loans classified as “requiring attention” became non-performing. As further deterioration of the economy is expected, this figure is predicted to rise further. Despite this, banks have set aside only about 3–5% of their total grey zone loans to cover potential losses (Nihon Keizai Shimbun, 1 September 2001).

Until recently, the FSA considered the risk deriving from grey zone loans as manageable and did not see a need for further tightening of classification or provisioning standards. It observed that banks made substantial progress in adjusting lending policies to the credit risk of borrowers, according to its bank inspection manuals. Further, FSA chief Yanagisawa insisted that Japanese loan classification standards are consistent with those of the US and other industrialised countries.

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Table 4

Operating profits of banks from core business

In trillion yen

	FY 1999	FY 2000	+/– (in %)
Net interest income	9,6	9,1	–4.7
Net fees and commissions	1,2	1,3	+5.0
Domestic operations	10,9	10,5	–3.6
International operations	1,2	1,3	+2.4
General and administration expenses	7,1	7,0	–1,1
Core business profit	5,0	4,7	–5,6
Source: Bank of Japan, 10 August 2001.			

Private, particularly foreign analysts doubt even the official bad-loan figures and are concerned over under-capitalisation of banks owing to inadequate provisions. UBS Warburg (Japan) Ltd. believes a more accurate figure for bad debts at all banks would be 70 trillion yen. Nikko Salomon Smith Barney Ltd. puts the amount at 125 trillion yen, while Goldman Sachs (Japan) Ltd. estimates lending worth 170 trillion yen has gone bad (Nihon Keizai Shimbun, 1 September 2001).

The U.S. investment bank Goldman Sachs suggested in July that bad loans could increase to 237 trillion yen, which would equate to almost half of the country's gross domestic product. The bank concedes the FSA applies U.S. supervision standards, but disputes whether these standards are appropriate for Japan's deflationary environment. Under deflationary conditions, firms posting deficits, or unable to increase operating profits, are gradually weakened by their interest burden. Not all analysts agree with Goldman Sachs' methodology, but most agree at least that the real bad loan problem is much greater than FSA figures indicate.

Differences between estimations of private think tanks and the FSA arise mainly from different assumptions on the future development of the Japanese economy. While private think tanks expect a further deterioration in the economy and therefore increasing bankruptcies, the FSA assumed in its calculations that newly emerging non-performing loans would slow as the economy begins to recover. In late August 2001, however, even FSA chief Hakuo Yanagisawa corrected his assumptions to a real economic growth of 1% or lower over the next three years and admitted non-performing loan disposal might take longer than expected.

There is yet another reason for different bad loan estimations: the authorities have not even set up a single, universally binding standard of bad loans. Banks report their loans currently under two definitions, a broader definition set by financial revitalisation legislation, and a narrower definition that counts only loans to borrowers at risk of failure, already collapsed or legally bankrupt. Further, there is still a wide gap of reporting quality among banks. While the FSA relies solely on such banks' reports, outsider analysts use their own models and include macroeconomic data in their estimations.

3.2 Government plans

The new prime minister Junichiro Koizumi unveiled plans in April 2001 to force banks to sell some of the cross-shareholdings in corporate clients and to write off their bad loans rapidly. The outline for the emergency economic package puts the bad-loan problem of banks at the centre of the country's economic problems and calls for an integrated resolution of the problems of non-performing loans of banks and excessive corporate debt.

The final form of the package will be decided in autumn 2001. According to the April draft, major banks shall dispose of their existing non-performing loans to bankrupt or nearly-bankrupt companies within a two-year period. Loans to borrowers who require attention or special attention are not a target of this scheme. Newly emerged non-performing loans would have to be written off within three years of the date they are classified as non-performing. The targeted banks are urged to periodically disclose the actual record of NPL disposal. The FSA announced that it would double its inspections of major banks from bi-annual to annual inspections. Additionally, the FSA would perform follow-up inspections of NPL disposals. However, the FSA confirmed its stance to urge banks to keep making profits. It would clarify its policy stance in the near future on the implementation standards for administrative measures to be taken under the FRC guidelines when the banks' actual profits fall below their planned levels by 30% or more.

While banks can sell NPLs in their entirety or resolve bad loans through the courts, the government encourages corporate reorganisation through informal debt-workouts. In June 2001, a committee of the Japanese Bankers Association issued draft guidelines on such voluntary debt-workouts, which gives restructured corporations three years to work out debts and return to profitability. Further, responsible corporate managers would have to be replaced and shareholders would have to contribute to the workout. In contrast to the government, however, the association understands judicial solutions as "usual". To qualify for voluntary debt-workouts, the committee recommended to require corporations to have posted profits in one of the last three years or to operate a profitable core business (Japanese Bankers Association, 2001, 1–9). However, even these proposals leave banks and corporations enough room for individual solutions, which in turn entails the danger of further delay of the corporate reconstruction process. The behaviour of Japanese bankers shows that they hesitate to force long-term customers into tight restructuring which would definitely drive a large degree of employees into unemployment.

The reform blueprint puts the public Resolution and Collection Corporation (RCC) at the centre of the disposal of bad loans. The RCC was originally established to collect loans from non-paying borrowers. Under the new scheme, the RCC might collect bad loans of certain companies from several banks and co-ordinate the restructuring of the borrowers. The terms of bad loan purchases by the RCC are still undecided. Until now, banks were reluctant to sell their bad loans to the RCC, because of its strict buying policy of paying only 3–5% of the face value of loans. LDP lawmakers urged the RCC to buy loans at market value, which might cause new losses for the government if prices deteriorate further.

To limit bank's exposure to stock market volatility, the emergency economic package of April 2001 also sketched a framework to reduce bank's equity holdings from currently about 150% to 100% of capital from 2004 onwards. By scaling down cross-shareholdings, this measure will simultaneously enhance corporate restructuring. To protect stock prices from deteriorating as a result of large-scale stock sales, a semi-public "Bank Equity Purchasing Corporation" (BEPC, provisional name) is to be established to purchase stocks from banks at market value over a period of three to five years. The body will then either hold its purchases for future resale within ten years or sell them immediately to general investors, probably as part of investment trusts. The facility will be created with some 10 billion yen in capital contributions from banks, but any shortfalls resulting from investment losses and unpaid debt will be covered by public funds. A plan for establishment and operation of the BEPC is due to be outlined in autumn 2001.

Although the emergency package was welcomed by market participants as a long-awaited first step to tackle such severe structural problems as the bad debt burden and corporate restructuring, the disposal plan falls short of addressing the underlying problems. The assessment of bad loans and the exclusion of loans "needing attention" from the plan reflects the authorities' unwillingness to recognise the real size of the bad-loan problem and its potential to grow further. Moreover, the package focuses only on major banks, which account for less than half of the banking system's total assets and problem loans, and which have stronger asset quality and capitalisation than regional banks and credit co-operatives.

This habit reminds one of the "forbearance" *("saki-okuri")* practices from the beginning of the financial crisis in the early 1990s, when financial authorities began to palliate the real problem, to limit regulatory action only to most severe problems of the most important banks, and to hope that over time economic recovery would bring increased income and asset values.

As long as the FSA hesitates to publicly recognise the full dimension of the problem of bad loans in the financial sector as a whole, even double inspections and further follow-ups will not bring the weakness of Japan's financial system to an end. It is doubtful, by the way, that 286 banking inspectors could thoroughly examine the assets and balance sheets of all major banks two to three times a year, besides conducting regular inspection of regional banks and credit co-operatives. The insufficient number of personnel forces the FSA to rely heavily on the figures provided by the banks — figures that already had to be corrected upwards by the supervisory agency several times.

In reaction to a slide of stock prices with the Nikkei 225 Index to a 16-year low and pessimistic economic forecasts by the central bank and even the government, FSA chief Hakuo Yanagisawa admitted in August that the disposal plan is no longer in accordance with reality. Yanagisawa estimates that the amount of non-performing loans in the banks' balance sheets will not decrease significantly until FY 2002. Non-performing loans would decrease to "normal levels" (that means they would be halved to only 7 to 10 billion yen or 2% to 3% of total loans at the 15 major banks) not earlier than in 2004 to 2007 (FSA, 2001/28, 6).

The critical point in this statement is not only the confession that the target of Koizumi's plan is not achievable. It is rather alarming that Yanagisawa, originally known as a proponent of strict enforcement of structural reform, joined in the chorus of powerful LDP lawmakers who call for a further delay of the bad loan disposal. The main argument of LDP politicians is that an accelerated bad debt-disposal would cause an increasing number of bankruptcies of small- and medium-sized companies that are debt-burdened but whose core business is healthy. This argument produced nothing more than the impression of an excuse and new protective measures, because such companies are to be treated with voluntary debt workouts.

Another indication that the actual plan cannot tackle the bad debt burden of banks is the request by the government to major banks for business plans that ensure that banks report profits and pay dividends for the current fiscal year. If banks that have received public funds could not pay dividends, the government might convert its preferred shares into common shares with voting rights, which would mean a de-facto nationalisation of some of the banks. But without being able to report losses, a proper disposal of bad loans is not possible. Until September 2001, the FSA did not make clear whether and how the government would carry out voting rights. When the scheme was implemented the government did not envision a situation in which banks would be unable pay dividends.

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The establishment of the "Bank Equity Purchasing Corporation" is also controversial. The scheme would not only support banks but also represent a dramatic intervention by the government into the stock market. The International Monetary Fund (IMF) criticises in an unusually open way: "The scheme has the potential to weaken much-needed market discipline on both banks and corporations" (IMF, 2001, 115). With a reduction of stock holdings to only 100% of capital, banks are not much less dependent on stock market volatility than before implementation of the scheme. The plan does not rule out that another scheme for stock or JGB repurchases may be needed in the future. The IMF criticises further that the scheme would be vulnerable to adverse selection by giving banks too much discretion in choosing the stocks they sell to the body.

The government announced in its first draft that it would enact specific rules in this respect. But such bold announcements were often followed by unclear regulations of financial authorities. These were also apparent in the aforementioned unspecific announcement that the FSA would clarify its policy stance in the near future on the implementation standards for administrative measures. Further, the government indicated an easing of the new fair value accounting rules, when a recovery in certain share prices is deemed possible. The ambiguous approach by Japanese financial authorities to the bad loan problem makes it difficult to expect a rapid disposal of bad loans. As long as authorities ease regulations when problems arise instead of implementing sanctions, banks have no incentive to get rid of bad loans and restructure.

4. Restructuring the Banking Sector

Restructuring of Japan's banking industry began slowly during the financial crisis of 1997, when several banks collapsed under the weight of their bad debts and the government for the first time began to let such banks fail instead of forcing other institutions to absorb weaker banks through mergers.

Until August 2001, the seven failed banks dealt with in the framework set up by financial revitalisation legislation passed in 1998 have been re-privatised. The Long-Term Credit Bank (LTCB) was bought by the U.S. private equity group Ripplewood in 2000 and renamed Shinsei Bank. In the same year, Nippon Credit Bank (NCB) started operations as Aozora Bank under the control of a consortium led by Softbank Corp. Five failed regional banks were transferred to new owners.

Banks that did not fail where forced to join forces in order to meet capital-adequacy requirements. The reorganisation of Japan's banking industry advanced in 1999, when three of the largest banks, Industrial Bank of Japan (IBJ), Dai-Ichi Kangyo Bank (DKB) and Fuji Bank, announced that they would form a joint bank holding company in October 2000. With the IBJ incorporated into Mizuho Group and with the failed LTCB and NCB now operating mainly as retail banks, the category of long-term credit banks as one part of the once strictly segmented banking system has virtually disappeared.

Beside the Mizuho Group, three main banking groups emerged:

— UFJ Holdings Inc. was formed by Sanwa Bank, Tokai Bank and Toyo Trust & Banking Co. in April 2001. According to a new restructuring plan submitted in 2001, a full merger of Sanwa and Tokai Bank is now scheduled for January 2002.
— The Bank of Tokyo-Mitsubishi announced the creation of another holding company with Mitsubishi Trust & Banking Co. and Nippon Trust Bank.
— Umitomo Bank and Sakura Bank, main banks of two traditional corporate conglomerates *(zaibatsu)*, agreed to merge by April 2002 into the Sumitomo Mitsui Banking Corp.

Since the formation of these four so-called "mega-banks", Japanese banks have been restructuring on a historic scale. UFJ Group announced a reduction of 8,100 staff and 108 branches until 2006. Mizuho plans to cut the number of its employees by 7,400 and to close 153 branches by 2005. Sumitomo Mitsui plans to close 170 to 180 branches and to reduce its workforce by 4,900 until 2003 and to sell the headquarters building of former Sakura Bank in the centre of Tokyo.

In terms of the speed of integration, UFJ Holding outperforms the other groups with its plan to push the merger between Sanwa and Tokai Bank three months ahead of the date originally expected. In April 2002, Mizuho Holdings Inc. will reorganise itself into a retail bank, Mizuho Bank, and a wholesale bank, Mizuho Corporate Bank. This move is oriented toward international developments, but is unprecedented in Japan. Deregulation led also to a greater co-operation of major banks with trust banks and insurance companies. This allows financial institutions to explore more income sources and to make use of economies of scale.

This progress, however, cannot conceal that all major banking groups failed to disclose convincing business plans to investors. The sheer size of the banks provides them with stability, but profitability remains low. In most cases full integration of computer systems is not to be achieved before 2003. But IT integration is a prerequisite for restructuring of branches. Moreover, full integration of staff of the formerly competing banks remains a difficult task in a society where employees build strong ties to their "home" company. This holds true especially in a conservative business such as banking, and with highly group-oriented graduates of Japan's elite universities. The four major banking groups will likely be forced to take more drastic actions, including full aligning of products of the merged banks, selling affiliates and forming tie-ups with foreign companies on advanced financial products.

Restructuring among regional banks picked up since the first bankruptcies spread a sense of danger through the industry in 1997. However, since restructuring came to a halt in 2000, the number of first and second tier regional banks remains at 120. In the midst of the restructuring process in 1999, observers and regulators expected this number to reduce to 80 to 90 banks by 2001 through incorporation in city banks, mergers among regional banks and bankruptcies.

The deepest restructuring took place in the Osaka region, the region with the strongest competition in Japan. Daiwa Bank began its move to form a new "super-regional bank" in April 2000, when it orchestrated a merger of the Bank of Osaka and Bank of Kinki, in which Daiwa Bank held the major stakes. By April 2002, Daiwa Bank plans to set up a holding company with the newly created Bank of Kinki-Osaka and Nara Bank, another regional bank. With the new structure, the new bank competes directly with Sumitomo Mitsui Bank, which also operates in that region.

Other regional banks survived with strong support from local authorities. After a first round of inspections in 1999, the FSA ordered regional banks to boost profitability and to increase their capital base. The banks managed to increase core profitability mostly by expenditure reductions and an improvement in the net interest spread. Among the first tier regional banks, the number of banks with a capital ratio below 8%, the standard set by the BIS, declined over two years from 19 to 4 by March 2001. However, the remaining 15 banks cleared the 8% only slightly. Second tier banks still struggle to clear the 8%, and some of these relatively small institutions might take the merger road when the authorities begin to act on the bad loan burdens of regional banks as well. The same holds true for the group of much smaller credit co-operatives. Their number declined only from 373 to 291, but more failures and closures are expected when results of FSA inspections in 2001 are published. Weak regional financial institutions adversely affect mainly local small and medium-sized companies. This is currently compensated by public institutions, but with a reform of these organisations, local companies will rely more on private banks.

One of the most obvious successes of the "Big Bang" is the opening of the financial sector for domestic non-financial competitors and foreign banks. Such new entrants shake up the conventional banking sector with innovative products and advanced technology. Foreign banks have been doing business in Japan for decades, but on a small scale. At least since the financial system reform of 1992, foreign banks had equal rights, as their domestic counterparts by law. But banking regulation restrained economically significant competition through products and prices. Only the Big Bang reform changed the environment in favour of foreign banks in two aspects: first, it allowed competition. This made it possible for the first time to make full use of comparative advantages such as financial strength, efficient structures and technologies, strong risk management systems and global networks. Second, deregulation of corporate finance and restructuring of cross-shareholdings and *keiretsu* corporate conglomerates propped up the investment banking sector, the very sector where foreign banks are most competitive over their Japanese rivals. The relative weakness of Japanese banks contributes further to a favourable environment for foreign financial institutions.

According to a survey by U.S. research company Thomson Financial, Goldman Sachs Group and two other U.S. firms were the top three arrangers of mergers and acquisitions involving Japanese companies in 2000. In particular, international deals such as the purchase of Mitsubishi Motor stakes by DaimlerChrysler, were dominated by foreign institutions. Besides investment banking, foreign banks have their greatest advantages in multi-currency products and syndicated loans. Others find their niches in consumer lending, treasury operations, pension operations and private banking.

Foreign banks penetrate even traditional fields of Japanese institutions in corporate finance. Despite long being a main bank for the company, IBJ failed to win an order from Nissan Motor Co. to raise 1.1 billion dollars for a new plant in Mississippi. Instead, Nissan invited fund-raising plans from several banks and placed the order with a U.S. competitor. Osaka-based Kansai Sawakaya Bank, formerly known as Kofuku Bank and acquired by Asia Recovery Fund of the US, offers unsecured loans of up to five million yen for small businesses, a bold move by the standards of usual Japanese banks, which concentrate solely on collateral-centred lending. In June 2001, Shinsei Bank and Tokyo Star Bank entered retail banking, which had once been strictly protected. Tokyo Star Bank (former Tokyo Sowa) is owned by U.S. investment fund Lone Star. Shinsei Bank obviously learned from Citibank, the only foreign retail bank that penetrated the Japanese market before the "Big Bang". Its branches offer extended opening hours even on Saturday and free 24-hour ATM service.

However, foreign banks still find the regulatory environment tough in Japan. Although the strict compartmentalisation of the Japanese banking system has been significantly weakened through the Big Bang, banks are still forced to build so-called "fire walls" between different banking departments. Universal banks are still prohibited in Japan.

Another trigger is the reliability of the Financial Services Agency. A key test is the dispute with Shinsei Bank on the buy-back of bad loans. At the hand-over of the failed LTCB to Ripplewood, the agency guaranteed that it had cleaned up the balance sheet and would buy back all loans if they fell more than 20% in value within two years. The U.S. investors, armed with advanced classification standards and measures, however, found many loans misclassified. One and a half years after they bought LTCB, bad loans amount to about 20% of total loans, much higher than at other Japanese banks. This fact notwithstanding, the government is reluctant to buy back these loans because it fears criticism by the diet and voters. For the time being, the FSA doubts that these loans had really declined by 20% in value. The real value is now set to be determined by a third party or through the courts.

This issue is important for the whole industry as NCB was sold to the Softbank consortium under the same conditions, and because there is a large overlap between Shinsei's loans and those of other banks, especially the Mizuho Group members DKB and IBJ. To avoid new bad loans through bankruptcies of borrowers, these banks have generally favoured keeping loans rolling over. As Shinsei has no incentive to roll such loans over but to liquidate them within the guaranteed buy-back period, it becomes increasingly difficult for other banks to fund shared borrowers.

But foreign banks also recognise increasing competition with foreign and domestic institutions. In 2000, 83 foreign banks were registered in Japan, down from a peak of 93 in 1997. Although a part of this reduction is due to bank mergers, a shake-out among foreign financial institutions is inevitable.

Along with foreign new entrants, domestic non-financial companies are making inroads into the banking sector. Internet-based Sony Bank started its services in June, following retail giant Ito-Yokado Co., which launched its IY Bank in May. Both new banks are concentrating their efforts on retail banking. IY Bank accepts deposits and offers online-account settlement services using a network of ATM in its Seven-Eleven convenience stores. Sony Bank will supply deposit and loan services to consumers. Some other industrial companies, including Toyota and BMW of Germany, are also exploring the new business terrain of consumer financial services.

5. Conclusion

The three targets of the Financial Big Bang, free, fair and global, have been partly achieved. Despite economic recession and financial crisis, the banking sector has changed significantly from a closed, government-protected and government-directed industry to one that is more open and market-oriented.

As a result of new competition, consumers enjoy much improved banking services, for example extended opening hours, 24-hour ATM service, advanced products and lower fees. More importantly, banks have explored new business plans like setting up internet banks or the division of the Mizuho Group into a retail and a wholesale branch. Banks loosened ties to their industrial conglomerates in the respect that they put their own profitability ahead of restructuring member companies of the conglomerate. Foreign institutions obviously accelerated the process. The tough approach of Shinsei Bank to debt-ridden borrowers has helped to diminish the traditional “All-Japan principle”. The profits that foreign banks make in Japan suggest that one of the three aims of the “Big Bang”, that of establishing a free market, has been achieved to some extent. Accordingly, the Japanese financial market is becoming increasingly global in terms of foreign financial institutions operating there. Japanese banks, however, are still closing down offices abroad to cut costs. The first results of increased competition, however, are still burdened by public support of domestic banks and by the existence of public and semi-public financial institutions.

To strengthen competition further, the government should push privatisation of public and semi-public financial institutions. According to a BOJ survey, public lending accounted for 136 trillion yen, or 18% of total outstanding loans to companies and households, as of March 2001. State institutions including post offices control about half of all financial flows in Japan. Tax exemption, government protection and subsidies, and therefore relaxed lending conditions allow public institutions to increase their market share at the expense of private banks. The prime minister already announced that he would submit bills dissolving or privatising major public corporations by the next ordinary Diet session in January 2002. One of the main targets of the prime minister and the administrative reform promotion bureau, an advisory panel to the prime minister, is the Housing Loan Corporation (HLC). The HLC dominates Japan's mortgage market and has about 70 trillion yen in outstanding loans. Loans provided by the Housing Loan Corporation accounted for about 40% of all new loans to individual homebuyers in recent years, prompting criticism from private financial institutions that the corporation has been competing with them unfairly. With a privatisation of HLC, private banks could raise their mortgage lending and increase profitability.

It is unclear, however, whether Koizumi will be able to succeed with his plan against opposition from affected ministries and LDP politicians. Public corporations have long been a conduit for pork-barrel policies used by politicians to benefit their supporters and constituencies. Bureaucrats, too, have relied on public corporations for positions after they retire from government *(“amakudari”)*. Ministries reported they could dissolve only five of 160 public corporations. LDP lawmakers are set to establish a special commission on this topic, obviously an attempt to water down the process.

The third principle of the financial reform was fairness. Through concentration in the Financial Services Agency, financial supervision in Japan made visible progress in terms of supervision quality. But the fact that the Financial Services Agency, whose head is a state minister and cabinet member, is slow in recognising the whole dimension of the structural problems in the banking sector cannot confirm this observation. There is also considerable doubt whether the FSA has reached a fair standard of supervision, given the treatment of Shinsei Bank complaints on bad loans and several punishments against foreign banks in recent months. Even though a normative change of Japanese banking supervision could be observed, the determination of former MOF officials in the FSA to soften the effects of a free market on their banks still seems to be alive and well.

The far-reaching principles of the financial market reform are still overshadowed by huge structural problems that have yet to be solved. The unchanged high burden of bad loans, high exposure to market volatility and low profitability is disappointing. This demonstrates the reluctance of the government to admit the whole size of the problem, because it would otherwise have to solve the problem rapidly. This would hit the economy hard in the short run, would cause an explosion of the unemployment rate and — perhaps worst — would hurt many lobbyists and supporters of the ruling Liberal Democratic Party. No prime minister would survive such a development in the current political landscape of Japan.

To lower the systemic risk and avoid a new credit crunch, private-sector analysts and the IMF suspect that further injections of public money into the banking sector may be needed. The current legal framework allows the government to aid banks with public funds in the event of a financial crisis. The government is divided over this highly unpopular issue, but the FSA set up indicators of a financial crisis to determine whether public funds should be injected into private financial institutions. These indicators include the so-called Japan premium, the lending behaviour of banks and the amount of cash held by non-financial companies as defensive measures. This could hint at another move toward more transparency and credibility of the agency, and might be an initial preparation for another round of public injections. Even without public discussion, the government could support banks through the back door, when the Resolution and Collection Corporation (RCC) purchases bad debts at market prices or higher. Losses of redistribution of such loans would have to be covered by taxpayers.

To resolve the bad-debt problem, the Japanese government needs first to recognise the whole dimension of the problem, including all financial institutions, not only major banks. For the following stage, bad debt disposal, the legislative tools are mostly in place. If all banks had to dispose of all their bad loans rapidly, a new injection of public capital might be necessary to avoid a new credit crunch. But this should be accompanied by strict performance targets and sanctions if banks miss their targets. The government needs to provide incentives for banks and borrowers to make use of the tools for bad loan disposal and restructuring that are already available. This might also include closing down banks that cannot achieve a healthy capital base. The authorities seem to lack both a complete recognition of the total problem, and the readiness to close down a larger number of financial institutions. In such an environment, public funds will raise moral hazard problems at banks and corporations.

Despite the seriousness of the crisis, Japan still has the economic power to choose between time and money: to spend seven to ten years to resolve bad loans as estimated by FSA chief Yanagisawa or to resolve the bad-loan crisis by injecting public money into the banking sector and restructuring the industry as soon as possible.

However, solving the bad-loan problem is a prerequisite for economic recovery. Without bad loan disposal, bad debtors have few incentives to raise efficiency and slash excess capacity. Instead, just to survive they would have to offer lower prices and thereby force healthy competitors to follow suit. This would cause new bankruptcies, lower dispensable income and lower consumption. An economic recovery cannot take place without fast disposal of bad loans.

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Zusammenfassung

Regulierung des Finanzmarktes

Das Ziel der umfassenden Finanzmarktreform "Financial Big Bang" in Japan war die Bildung eines international wettbewerbsfähigen Finanzsektors unter den drei Prinzipien frei, fair und global bis 2001. Politiker standen dabei zwei Herausforderungen gegenüber: die Wettbewerbsfähigkeit langfristig zu stärken und kurzfristig strukturelle Probleme zu lösen. Fünf Jahre nach dem Start der Reform scheint das Land mehr Fortschritte in Bezug auf die langfristige Zielsetzung denn auf die kurzfristige gemacht zu haben.

Dieser Artikel zeigt, dass die Reform der Aufsichtsbehörden ein modernes Aufsichtsmodell entwarf, das mit europäischen Modellen durchaus vergleichbar ist, obwohl seine Entwicklung und Durchsetzung noch nicht vollendet sind. Der Artikel würdigt weiterhin, dass die Deregulierung mehr Wettbewerb und damit den Wandel zu einem auf den Prinzipien des freien Marktes basierenden Finanzsektor zuließ. Der Eintritt ausländischer und einheimischer Wettbewerber sorgte für die Einführung neuer Produkte und neuer Geschäftsmodelle. Strukturelle Probleme der Banken dagegen, insbesondere das Problem notleidender Kredite, blieben ungelöst und behindern die Vollendung des Reformprozesses und die wirtschaftliche Entwicklung des Landes. Die aktuellen Regierungsprogramme zur Abschreibung notleidender Kredite versprechen keine rasche Lösung der strukturellen Probleme.